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Financing the Small and Medium Scale Enterprises in Faisalabad (Pakistan)

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ABSTRACT

An SME entity is defined as a business with an investment in productive assets not including land, building, ranging between Rs. 2.40 million and employing between 10 - 99 workers. This research paper was undertaken to analyze the financing the SMEs and its trend and growth in Faisalabad region. Research was conducted by taking the sample of 5 banks, in which SME bank has the key role in financing the SMEs in Faisalabad region. Data were collected through personal visits of the main branches of financial institutions and sample banks within the Faisalabad region. The discussion and results shows a gradual increase in the financing trend of SMEs in Faisalabad region. It has registered a growth of 72% and has risen from Rs. 145 billion to Rs. 251 billion by June 2005. The research revealed the results that problems like lack of adequate security, miss-use of credit facilities are the hurdles for the rapid growth of the SMEs with in the Faisalabad region. Under the above discussion it is suggested that due to existence of great potential for SMEs in Faisalabad region, large scale industries should involve themselves for the growth of SMEs. The step taken by SBP for assigning targets for SMEs, financing will also contribute towards growth of SMEs financing in this region.

Key Words: SMEs; Finance; Faisalabad region; SME bank; Growth; Trend; Security; Credit; SBP; Short term financing

INTRODUCTION

In order to define financing, growth and trend of financing in this sector, a comprehensive definition is required. Different departments and organizations define SMEs in accordance with their functional ease rather than market situation. But here we included the definition stated by State Bank of Pakistan in SME prudential regulations. (2004-05)

An entity, ideally not being a public limited company that does not employ more than 250 persons (manufacturing) and 50 persons (trade/services) and also fulfils one of the following criteria:

i. A trade/service concern with total assets at cost excluding land and building up to Rs. 50 million.
ii. A manufacturing concern with total asset at cost excluding land and building up to Rs. 100 million.
iii. Any concern (trade/service/manufacturing) with net stales not exceeding Rs. 300 million as per latest financial statement.

For making strategies, their implementation and for providing assistance to SMEs the Government has restructured the key support institution such as Small and Medium Enterprise Development Authority (SMEDA) and SME Bank (Prudential's For SMEs 2004 - 05). The small and medium enterprises have played key role in providing impetus to the development of some of the world's best economies like Taiwan, Korea, Hong Kong and China. Countries in South America and India have also been concentrating their efforts in developing the SME sector. The SME sector is important in terms of contribution to the economy and this is likely to be a characteristic of SMEs across the world. According to the bank of England (1998), SMEs accounted for 45% of UK employment and 40% of sales turnover of all UK firms. This situation is similar across the EU (Bank of England, Report on SMEs, June 2004).

Economic importance of SMEs in Pakistan. Table II shows that SMEs contribute more than 90% of business in Pakistan, all of which function within the private sector and mostly operate in un-documented informal part of the economy. They represent a significant component of Pakistan's economy in terms of both value addition and employment generation. As they predominantly provide employment to lower income groups, they are also considered an important vehicle for poverty reduction. SMEs in particular, play a key role in manufacturing sector by providing 80% to total employment contributing over 30% to GDP and generating one-fourth of the sectors export earnings.

Financing the SMEs in Pakistan. Like other developing countries across the world, SME sector, in Pakistan also does not have adequate access to financing from formal sector. SMEs have been relying primarily on the credit facilities from the informal sector. Cost of finance from informal sector is higher than the cost of finance from formal sector like banks.

In Pakistan corporate sector is the major recipient of financial system credit with 54% share followed by SME sector 19% However, there has been a rapid growth in SME

Table I. Share of subsectors of SME's

Sub-sectors	Percentage share
Cotton weaving	13%
Other textiles	6%
Metal products	7%
Carpets	4%
Art silk	5%
Grain milling	16%
Jewelry	4%
Wood and furniture	10%
Other	35%

(Economic survey of Pakistan, 2003-04)

Table II. SME's contribution to business sector

Years	Employment	GDP	Value Added	Export Earning
2000-01	32%	12%	9%	8%
2001-02	48%	16%	15%	13%
2002-03	67%	19%	18%	15%
2003-04	73%	24%	23%	19%
2004-05	80%	30%	30%	25%

(Economic survey of Pakistan, 2003-2004)

financing now. In fact, it has registered a growth of 72% and has risen from Rs. 145 billion to Rs. 251 billion by June 2004 (Ali & Farrukh, 2005).

Approximately SMEs activity in Faisalabad Region is concentrated in five sub-sectors, grain milling, cotton weaving, wood and furniture, metal products and art silk.

METHODOLOGY

SMEs are the major contributor to the economic development of Pakistan. Due to un-documented economy and lack of information, data are not easily available to check the trends in SME financing. Now-a-days SME financing is a major issue. Data have been collected from primary as well as secondary sources. Survey approach has been selected for research and questionnaire has been used as research instrument. Secondary sources include journals, periodical, internet search, prudential regulation issued by SBP and other supporting material from books related to financial issues.

Sample selection. Stratified random sampling was used as the sample selection technique. This sampling plan has been the primary source of gathering information. Sample consists of 5 bans from Faisalabad region. Sample consist of 2 commercial banks in public sector NBP and Habib Bank AG Zurich, 2 commercial banks, in private sector Union Bank, Alfalah and the last one is SME bank, which has been established purely for SME financing.

Collected data has been presented in the form of tables and graphs, making it easier to understand the pattern and trend of financing.

SME Bank Ltd. Table III. Shows that SME bank has been established as a result of merger of small business finance corporation (SBFL) and regional development finance corporation (RDFC).

SME bank has been established in 2001 in Faisalabad region. It is mainly concerned with the financing the small and medium enterprises within the Faisalabad region. The sole purpose of SME bank is the growth of SMEs in this region. SME Bank Ltd. is providing financing facilities in shape of long term as well as in short-term.

Normally SME bank grants loans within the range of 1 - 5 million. The maximum limit of credit is 30 million. The collected is required for security if credit limit exceed Rs. 1 million.

The SME bank changes mark up of KIBOR + 6% that is quite high as compared with other sample banks. But still default rate is very low and non-performing loans (NPLs) are 5% of total portfolio.

It also provides project financing facility to its customers. Bank share in the project this 60% with the condition that borrower must have 40% share in form of equity.

The reason for low percentage of NPLs is that the complete investigation is made before the provision of credit that usually take one month's period.

In order to design strategies for this sector, a comprehensive definition is required. But un-fortunately, there is no uniform definition of SMEs application across the board in Pakistan. Different departments and originations define SMEs in accordance with their functional ease rather than market situation. But here, we will include the definition stated by State Bank of Pakistan in SME Prudential Regulations:

Bank Al-falah. Table IV shows that Bank Al-falah has started financing the SMEs for just an year or so. It has initiated a program especially meant for SMEs in the name of ALFALAH KAROBAR. Running finance in provided under this scheme and limit is form 0.5 to 10 million. Usually residential property and leased asset are taken as security from the borrower.

Union Bank. Table V shows that Special scheme of Union Bank for SMEs "TANABANA". They are granting credit at a mark up of Kibor + 2.5%. Recovery rates are normal. Limit of financing varies according to the nature of SMEs.

National Bank of Pakistan. Table VI shows that SBPs special prudential regulations have induced all commercial banks to finance SMEs. NBP has also designed especial scheme in the name of NBP Karsaaz. Interest rates charged in Kibor + 2%. Recovery rates are a bit lower. NBP is not financing in short term period.

Habib Bank AG Zurich. Table VII shows that Habib Bank AG Zurich has also devised certain financing schemes for SMEs. Yet there has not been any program lending by Habib Bank AG Zurich. Habib Bank AG Zurich is also charging markup of Kibor + 2%.

Table III. Financing mix of SME's bank to SME's sector in Faisalabad–Pakistan

Financing	July 1st to Dec. 31st 2004	Jan. 1st to June 30th 2005	Jul. 1st to Dec. 2005
Short term financing	27.9 Million	29.9 Million	33.12 Million
Long term financing	32.4 Million	35.1 Million	38.8 Million

Table IV. Financing mix of bank Al-Falah to SME's sector in Faisalabad–Pakistan

Financing	June 1 to Dec. 31st 2004	Jan. 1st to June 30th 2005	Jul. 1st to Dec. 2005
Short term financing	1.36 Billion	1.4 Billion	1.6 Billion
Long term financing	375 Million	400 Million	375 Million

Table V. Financing mix of Union bank to SME's sector in Faisalabad–Pakistan

Financing	June 1 to Dec. 31st 2004	Jan. 1st to June 30th 2005	Jul. 1st to Dec. 2005
Short term financing	266 Million	299 Million	315 Million
Long term financing	175 Million	155 Million	182 Million

Table VI. Financing mix of National bank to SME's sector in Faisalabad–Pakistan

Financing	June 1 to Dec. 31st 2004	Jan. 1st to June 30th 2005	Jul. 1st to Dec. 2005
Short term financing	Nil	Nil	Nil
Long term financing	398.8 Million	472.7 Million	559 Million

Table VII. Financing mix of Habib bank A.G. Zurich to SME's sector in Faisalabad–Pakistan

Financing	June 1 to Dec. 31st 2004	Jan. 1st to June 30th 2005	Jul. 1st to Dec. 2005
Short term financing	7.8 Million	8.6 Million	10 Million
Long term financing	3.7 Million	5 Million	6.75 Million

DISCUSSION

SMEs constitute a major portion of our economy. Its importance can be judged from its contribution toward the GDP (30%), employment (80%) expert earnings (25%).

Being neglected sector, a period ago, it was facing many problems and its financing issues were the most acute. But the trend has been changed now. Our research results show that the financing in SMEs is increasing day by day. It is mainly due to rising trend in our economy. Banks are like a key that start the engine of the economy. They are performing their duties well by providing different types of loans to SMEs.

But it is not enough. The full potential of this sector is yet to be explored. For this purpose, we have to discuss, why SMEs not go for debt financing what are the problems they facing during the access to finance, what are the financial institutional limitation in granting loans to SMEs.

Our interaction with the bank has transpired that one basic reason for reduced access to finance by SME borrower has been inadequate regulations. Banks are enforced to evaluate the financing request from prospective borrowers under the existing regulations, which are basically driven by their requirements for landing to corporate sector (Business recorder; SME financing, 2004).

From the borrowers' point of view there are many problems in accessing finance from financial institution. First of all there is information barrier. We have un-documented economy, while banks require complete documentation. Un-documented economy is the result of poor literacy rate. Fruits of proper documentation are un-known that documentation will lead to pay heavy taxes. They have not the complete record of their business that hinders access to finance from banks.

SMEs are also reluctant to get finance from banks due to their inefficient repayment capacity.

Managerial expertises are deficient in the properties of SMEs. They have not any knowledge about how to manage there finances that result in under utilization of business resources (Salman & Ehsan-ul-Haq, 2003).

Mostly, SMEs neither have valuable assets that can be refined as collateral against any credit facility nor have any strong personal references or guarantee. This is a major problem in accessing finance.

Process of credit provision is also cumbersome and most SMEs avoid indulging in it.

Results of our research have showed that because of increasing trend in financing in SMEs sector, surely, SMEs will grow in future. Since, there will be adequate capital with SMEs they will hire the service of expert management. Because of keen interest now taken by regulators, this sector is certainly going to improve and increase its contribution in the economic development of the region.

RECOMMENDATIONS

In the light of above discussion it is suggested that

government should implement the prudential regulations that have already been drafted. If we want to compete with in international challenges, which we are facing in the international market due to the WTO regime we should enhance our productivity in SME sector. GOP should arrange seminars, work shops and training programs in different cities of Pakistan, to create awareness. SME sector should seek benefit from Japan, Malaysia, Singapore and China o improve its management through adopting ICT web based system (Jarvis, R., 2000).

GOP should enhance the Ancillarization concept in the economy. Ancillarization has been instrumental in a big way toward accelerating the industrialization of many Asian countries.

Ancillarization symbolizes a new form of production organization on the lines of Japanese system of outsourcing from long term small scale association.

ICT system will provide solution for SMEs problems, both specific as well as general thus enabling the SMEs to move to a higher level of performance and help them to face the challenges emerging from globalization.

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