

Empowering SMEs through Finance and Technology



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Small and Medium Enterprises (SMEs) are recognized as the backbone of an economy and the heartbeat of communities. As noted by 'Small and Medium Enterprises (SMEs) Finance – World Bank':

"In developing countries, SMEs are central to economic diversification, productivity, and poverty reduction. Yet, they face persistent challenges in obtaining the financing needed to start, sustain and grow."

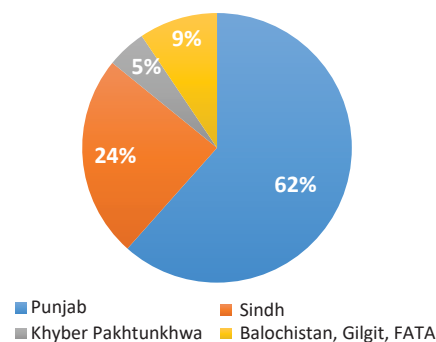
Small and medium enterprises' growth is critical to Pakistan's economic development along with broadening trade. However, barriers such as high credit costs, insufficient collateral, and low digital adoption have restricted their contribution to GDP. The State Bank of Pakistan (SBP), as the authoritative financial institution, has implemented a comprehensive framework which incorporates finance through targeted refinancing, risk coverage, and subsidized lending along with technology and digital supply chain finance (DSCF), e-guarantees, and fintech. The State Bank of Pakistan's initiatives within the prudential regulatory framework highlight their expected impact on SME growth, which is backed by empirical data and policy references.

The SME sector is the cornerstone of Pakistan's economy, constituting around 40% of GDP, employing nearly 80% of the non-agricultural labor force, and contributing around 25% of manufactured exports (*Small and Medium Enterprises Development Authority- SMEDA, 2023*).

"With over 5.2 million SMEs in Pakistan, the sector represents approximately 90% of businesses, contributing 40% to the country's GDP and 30% to the

total exports. The sector also employs an estimated 80% of the non-agricultural labor force in Pakistan. Despite their significance, SMEs only receive 6-7% of private sector financing (*Enhancing the Economic Efficiency of Small and Medium Enterprises in Pakistan- Competition Commission of Pakistan, 2023*).

SME Provincial Contribution



1) SME Provincial Contribution

Punjab and Sindh are densely populated provinces. Punjab, due to a more concentrated population, is the undisputed leader in Pakistan's SME sector, followed by Sindh, largely due to the presence of the capital city, Karachi. As per the State Bank of Pakistan in 2024, despite this significant contribution, SME access to formal finance has historically remained below 6% of private sector credit. SBP acknowledged this gap and has prioritized SME financing as a core pillar of inclusive economic growth.

SBP adopted a strategic approach that combines prudential regulation, subsidized financing schemes, digitalization, and risk mitigation mechanisms to enhance SME credit penetration.

2) Targeted Financing and Risk Mitigation Schemes

a) Recapitalization and Concessional Facilities- SBP operates recapitalization facilities designed to make capital more accessible and affordable.

- **SME Asaan Finance:** A collateral-free lending program launched by SBP to provide refinancing to banks at concessional rates and share partial credit risk, enabling financing up to Rs. 10 million for small enterprises. This scheme was active for 3 years (SBP, 2021).
- **Refinance Facility for Redevelopment of SMEs:** Supports technological upgradation and modernization by offering low-cost term financing for machinery (SBP, 2021). The chief target is to elevate the SME sector through investment in technology, methods of production, and reducing borrowing costs. These schemes directly address key barriers such as high collateral requirements and high markup rates.

b) Risk Coverage Scheme (2024–2029)- Considering the SMEs pivotal role in economic growth and employment creation, SBP launched a Risk Coverage Scheme for SMEs in August 2024, effective till June 2029, which provides first-loss coverage to banks. As per SH&SFD Circular No. 02 of 2024:

- Government will absorb credit loss (principal portion) on banks' fresh exposure against SMEs
- 20% first-loss coverage against banks' fresh exposure to SEs
- 10% first-loss coverage against banks' fresh exposure to MEs

The scheme covers loans for up to five years with a cap of Rs. 25 million for small enterprises and Rs. 200 million for medium enterprises. The scheme covers all types of loans, including working capital, running finance, and long-term loans. "According to a State Bank of Pakistan (SBP) notification on Thursday, the risk coverage scheme aims to double the outstanding financing to SMEs to Rs. 1.10 trillion over the next five years, starting July 1, 2024, compared to the current financing to this critical sector of the economy (*The Express Tribune*, 2024).

c) Credit Guarantees and Training- Earlier frameworks, such as the Credit Guarantee Scheme for Small and Rural Enterprises, offered 60% coverage for collateral-deficient borrowers (SBP, 2017).

SBP also requires banks to build dedicated SME divisions, train competent credit officers in SME appraisal, and incorporate digital scorecards and simplified due diligence mechanisms. These measures streamlined SME financing practices and aligned them with prudential governance standards.

3 Regulatory Framework and Supervisory Reforms

The State Bank of Pakistan's Prudential Regulations for SME Financing 2024 provide the regulatory foundation for SME banking. The prudential regulations simplify credit approval processes, set exposure limits, and establish clear classification and provisioning standards. They emphasize:

- Use of digital loan origination and documentation
- Application of automated credit scoring models
- Expedited decision timelines not exceeding 25 working days from the date of complete application submission

These reforms reduce transaction costs for both banks and borrowers and enhance consistency in risk management practices.

4) Technology as a Catalyst: Digital Supply Chain Finance and e-Guarantees

a) Digital Supply Chain Finance (DSCF)- Digital integration can serve as a facilitator for SME growth by accelerating access to finance within the supply chain mechanism. In this regard, a landmark policy step was taken through SBP's Circular SH&SFD No. 01 of 2024, directing all banks to:

- Establish a dedicated Supply Chain Finance (SCF) function
- Launch a digital SCF solution within six months, either in-house or via fintech collaboration
- Submit a capacity-building plan within three months (SBP, 2024)

This initiative places SMEs within customer-centric value chains, allowing them to obtain working capital against confirmed receivables or payables. As per the Global Trade Review (2024), this regulation could unlock a USD 9 billion SCF market potential in Pakistan.

b) Digital Guarantees and e-Issuance- SBP encourages digital submission of risk coverage and guarantee claims, e-KYC onboarding, and electronic documentation of SME loans. Such automation helps reduce response time, minimize manual errors, and enhance audit transparency.

- c) **Challenge Fund for Digital Innovation-** In July 2024, SBP introduced the Challenge Fund for SMEs, inviting banks and fintechs to pilot innovative digital lending solutions using alternative credit data. The aim is to target beneficiaries, focus on origination of digital loans and processing systems, develop new digital financial products like digital scorecards, enable digital onboarding of SMEs for account opening, and upgrade or develop digital banking platforms.

5) Evidence and Market Outcomes

The SBP's data indicates:

- **Outstanding SME financing:** Rs. 490.96 billion
- **SME share in private sector credit:** 5.5% (previously 5.2%)
- **Total SME borrowers:** approximately 176,246 (up from 154,229)
- **Portfolio composition:** Working capital Rs. 265 billion, fixed investment Rs. 198 billion, and trade finance Rs. 26 billion
- **Sectoral distribution:** Trading 43%, manufacturing 30%, services 27%
- **Non-performing loans:** 16.58% (down from 17.12% a year earlier)

Despite macroeconomic challenges, these figures suggest a gradual expansion in SME credit outreach and improved portfolio quality. The new risk-sharing mechanism is expected to further enhance these trends.

6) Challenges and Path Forward

The policy is sound, but major implementation gaps remain:

- High opportunity costs for banks, as risk-free government securities often yield higher returns at elevated rates
- Banks must integrate DSCF platforms, which involve significant technological investment and require allocation of digital inclusion costs
- Many SMEs lack the capacity or knowledge of e-KYC and digital invoicing systems, impeding onboarding
- Pakistan's credit bureau data remains limited, making risk assessment difficult for small or informal enterprises
- Efficient processing of first-loss guarantee claims is essential to maintain bank confidence

7) Conclusion

Pakistan's SME sector is an integral part of the economy and is already in an evolutionary phase. For sustainable future growth, SBP is incorporating the approach of refinance and risk-sharing mechanisms with digitalization and prudential supervision to expand SME financing. Though early data reflects positive momentum, long-term success will depend on continuous capacity building, increasing digital literacy, and collaborative innovation between banks and fintechs. If effectively implemented, these initiatives can significantly enhance productivity and employment and also boost the export potential of SMEs, allowing them to better compete in regional and global markets, ensuring inclusive economic growth across Pakistan.

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