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**MARKETING: THE CRUCIAL SUCCESS FACTOR
FOR PAKISTAN'S CREDIT GUARANTEE SCHEME**

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Abstract

Despite their significant contribution to GDP and employment, SMEs face constraints in accessing finance in Pakistan. To motivate banks to lend to SMEs, the State Bank of Pakistan introduced a “Credit Guarantee Scheme for Small and Rural Enterprises” in 2010. However, the response to the scheme was initially somewhat muted, which may arguably have been due to factors like the design of the offer, its governance structure, or the reluctance of financial institutions to engage with SMEs in general and the credit guarantee scheme in particular—or a combination thereof. Nevertheless, in this paper, we confine our focus to a discussion of how inadequate marketing diluted the scheme’s impact. Specifically, several commercial banks could not tailor elements of their marketing mix—including people, products, processes, and promotions—to take full advantage of the scheme. That said, periodic revisions of the scheme helped to address some of its shortcomings, while the expectation is that other indicators will improve due to the recent changes in the scheme’s parameters. The key finding is that policy makers can maximize the impact of a credit guarantee scheme by paying attention to the marketing mix, which sets up participating financial institutions for success (or failure) during the implementation phase. In addition, the scheme’s structure should be a long-term intervention and its intended duration should be clear at the outset so that the participating financial institutions are motivated to design and roll out specialized products that tap the full potential of credit guarantees. Furthermore, the scheme’s originators should be prepared to develop the entire ecosystem, which may include some initial hand holding of SMEs.

Keywords: Asian economies, SMEs, financing, credit guarantee

JEL Classification: G21, G30, G32

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1. INTRODUCTION TO SMES AND SME FINANCING IN PAKISTAN

People frequently refer to small and medium enterprises (SMEs) as the backbone of an economy. This analogy reflects how integral SMEs are in terms of generating employment and contributing to the GDP. However, their importance does not automatically make them priority recipients of financing from financial institutions. Rather, SMEs' lack of access to finance is a widespread phenomenon, common to developed and developing countries (ADB 2015; OECD 2017).

SMEs represent approximately 90% of the enterprises in Pakistan and provide employment for nearly 80% of the non-agricultural labor force, according to the country's Small and Medium Enterprise Development Authority's (SMEDA) estimate. In addition, they contribute 30% to the GDP; 25% to the exports of manufactured goods; and 35% to the manufacturing value added (SBP 2017a). Despite these sizable contributions, their share of the total private sector financing of banks and DFIs fell from 17% in December 2006 to around 8.7% at the end of December 2017, according to data from the SBP.¹

SME credit took off after 2002 owing to some key support factors. First, the banking system had considerable liquidity. Banks' deposit mobilization grew 14% year on year in the fiscal year 2001–2002 (FY02) alone (i.e. between July 2001 and June 2002); this was the strongest growth in deposits since FY97. The major impetus came from an improvement in the country's external account after September 2001. Against the backdrop of a considerable current account surplus, the central bank made foreign currency market purchases of US\$3.9 billion during FY02; for the domestic economy, this meant that there was a large corresponding injection of fresh rupee liquidity. At the same time, given the relatively subdued demand for bank funding from the government during this period, banks were in search of other profitable avenues. SMEs fit the bill, especially since the macroeconomic environment was favorable and businesses were performing well at this stage.

However, from 2008 onwards, the economy experienced a downturn. While the financial crisis raging across the globe added to the uncertainty, in Pakistan, it was the worsening energy shortages and rising security issues that affected businesses. SMEs were perhaps the hardest hit; as non-performing loans (NPLs) began to climb (Figure 1) and banks began to demand higher interest rates, further compounding the cash flow constraints that SMEs faced.

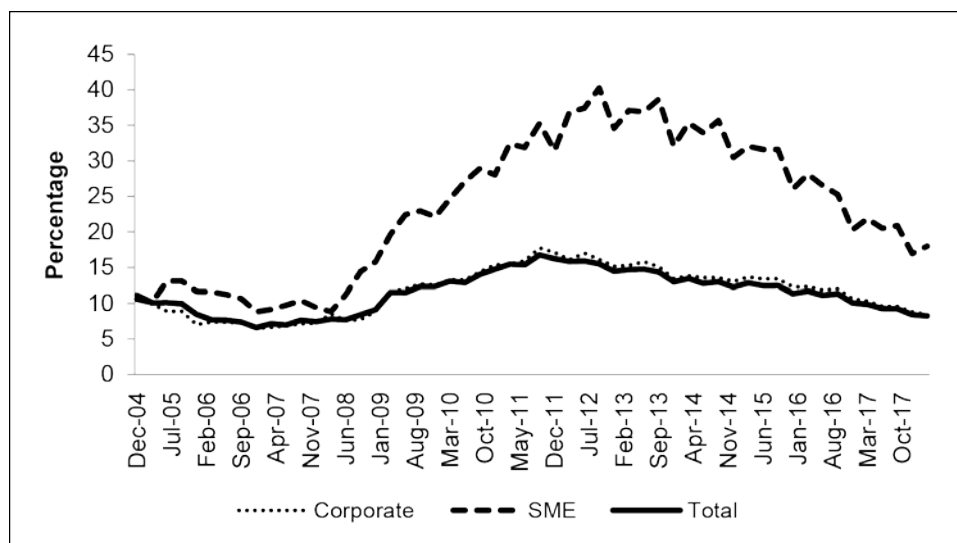
Banks that booked losses on their SME portfolios during this episode largely avoided SME financing for the next five years. Only after 2013, with macroeconomic indicators showing signs of recovery and the central bank (SBP) providing encouragement, did banks cautiously begin to approach SMEs again. To this day, many bankers regard the relatively high SME NPL ratio with trepidation.² However, a recent study suggests that there is a legacy impact of toxic assets, claiming that the fresh NPL ratio is merely 8%, rather than the near 20% SME NPL ratio that studies reported until recently (Aslam and Sattar 2017). Essentially, the overall SME NPLs seem to be inflated because

¹ Source: *SBP Quarterly SME Finance Review*, December 2017. <http://www.sbp.org.pk/departments/ihfd-qdr-FReview.htm>

² The SME NPL ratio was as high as 22.1% in March 2017, though it had subsided to 18.3% by March 2018. Source: SBP's SME Financing Data Tables—March 2018. <http://www.sbp.org.pk/sme/PDF/DFG/2018/QSMEF-Mar-2018.pdf>

of a large infection ratio of only a few institutions and the tendency not to write off legacy defaulted loans.

Figure 1: Segment-wise Infection Ratio
(NPLs as % of advances)



SME = small and medium-sized enterprise.

Source: State Bank of Pakistan.

Besides NPLs, the risk-based capital requirements that the State Bank of Pakistan (SBP) imposed in line with the Basel Accords, together with the delayed enactment of non-judicial foreclosures in the country, may have contributed to a narrower lending focus of commercial banks away from segments that they perceived to be riskier—like SMEs—and in favor of large corporations (Khalid and Nadeem 2017). Finally, the factors that people typically associate with limited access to finance for SMEs—such as insufficient collateral, weak credit information and reporting systems, inadequate recovery mechanisms, and so on—were also applicable in Pakistan’s case (since these aspects have already been discussed at length in earlier chapters, we do not reproduce them here to avoid duplication).

Recently, there have been some signs that a recovery in SME financing may be underway. For instance, a bank lending survey that the SBP conducted during Q1-FY18 suggested that the demand for loans and availability of funds was higher than in Q1-FY17 (SBP 2017c). However, a word of caution is necessary: whether bank financing of SMEs has firmly taken root will become apparent as interest rates trend upward and the yields on government securities—particularly long-term paper—rise enough to entice banks once again. Lately, when the policy rate maintained a historic low of 5.75%³ and the yields on government securities were contained, banks were themselves exploring alternative avenues to divert their liquidity, and the SBP’s incentives to encourage SME financing emerged at an opportune time. It remains to be seen just how gradually (or drastically) banks will rebalance their lending and investment portfolios if the lure of high-yielding government securities returns.

³ The Monetary Policy Committee (MPC) cut the policy rate by 25 basis points in May 2016 to a historic low of 5.75%. Monetary policy decisions subsequently maintained the rate until November 2017. This chapter was submitted prior to the January 2018 MPC meeting.

2. STATUS OF THE CREDIT GUARANTEE SCHEME (CGS) IN PAKISTAN

The SBP launched the CGS for Small and Rural Enterprises (hereafter referred to simply as the “CGS”) in March 2010 with the assistance of government and donor agencies.⁴ In keeping with the typical aim of such schemes, the goal was to help to alleviate the severe credit rationing for small and rural enterprises. The intention of the CGS was not to be a permanent source of support; rather, it aimed to act as a sort of stopgap measure that banks could utilize to realign their strategic direction in favor of meeting SMEs’ financing needs on a sustainable basis.

The salient features of the CGS at the time of its launch were⁵:

Capital structure: The Financial Inclusion Programme, funded by the UK’s Department for International Development (DFID), allocated initial seed money of around Rs1.4 billion approximately US\$6 million). There was anticipation that the scheme would attract additional funding from the Government of Pakistan, international donor agencies, and the private sector over time.⁶

Areas of financing and target clients: Regarding its geographical focus, the CGS reserved 50% of its fund for small and rural enterprises from three less developed regions of Pakistan. It intended to allocate the remaining 50% amongst selected clusters in other parts of the country. The scheme targeted the following major priority clusters: surgical instruments, sports goods, fans, ceramics, cutlery, fisheries, agricultural services (like cold storage, quality seeds and fertilizer, bio gas, etc.), and retail enterprises. New and collateral-deficient borrowers were the priority.

Risk sharing: The scheme originally guaranteed up to 60% of the participating financial institutions’ (PFIs’) fresh portfolio of financing to small and rural enterprises, whereas the PFIs themselves bore the remaining 40% of the risk.

Guarantees: The scheme aimed to guarantee the portfolio of new loans of a PFI that met its specific CGS criteria (partial guarantee, extended on individual basis) to the extent of its allocated credit guarantee limit (CGL).

Guarantee fee: The CGS provided a free facility for PFIs.

Pricing: Broadly, the applicable mark-up rate would be a maximum of the 3-month Karachi Interbank Offered Rate (KIBOR) plus 300 bps.

Selection of PFIs: Commercial banks received an invitation to show their willingness to participate in the scheme. Then, to allocate CGLs to each PFI, the SBP evaluated and rated the willing banks on pre-established criteria: factors like the PFI’s branch network in SME clusters/agriculture target areas, share of SME and agriculture finance in total advances, SME and agriculture NPLs, and small business and agriculture finance experience.

⁴ In this chapter, we have restricted our focus to the SBP’s CGS for Small and Rural Enterprises. A separate Microfinance Credit Guarantee Facility was also launched in 2010; however, it had a different set of objectives, participants, and dynamics, suited to a separate study. The CGS that we chose to analyze is more relevant to SMEs. Until the end of 2017, it mostly targeted the “S” portion, that is, small enterprises (SEs); however, in the future, the scheme will also cater to medium enterprises (MEs), according to the new Policy for Promotion for SME Finance (SBP 2017b).

⁵ Extracted/paraphrased from SMEFD Circular No. 01 of 2010, dated 19 March 2010, as cited in the Appendix.

⁶ As of December 2017, the DFID’s contribution amounted to Rs3.3 billion (approximately US\$30.2 million), while the federal government’s contribution was Rs300.0 million (around US\$2.8 million).

Eligibility of borrowers: The selection criteria required eligible borrowers, among other things, to have regular and estimable positive cash flows, be within the defined target market, be in conformity with the Prudential Regulations for SMEs/Agriculture Financing, have a clean e-CIB record, and be above average borrowers, in line with the credit policy of banks.

Loan limit and tenure of guaranteed amount: The original intention was that the scheme would offer both short- and medium-term loans of up to three years for both working capital and medium-term capital needs, with the guarantee extending to loans up to a maximum amount of Rs5 million (approximately US\$58,000) for a single borrower. However, the loan limit for the subsistence farmers under the scheme must not exceed Rs0.5 million (approximately US\$5,800).

Payment of claims: The scheme would pay 50% of the claim (with the total claim capped at 60% of the outstanding loan amount) to the lender when the loan was categorized as doubtful and the remaining 50% of the claim at the time of loss.⁷ However, the expectation was that banks would continue with their regular procedure for the recovery of loans and report their status to the CGO on a yearly basis. As soon as it had recovered the loan, the PFI was obliged to return the proportionate share of the CGS to the guarantee fund.

Monitoring of guaranteed portfolios: The Banking Inspection Department of the SBP would review the guaranteed loan portfolios of PFIs during its regular and special inspections of the PFIs to ensure compliance.

That said, the scheme revised several of its provisions over time. For instance, based on negative feedback from PFIs on mark-up and sector/regional restrictions, the scheme underwent modification in 2011 to relax the restrictions. At the same time, it lowered the guarantee share to 40% of the outstanding principal amount, and there was an upward revision of the financing limits. In addition, to make the scheme more inclusive, microfinance banks were also able to participate in the scheme from December 2012.⁸

Regarding the current status, lending under the CGS has risen, with both the number of guaranteed borrowers and the amounts sanctioned increasing notably over time (Figure 2). A lone exception occurred in 2015, when the incremental flow of lending remained relatively low due to a dip in one main beneficiary bank's utilization—although most of the smaller banks showed better utilization during the year. Essentially, this lower flow reflected the dominance of one big commercial bank in the CGS portfolio. To avoid such a sharp decline in the future, the SBP duly diversified the CGS portfolio to ensure more inclusive participation by banks.

In total, the CGS has facilitated lending to around 32,000 borrowers, financing an amount of Rs25.1 billion (approximately US\$227 million) by December 2017. The sector breakdown shows that around 21,000 small farmers and 9,000 small and micro enterprises have received loans under the CGS. Over 4,000 borrowers have benefitted from clean lending.

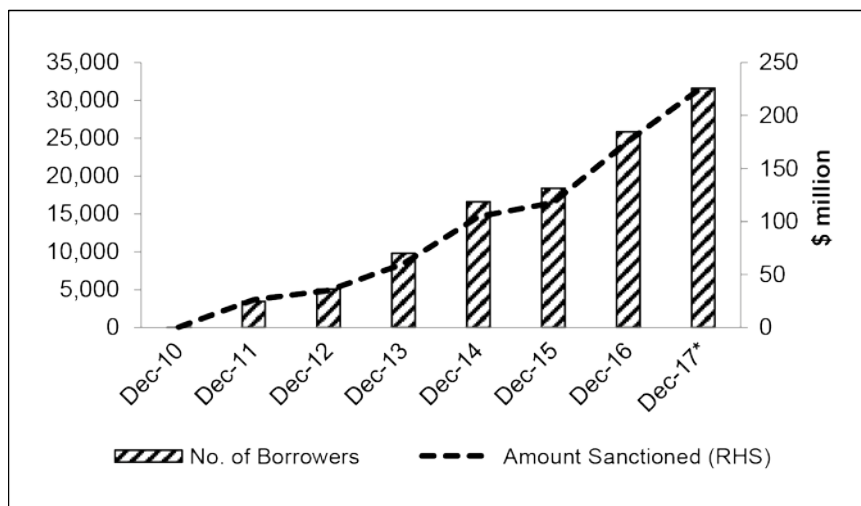
Once we start disaggregating the data, though, some imbalances emerge. For instance, the province-wide distribution reveals that the CGS activity is heavily skewed, with Balochistan in particular lagging behind among the four provinces (Figures 3a

⁷ Changed to a 100% claim on loss categorization of a loan in 2011 (SMEFD Circular No. 02 of 2011).

⁸ The interested reader may refer to the Appendix for a complete list of circulars documenting the changes.

and 3b). Meanwhile, the high CGS-specific financing activity in Punjab is in line with the broader province-wise lending pattern; specifically, Punjab—the most populous province of Pakistan—accounted for nearly 50% of the bank advances to the private sector as of the end of December 2017.⁹

Figure 2: Utilization of the CGS for Small and Rural Enterprises

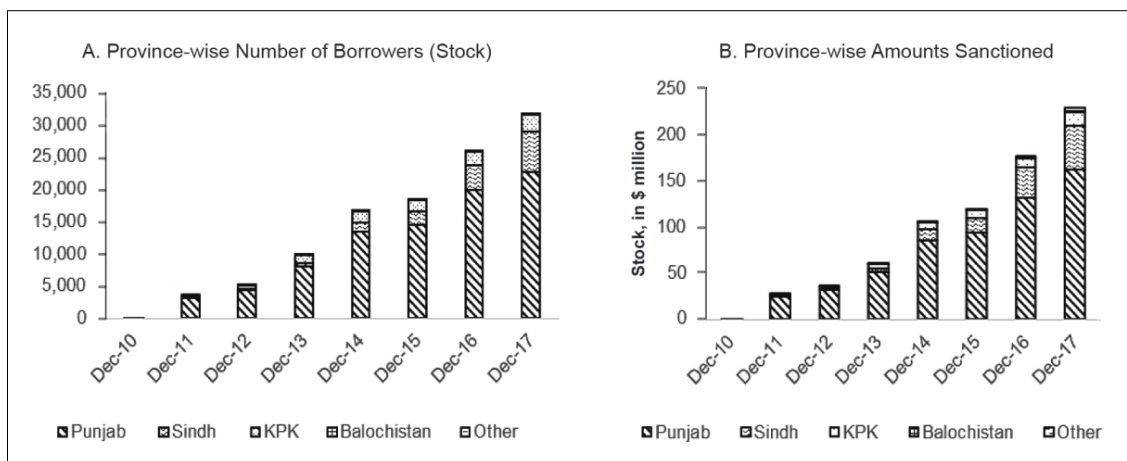


RHS = right-hand side.

* Latest available data at time of manuscript submission.

Source: State Bank of Pakistan.

Figure 3: Borrowers and Amounts Sanctioned by Province



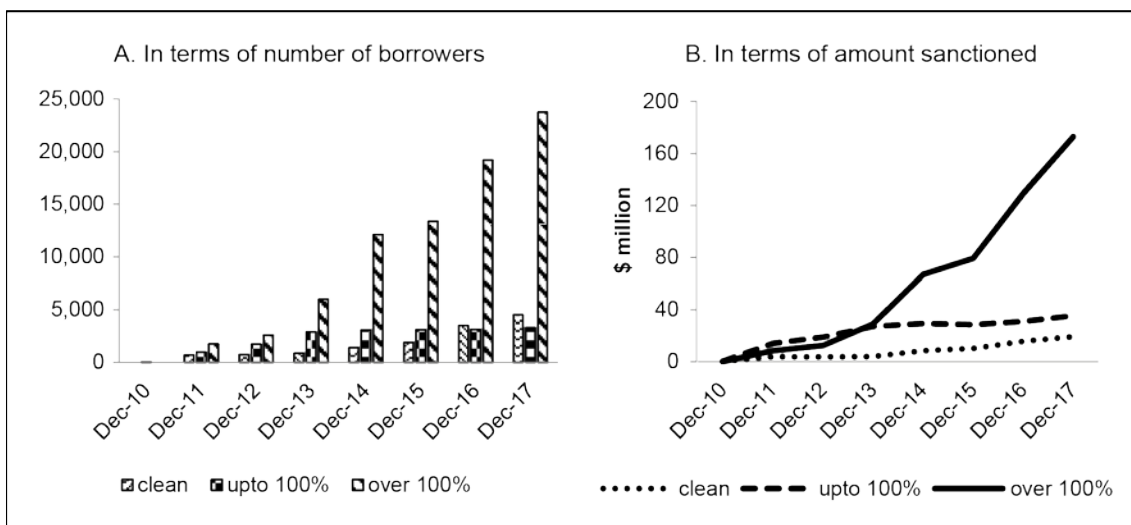
Source: State Bank of Pakistan.

⁹ According to the provisional estimates of the 6th Population and Housing Census 2017 conducted by the Pakistan Bureau of Statistics, Punjab remains the most populous province of Pakistan, accounting for nearly 53% of the country's 207.8 million population. The source for province-wise data of bank advances is the SBP.

Moreover, though the intention was that the CGS, among other things, would provide support for collateral-deficient borrowers, the data disaggregated by the value of collateral reveal that, in the vast majority of cases, the value of collateral for guaranteed loans exceeds 100% of the value of the loan (Figures 4a and 4b). One explanation for this is that banks with some previous experience of dealing with agriculture financing continued to serve this segment under the CGS. Therefore, the value of collateral (often land, in the case of agriculture financing) tended to be higher than the loan amounts. While it seems counterintuitive for the value of collateral to exceed 100% of the loan in spite of the CGS cover, the scheme did not explicitly prevent such practices, keeping in the mind the trade-off with utilization: given that the market norm was to require at least a 30% margin over and above the financing amount, it was felt that restricting the value of collateral over 100% of the loan value would involve a trade-off in PFIs' utilization of the scheme. The anticipation was that the market would gradually catch on to the CGS dynamics and demand lower collateral from borrowers as time progressed. However, given that this self-adjustment was largely missing, the SBP ultimately linked the risk coverage ratio with the level of collateralization in January 2017. While the trend of over collateralization had admittedly not occurred until a year after the introduction of the tiered risk coverage mechanism (judging by December 2017, the numbers presented in Figure 14.4a and Figure 14.4b), the expectation is that the situation will nonetheless improve gradually in the future.

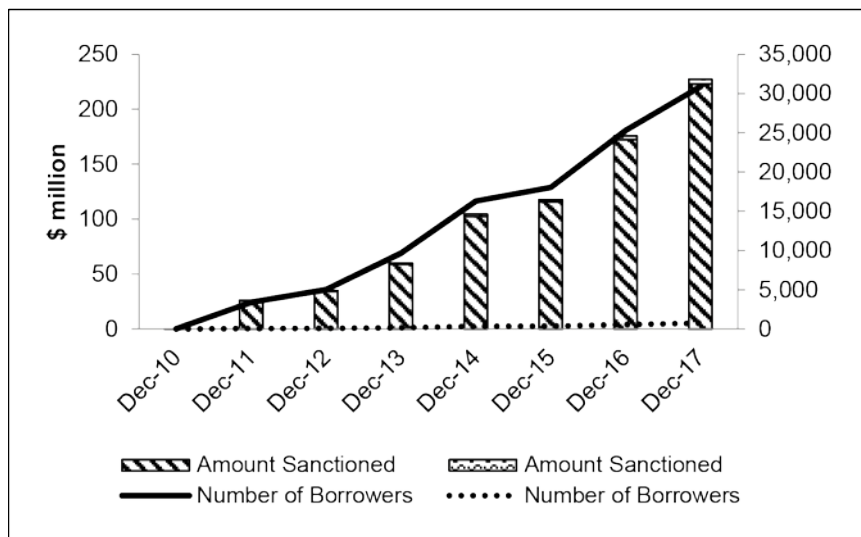
Moving on to the gender distribution, the disaggregated results again leave much to be desired (Figure 5). In terms of the number of borrowers and the amounts sanctioned, females remain clearly disadvantaged relative to men. Naturally, it is necessary to assess this trend while keeping in mind the broader exclusion of women from the financial system in Pakistan; according to the World Bank's Global Financial Inclusion database, only 3% of women in the country had an account with a formal financial institution compared with around 14% of men in 2014. Thus, the anticipation ex ante was gender disparity in the CGS numbers. Even so, the sharp contrast evident in Figure 14.5 calls for corrective action.

Figure 4: Value of Collateral, as % of Loan Stock



Source: State Bank of Pakistan.

Figure 5: Gender-wise Distribution



RHS = right-hand side.

Source: State Bank of Pakistan.

3. CASE STUDIES

To supplement the hard data with qualitative insights, we interviewed commercial bankers to understand why some banks fared relatively better in utilizing the CGS while others failed to capitalize on it. Prior to this exercise, we held informal discussions with SBP officials in charge of designing and monitoring the CGS. The predominant view that emerged from these discussions was that, barring a few exceptions, the majority of banks had lagged behind in the utilization of the scheme owing to improper marketing on their part.

To assess this theory, we framed a conceptual model that borrowed elements of the influential “4 Ps” of marketing, originally credited to Jerome McCarthy in the 1960s. In this model, decision making in the domain of marketing consists of four central elements, namely product, price, place, and promotion—abbreviated to the “4 Ps.” The broad concept of the marketing mix has stood the test of time, while researchers have tweaked specific elements as required. For example, Keller and Kotler (2016) offered the additional 4 Ps of modern management: people, processes, programs, and performance. Combining the elements that we deemed to be the most relevant to our CGS study, we initially proposed a customized 5 P model consisting of people, product, process, promotion, and price.

The intuition was that a given bank will typically develop its approach to loans for small and rural enterprises within the ambit of the various elements of the marketing mix. Our interest was in identifying the unique traits of each bank’s marketing mix and the way in which these were supporting (or detracting from) its positioning towards (a) SME banking and financing in general and (b) CGS utilization.

Next, we determined that the case study approach was well suited to the analysis. The case study method has certain advantages and limitations compared with other approaches, like econometrics or survey analysis, as Yin (2011) documented in detail. To clarify at the outset, we did not mean these case studies to be representative of all PFIs associated with the CGS. Their intended purpose was to add value to our general understanding of how commercial banks are approaching SME financing as well as whether (and how) the CGS has had an impact on their lending methods.

Presently, we interviewed senior SME officials belonging to four commercial banks. We adopted the convenience sampling approach while trying to gather feedback from success as well failure cases. On average, the interviews lasted for around one-and-a-half hours. While we utilized a questionnaire consisting of open-ended questions to ensure that the interviews remained on track, the discussion was semi-structured; the ordering of the questions was varied, and we posed follow-up questions on the spot to probe further, whenever appropriate.

The following are the three case studies developed from in-depth interviews. Clarification is necessary here: while we interviewed officials from four banks, one bank preferred to give us insights off the record. Respecting its preference, we did not develop a separate case study on this bank and only used the insights that its representatives shared to inform our policy recommendations. Secondly, apart from the Bank Alfalah case, we have employed fictional names in the other two cases. We left the decision regarding whether to identify the bank by name or to employ a fictional name to the bank's discretion. From our viewpoint, obtaining candid views was the topmost priority; if a bank was more willing to share its views openly only if we did not identify it by name, this was a compromise that we were prepared to make.

Finally, to prevent any confusion on the reader's part, while our 5 Ps marketing mix framework originally included "price" as one of the five elements, the following case studies do not contain a separate sub-section on this element. This is because the pricing aspect eventually proved to be a non-consideration in the sense that all the banks that we interviewed had similar views on the pricing of guaranteed vs. non-guaranteed loans. Essentially, the interviewees were of the view that banks in Pakistan have not yet fully moved towards risk-based pricing for individual SME loans and may take some time to mature to that level.

Thus, each subsequent case study consists of four numbered sub-sections only (People, Product, Processes, and Promotion). After the detailed case studies, we present a summary of the key findings from the three cases in Table 1 for ready reference.

3.1 Case Study I: Bank Alfalah

Bank Alfalah strengthened its focus on SMEs around four years ago. The first two years following this strategic shift were fairly challenging and involved a significant learning curve to understand and serve the SME segment efficiently. The bank's persistence was rewarded: even though its total assets of Rs988 billion (around US\$9 billion) do not place it among the top-3 largest banks in Pakistan, Bank Alfalah's Rs41 billion (around US\$371 million) SME portfolio as of December 2017 places it among the top-3 banks in terms of SME portfolio size, and the bank has ambitions to become the market leader in the years to come. More broadly, the bank's increasing branch network reflects its growth orientation, as the number of branches increased from 471 in 2012 to 638 by 2017, while the number of permanent employees rose from 6,666 to 7,698 during the same period.

The following are some of the distinct features of Bank Alfalah's marketing mix. Some features pertain to SME banking in general, while others facilitate financing for small and rural enterprises via the CGS.

3.1.1 People

Bank Alfalah espouses the belief that commitment to SME banking amongst the top management is crucial. Once it has established this commitment, it can flow top-down throughout the organization, bringing about the change in mindset required to cater to SMEs.

In Bank Alfalah's specific case, the realization that the corporate and consumer lending avenues were increasingly becoming saturated gave birth to the realization that the bank needed to target a new segment, namely SMEs. The bank then systematically bolstered its human resources by recruiting professionals who had a proven track record of dealing with the SME segment.

Moreover, Bank Alfalah trains its existing resources and potential clientele. In terms of internal capacity building, the bank encourages its relationship managers (RMs) effectively to become business advisors for SME clientele, a role that RMs can take on only after they have undergone specialized training and achieved certification from the bank. In addition, Bank Alfalah offers non-financial advisory services to its SME clientele in the knowledge that this hand holding will serve the bank's best interests in the long run.

3.1.2 Product

Bank Alfalah feels that its strengths include its accessibility (via its branch network), its service standards, and the flexibility with which it approaches SME banking. In particular, the bank prides itself on a product design philosophy that it grounds on needs assessment and a client-friendly customer interface rather than a one-size-fits-all approach or imitation of widely used products and services.

Bank Alfalah recognizes that financing is just one aspect of SME banking and that SMEs require a few services beyond credit, such as cash management and non-financial advisory services. The bank segments its target market on a number of bases, such as by sector, industry, and geography, to create offerings that match the clients' needs.

The bank is prepared to extend financing to those enterprises that are on the verge of value generation—meaning they are not yet well established and require some financial and non-financial support to become so. Moreover, the bank appreciates that SME development requires time and thus remains open to the idea of extending term loans of 5–10 years' duration.

With specific reference to the CGS, Bank Alfalah feels that the scheme gives it the comfort to extend financing in cases into which it may otherwise not have ventured, such as lending to collateral-deficient small enterprises. The CGS supports its value chain and cash-flow based lending, which represent a subset of the bank's substantial collateral-free SME loan portfolio.

3.1.3 Processes

Bank Alfalah initially utilized the advisory services of a renowned international financial institution to help to set up its SME department and process flows. To this day, the bank continues to leverage partnerships, collaborating with local players like Karandaaz (a nonprofit company that promotes access to finance for small businesses) and the SMEDA to good effect.

As far as approvals for SME loans are concerned, Bank Alfalah has moved towards a relatively decentralized decision-making approach over time in the pursuit of quicker turnaround times for loan applications. In certain cases, the bank has granted local area managers greater powers, with a simultaneous reduction in the role of the risk management department at the approval stage. However, this was a gradual shift away from the earlier centralized setup and was only possible after a considerable learning curve in the handling of SME financing.

In relation to the CGS, the bank disseminates relevant information pertaining to the scheme, including details of the periodic revisions that the SBP has made, through its internal SME helpdesk. Bank Alfalah's SME Head personally supervises this helpdesk and designed it to ensure that officials at all levels, from RMs to senior management, have current knowledge of the various products, policies, and regulations pertaining to SME banking.

Furthermore, the bank has an innovative approach geared towards making optimal utilization of its CGS limit. Having initially obtained the CGS cover against lending to a fresh client, Bank Alfalah typically removes the client from the scheme's coverage after a period of around two years, which it deems to be sufficient time to develop a sense of comfort regarding the client. With its available limit thus replenished, the bank then lends to another fresh client under the cover of the CGS. Thus, via rotation, it retains a greater proportion of riskier loans under the cover at any point in time.

3.1.4 Promotion

Rather than simply relying on SMEs to approach one of its branches, Bank Alfalah adopts a proactive approach to promotional activities. As part of its "market-storming" activities, officials don the bank's T-shirts, identify a high-potential SME cluster (like an industrial area), and conduct outlet-by-outlet visits to small enterprises to generate leads. On other occasions, the bank collaborates with the SBP and SMEDA to set up helpdesks for interacting with SMEs. Recently, the bank has also begun to advertise details of schemes that are relevant to SMEs—like the SME refinance scheme—via its ATMs.

That said, Bank Alfalah considers brochures and word-of-mouth promotion to be among the most effective ways to promote its offerings. In addition to being cost effective, the word-of-mouth approach works because small enterprise owners tend to have a close, interconnected network; serve one client effectively and he/she will happily spread the word among his/her network or community of SMEs.

3.2 Case Study II: Zakir Bank¹⁰

Zakir Bank ranks among the top-10 banks in Pakistan in terms of total assets. It largely focuses its lending to SMEs on seasonal financing, that is, short-term financing linked to agriculture crop cycles. Nevertheless, the bank has recently undergone major

¹⁰ Fictional name. We have deliberately withheld details relating to the bank's total assets, SME loan portfolio, number of branches, and number of employees to maintain the bank's anonymity.

restructuring, which is expected to bring about changes in the way in which it approaches SME financing. Zakir Bank's management acknowledges that the bank has so far been unable to utilize the SBP's CGS to its full potential and attributes this primarily to a lack of awareness of the scheme's benefits at certain organizational levels within the bank.

The following are some of the distinct features of Zakir Bank's marketing mix.

3.2.1 People

Regional heads play a pivotal role in the bank's SME operations. The bank assigns them targets and expects them to meet these targets through the dedicated efforts of their resources. Some proactive regions regularly surpass even ambitious targets, whereas others tend to lag behind, and this is primarily due to the dynamism of the regional heads.

As mentioned earlier, Zakir Bank's strength is seasonal financing. Intuitively, from a regional head's perspective, if the region can achieve profitability with the quick turnaround times associated with seasonal financing alone, there may be little incentive to venture into general financing and extend long-term loans. To address this aspect, Zakir Bank is now training its regional offices about the dynamics and merits of exploring general financing. Specifically, the bank's management is keen to create a better mix of seasonal and general financing to offset the sharp troughs that it is experiencing currently, as soon as the seasonal demand declines. Zakir Bank is also educating its regional heads and credit officers about the potential benefits that it can gain from greater participation in the CGS, which, in principle, may enable the bank to extend general financing even in certain collateral-deficient cases.

3.2.2 Product

Zakir Bank's seasonal loans tend to be short term, typically around 6–8 months' tenor, with disbursement and retirement linked to rice, cotton, and wheat crop cycles. The bank has not made inroads into value chain financing yet.

It has, encouragingly, designed separate policies for SEs and MEs, in line with the SBP's directives; these were reportedly pending board approval as of December 2017. Once it has approved these policies, Zakir Bank will be in a better position to design separate products and offerings for its small and medium clientele.

3.2.3 Processes

Regarding lending decisions, there are three main layers. Layer 1 comprises the area credit manager and the Commercial and SME Centre (CSC) Head. Currently, this layer does not have power of approval; it only recommends SME financing cases to layer 2, at which the regional head has the first power of approval. For cases that exceed the designated authority of the regional head, the head office (i.e. the third layer) makes the finance decision. From 2018 onwards, though, Zakir Bank intends to extend powers of approval to a certain point for layer 1 as well. The intention is to expedite the processing and turnaround time for smaller loans.

3.2.4 Promotion

The CSC Head is in charge of marketing activities across the relevant region. Marketing for the various branches in a region is centralized in a bid to improve the turnaround time.

The bank deems word-of-mouth marketing to be the most efficient channel for SME marketing; the emphasis is on serving the existing SME clients well, in the expectation that these satisfied SMEs will then spread the word about Zakir Bank among their networks. Other marketing activities include outreach to corporations, with the aim of cross-selling to SME vendors in their supply chain, as well as liaison with associations that have linkages with SMEs.

3.3 Case Study III: Jalib Bank¹¹

Like Zakir Bank, Jalib Bank ranks among the top-10 banks in the country in terms of total assets. The bank established a separate SME department in 2012, which provided a major impetus to its SME portfolio. Moreover, Jalib Bank began to participate actively in the CGS for Small and Rural Enterprises from 2013. Initially, it concentrated the CGS cover heavily on lending to rural enterprises. However, since 2015, the bank has expanded its focus to small enterprises as well. Presently, Jalib Bank is actively catering to the SME segment through its extensive branch network.

The following are salient features of the bank's marketing mix.

3.3.1 People

Jalib Bank's management has a pragmatic approach to SME banking. Having made a firm commitment to focusing on SMEs in 2012, it has consolidated its presence in this segment over time. As far as the CGS is concerned, the bank is among the top utilizers of the scheme. That said, its share of guaranteed loans as a proportion of the bank's overall SME portfolio remains miniscule. This reflects the bank's view that the CGS merely provides added comfort at this stage rather than being a core component of its SME financing strategy.

Regarding investment in its SME staff, the bank pays due attention to capacity building. Bank officials cite extended training—such as that imparted to management trainees, which spans several months and consists of classroom learning and field rotations—as being particularly effective interventions compared with shorter-duration training spread over two to three days, which may not have such a lasting impact.

3.3.2 Product

Jalib Bank engages in both program lending and conventional lending for SMEs. The bank has around seven distinct products that are designed to suit the requirements of this segment. These include dealer finance, vendor finance, fleet finance, school finance, seasonal finance, and so on. The bank has also tried to tap the potential of female-owned enterprises, including day care centers and clinics requiring financing for medical equipment. While dealer finance is a collateral-free product, most other offerings include some element of collateral. Jalib Bank derived comfort from the risk cover made available by the CGS against such products and plans to extend the menu of similar CGS-backed products in the future.

Jalib Bank feels that there is scope to develop unique products, keeping the parameters of the CGS in mind. However, it is of the view that this would be feasible if (a) there was surety that the scheme would continue for a committed period (say, 5 to 10 years) as opposed to the looming possibility that it may cease abruptly and (b) the

¹¹ Fictional name. We have deliberately withheld details relating to the bank's total assets, SME loan portfolio, number of branches, and number of employees to maintain the bank's anonymity.

revisions of the scheme's parameters were minimal, because these tend to disrupt the strategic approach that the bank adopts.

Regarding value-added services, the bank assists SME clients in preparing their feasibility studies, account statements, and application formalities. However, until now, this did not occur in a particularly structured way. Moving forward, the bank plans to take up the provision of formal non-financial advisory services, being aware that the central bank (SBP) has also advocated this direction.

3.3.3 Processes

Jalib Bank took some technical assistance from the IFC in the earlier stages, when it rolled out its SME department, and acknowledges that this support helped the bank to establish its loan collection setup. However, beyond this initial assistance, the bank has adopted and refined its SME-specific processes using the expertise of its internal resources and feels that it has sufficient understanding of the local SME dynamics without having to rely on external specialists.

The hierarchy of SME-serving personnel is broadly composed of credit marketing officers, who report to a hub manager, who in turn reports to a regional assistant general manager for credit. In addition, around 17–18 SME specialists are located at the head office.

For product-based lending, the approval authority rests with the regions, whereas, for conventional lending, some authority to approve smaller loans is delegated to lower levels. Importantly, the bank has also made an effort to separate its risk function, embedding it within six major regional hubs.

3.3.4 Promotion

Jalib Bank reaches out to SMEs via seminars, exhibitions, and promotional activities in conjunction with associations. It also taps the knowledge base of the SMEDA, with the research studies that the latter has conducted serving as useful inputs for the bank's product development efforts.

Moreover, the bank utilizes its extensive clientele and branch network to good effect; for example, banners and standees placed within its branches are an effective way to undertake internal marketing. With respect to technology and digital marketing, though the bank has taken advantage of these channels on the consumer side (e.g., facilitation of consumer loans via ATMs), it has not yet leveraged them in outreach efforts for SMEs, mainly because the bank feels that the majority of its potential clientele is not literate or technically savvy enough to appreciate or benefit from this approach.

Table 1 summarizes the key findings of the aforementioned case studies for quick reference.

Table 1: Summarized Findings from the Case Studies in Terms of the Adapted 4 Ps Marketing Model

	(I) Bank Alfalah	(II) Zakir Bank	(III) Jalib Bank
People	Commitment to SME banking among top management. Recruits professionals with specialized experience of dealing with SMEs. Invests in training for bank RMs as well as NFASs for SME clientele.	Has begun training its regional offices about the merits of extending general (long-term) financing to diversify beyond seasonal (short-term) financing. Also educating its credit officers about the advantages of the CGS (albeit a little belatedly).	Commitment to SME banking among the top management. Created an SME department in 2012 and began utilizing the CGS in 2013. Invests in capacity building, including extensive training for management trainees.
Product	Segments the SME target market by sector, industry, geography, gender, and so on. Offers products that meet the needs of clients. Utilizes the CGS to boost value chain- and cash flow-based lending to collateral-deficient SMEs.	Introducing separate policies for small enterprises and medium enterprises, with the aim of subsequently offering specialized products to each segment. Has not made notable inroads into value chain financing as yet.	Offers specialized products to SMEs, like dealer finance, vendor finance, fleet finance, school finance, and so on. Assists SME clients in preparing feasibility studies, account statements, and loan applications.
Processes	Has gradually moved towards a fairly decentralized approach to SME lending. To facilitate information sharing, an internal helpdesk also keeps track of CGS updates, including the SBP's amendments, and disseminates the details among staff.	Previously, there were two to three hierarchical layers involved in SME lending decisions. Now, the bank intends to extend certain powers of approval to the lowest layer to reduce processing and turnaround times.	Up to three hierarchical layers are involved in SME lending decisions. For conventional lending, the bank delegates some authority to lower layers to approve smaller loans. It has made an effort to separate its risk function.
Promotion	Actively reaches out to SMEs. Utilizes special brochures and helpdesks at events to generate word of mouth. As part of "market-storming" activities, the bank's staff make personal visits to SME clusters to generate leads.	Places emphasis on serving existing clients to generate positive word of mouth. Collaborates with corporations for cross-selling to SME vendors in their supply chain and liaises with the domestic SME association (SMEDA).	Strong liaison with the SMEDA. Reaches out to SMEs via seminars, exhibitions, and other promotional events. Utilizes marketing props like standees and banners placed within branches to good effect.

4. CHALLENGES FOR THE DEVELOPMENT AND EFFECTIVENESS OF THE CGS IN PAKISTAN

In addition to bank-specific dynamics, the case study interviews revealed some broad challenges relating to the CGS that are common across multiple banks. For instance, it is reasonable to expect that the CGS will appeal most to those banks that have a demonstrated focus on SMEs, as Bennett, Doran, and Billington (2005) discovered in the case of a credit guarantee company established in Egypt in 1989.

However, in Pakistan's experience with the CGS thus far, this mindset has been largely elusive. An unpublished development impact study revealed that only one PFI explicitly linked participation in the CGS with profitability, whereas other considerations motivated the remaining PFIs—like being part of a broader development agenda, supporting the central bank's initiatives for financial inclusion, and contributing to the country's economic development (APEX Consulting 2016). Significantly, the one bank that *did* associate CGS participation with profitability in this impact study was also

convinced that SME financing, in general, was a key driver of profitability. Our case study interviews echoed similar sentiments.

Hence, first, a pre-condition for the effectiveness of the CGS may be to generate commitment and buy-in amongst the top management of banks regarding SME banking. In this context, some key findings from the IFC's experiences (IFC 2007, 2010) suggest that, to maximize the impact, banks seeking to tap SME banking may:

- Segment by type of client, with reference to aspects like industry, ownership structure, and trade;
- Determine priority target segments in line with the bank's own strengths and weaknesses;
- Segregate sales and risk so that credit approval lies outside the domain of relationship managers;
- Segregate sales and relationship management;
- Invest in the product development skills of bank staff;
- Adopt a proactive approach to client acquisition by mining internal and external market data;
- Utilize low-cost delivery channels to minimize the costs of SME relationship management, like call centers, Internet banking, direct marketing, and so on;
- Adopt effective data systems that automate portfolio monitoring.

Encouragingly, the case studies developed in this chapter reveal that banks in Pakistan are adopting some of the above-mentioned measures—like prioritizing target segments and separating the risk and sales function. Meanwhile, there is room to develop other aspects, such as the utilization of technology and low-cost delivery channels to reach SMEs, the mining of internal and external market data, and so on. At the same time, with a view to mitigating information asymmetries and facilitating banks' assessment of SMEs, policy makers may consider pursuing the establishment of a credit risk database (CRD), similar to the one operating in Japan. In contrast to the personally identifiable information that credit bureaus tend to collect, the Japanese CRD collects anonymous data relating to SME credit, thus circumventing concerns relating to privacy; furthermore, by pooling information, it enables users to develop a profile of the average borrower in a group and facilitates the creation of reliable scoring models that can ultimately enable banks to gauge the creditworthiness of SMEs better (Kuwahara et al. 2015).

Naturally, adequate training remains a core requirement to ensure the CGS's effectiveness. The banks highlighted a scarcity of SME specialists during the interviews. Moreover, the training of SMEs tends to be even more challenging, given the diversity of SMEs and the fairly heterogeneous background of their owners. Our interviews with commercial bankers revealed a certain skepticism regarding the capability of the majority of SMEs to benefit from training; frequently, they cited the low literacy level as a binding constraint. In fact, financial literacy is even scarcer, with estimates suggesting that only around 26% of adults in Pakistan are financially literate (Klapper, Lusardi, and Van Oudheusden 2015). It is hardly a surprise, therefore, that most commercial bankers whom we spoke to seemed disinclined to engage in systematic hand holding for SME clientele of their own volition, such as through the provision of non-financial advisory services (NFASs). However, now that the central bank has categorically advised banks to introduce NFASs (SBP 2017b), this attitude is

likely to change; the expectation is that the banks, the SBP, and the SMEDA (the relevant public sector SME association) will collaborate to make this training effective.

More widely, financial literacy is so critical that it merits a coordinated, national-level focus; this may, among other things, take the form of a dedicated national strategy for financial education or be part of a holistic strategy to foster financial inclusion (OECD/INFE 2012). Pakistan has opted for the latter, with financial literacy being the component of the broader National Financial Inclusion Strategy (NFIS) launched in 2015. Specifically, the NFIS recommended the roll-out of phased nationwide awareness and education programs covering diverse topics, including the CGS, with a particular emphasis on SMEs, women, and small farmers (SBP 2015), and the central bank has been actively conducting workshops and events in the pursuit of this goal ever since.

Moving on to the question of risk coverage, our interviews revealed varying responses, with the majority of the banks reporting that a minimum of 50% cover was necessary for them to take the CGS seriously, whereas one bank claimed that it needed 100% risk cover to enhance CGS utilization. Following the existing literature, Beck, Klapper, and Mendoza (2010) reviewed 76 partial credit guarantee funds across 46 developed and developing countries and found that, while the guarantees offered ranged from 50% to 100%, the median coverage ratio was 80%. Thus, while the provision of 100% risk coverage may distort the incentives for PFIs to assess and monitor risk adequately, expanding the coverage (say, from 60% to 80%) may be an option worth exploring for priority segments. In addition, the guarantee dimension may be linked to broader economic conditions. For instance, the guarantee cover may increase in turbulent economic times to compensate for the higher default risk on SME loans; similarly, it may reduce when the economic conditions are more stable, in line with the declining SME loan default risk (Yoshino and Taghizadeh-Hesary 2016).

Regarding the current sector-specific approach, whereby banks must use 30% of their limit for specified sectors that they select themselves, the banks interviewed in this study did not see the value of this requirement. On the contrary, they felt that the SBP's sector selection—based on the sectors' potential for growth, exports, and overall importance for the economy—would be more suitable. The SBP may assign these priority sectors higher guarantee coverage to encourage banks to serve them through a market-based mechanism.

Apart from the challenges for the CGS that surfaced during the interviews, other challenges relate to the disaggregated data and figures contained in the earlier "Status of the CGS in Pakistan" section. Recalling the skewed province-wise distribution, it appears that the scheme's originators may have foreseen that some provinces would derive disproportionately greater benefits from the CGS at the expense of others if there were no specific directives. This would explain the inclusion of the geographical restrictions at the scheme's launch, which earmarked 50% of the guarantee funds for certain less developed regions. Unfortunately, many PFIs did not receive the early geographical restrictions disclosed at the scheme's launch in March 2010 well, and the scheme relaxed them within a year.¹² Subsequently, the overall lending backed by the CGS accelerated but at the expense of an even geographical dispersion. Furthermore, the preference for collateral-deficient borrowers that the scheme envisioned largely remained unmet, and female borrowers remained under-represented.

¹² Documented in SMEFD Circular No. 02 of 2011, dated 14 February 2011 (Appendix).

In the future, addressing these geography, collateral, and gender dimensions remains a challenge. Nevertheless, the recent measures that the SBP has taken may prove to be instrumental in correction:

- **Geography:** It introduced the concept of underserved areas in 2017, whereby lending to underserved areas will attract 60% coverage.¹³ In addition, in the broader domain of SME financing, the SBP will provide provincial targets for SME financing to banks as of January 2018 (SBP 2017b).
- **Collateral:** The SBP has linked the extent of CGS risk coverage with the level of collateralization as of January 2017. Specifically, there will be 60% guarantee cover on clean lending, 40% cover if the value of collateral is up to 100% of the loan value, and only 20% cover if the value of collateral exceeds the loan amount.¹⁴
- **Gender:** The SBP has introduced a refinance cum credit guarantee scheme for female borrowers operating in underserved areas of Pakistan.¹⁵ Under the scheme, PFIs can obtain refinancing of Rs1.5 million from the SBP at 0% and for onward lending to female entrepreneurs in underserved areas at a markup of up to 5% per annum. Such loans will also be eligible for 60% risk coverage under the CGS. The scheme is applicable for underserved areas; thus, it initially excluded 24 districts. Now, it has further reduced the excluded districts to 10. In fact, even apart from this refinance cum credit guarantee scheme, female borrowers are eligible for a 60% guarantee under the CGS for amounts up to Rs25 million (approximately US\$226,000) as of January 2017.

5. CONCLUSIONS AND POLICY RECOMMENDATIONS

Synthesizing the discussion up to this point leads us to the following policy recommendations:

- *The CGS originators should nudge PFIs to tweak their marketing mix:* The CGS originators should encourage PFIs to modify their marketing mix elements—like people, products, processes, and promotion—so that the latter can make optimal use of the scheme. Ideally, these should be “nudges” in the tradition of Thaler and Sunstein (2008); that is, the choice architecture should encourage PFIs to make decisions regarding their marketing mix that would make the PFIs better off by making the choices intrinsically appealing rather than through enforcement. However, if severe imbalances persist over time, the originators may ultimately issue specific directives.
- *Securing the buy-in of PFIs is essential, especially in the build-up to the scheme’s launch:* This may be a two-stage process. In the first stage, PFIs need to be convinced that SME banking and financing are profitable and not just something that they need to pursue because policy makers are pushing them in that direction. In the second stage, they need to believe that the CGS is a useful intervention that enables them to tap SME financing in a sustainable manner. Ideally, when a CGS is launched, there should be clarity regarding its intended duration; any scheme with declared availability of less than five years

¹³ IH&SMEFD Circular No. 01 of 2017.

¹⁴ That said, loans extended to certain priority borrowers receive 60% guarantee cover regardless of the collateralization level, as IH&SMEFD Circular No. 01 of 2017 documents (Appendix).

¹⁵ Details given in IH&SMEFD Circular No. 05 of 2017 (Appendix).

(or with tenure that is not specified at all) may not convince PFIs to build specialized products centered on the CGS.

Another way to promote PFIs' greater involvement in and commitment to CGS activities would be to involve them in the strategic management and decision-making process. This is a common practice in OECD member countries; for instance, the board of directors of Slovenia's Small Business Development Fund, which decides which applications it will guarantee, consists of representatives from the government and banks (OECD 2010). At present, the five-member Technical Committee responsible for overseeing the CGS in Pakistan includes one representative from PFIs; with plans underway to convert the CGS into a credit guarantee company, it is likely that the representation of PFIs on the board of directors will be expanded even further.

- *Trust building should be an ongoing exercise:* Even after the launch, the scheme's originators would do well to conduct extensive consultations with PFIs, especially before making any modifications to the scheme's parameters. Such trust-building exercises may enable the originators to make the right changes on the first attempt and reduce the need to make frequent revisions. Moreover, the originator should adopt the role of a relationship manager and advisor to PFIs.

For the CGS in Pakistan specifically, the SBP may also engage with banks to address some reservations regarding cumbersome reporting and a certain fear of the regulator imposing penalties if the banks inadvertently slip up in implementation (which some respondents voiced during the case study interviews). By extension, it may simplify reporting and other procedural requirements where possible and where the regulator deems appropriate. On this note, the decision to convert the existing CGS into an independent credit guarantee company¹⁶ (SBP 2017b) may also give PFIs some comfort if the direct involvement of the SBP recedes as a result.

- *The CGS originators must be prepared to develop the entire ecosystem:* Even if its core domain consists of financial institutions, the CGS originator must be prepared to develop the willingness and ability of borrowers as well. This may take the form of undertaking direct interventions (like training that the CGS originator conducts), leveraging partnerships with SME associations (such as the SMEDA in Pakistan's case), or nudging lenders to take up the hand holding and capacity building of SMEs.

In the case of banks, the dearth of SME specialists may be addressed by hiring specialized batches for SME banking, with a focus on NFASs and cash flow assessment based on non-traditional approaches. Among other things, training may emphasize how bank officials may practically overcome the "high-risk" stigma that may accompany SME lending in the bank's own internal regulations (Deelen and Molenaar 2004) and how the guarantee scheme can help to overcome the dearth of reliable information typically provided by SMEs. Other initiatives could include the adoption of digital loan applications and loan origination systems to reduce the turnaround time and leveraging technology for data mining, lead generation, and marketing.

¹⁶ The proposed Credit Guarantee Company may be operational by 31 December 2018, according to the Policy for Promotion of SME Finance unveiled on 22 December 2017.

In conclusion, while the marketing mix may not be the first concern that strikes policy makers during the design and implementation of a CGS, the observed experience in Pakistan's case suggests that it can have a significant bearing on the scheme's overall impact. By extension, the aforementioned recommendations could be a useful starting point in plugging marketing-related gaps. For instance, with respect to the four Ps, they may motivate the top management of PFIs: (i) to define strategies that outline how the bank will tap the full benefit of the CGS, which may include the provision of new, specialized products; (ii) to commit to investments in people, including the bank's own staff as well as SME clientele; (iii) to streamline and decentralize processes wherever feasible so that it can extend the CGS guarantees with minimum delay; and (iv) to allocate budgets to marketing activities to reach the target market for CGS offerings (like collateral-deficient SMEs). Moreover, if they are able to involve PFIs in framing the rules governing the CGS fund and its administration, policy makers may find that banks take greater ownership of CGS outcomes. Furthermore, the need to make frequent alterations in the scheme's parameters (in response to resistance or reservations that PFIs raise) may decline, since the revisions would occur through mutual consultation with PFIs in the first place.

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APPENDIX

Table A1: Selected Circulars and Circular Letters Relating to the CGS for Small and Rural Enterprises

Circular No./Policy	Date	URL
SMEFD Circular No. 01 of 2010	19 Mar. 2010	http://www.sbp.org.pk/sme fd/circulars/2010/C1.htm
SMEFD Circular No. 02 of 2011	14 Feb. 2011	http://www.sbp.org.pk/sme fd/circulars/2011/C2.htm
IH&SMEFD Circular Letter No. 03 of 2012	1 Mar. 2012	http://www.sbp.org.pk/sme fd/circulars/2012/CL3.htm
IH&SMEFD Circular Letter No. 14 of 2012	4 Dec. 2012	http://www.sbp.org.pk/sme fd/circulars/2012/CL14.htm
IH&SMEFD Circular Letter No. 04 of 2013	10 May 2013	http://www.sbp.org.pk/sme fd/circulars/2013/CL4.htm
IH&SMEFD Circular Letter No. 11 of 2015	23 Jul. 2015	http://www.sbp.org.pk/sme fd/circulars/2015/CL11.htm
IH&SMEFD Circular No. 01 of 2017	13 Jan. 2017	http://www.sbp.org.pk/sme fd/circulars/2017/C1.htm
IH&SMEFD Circular Letter No. 04 of 2017	16 Jun. 2017	http://www.sbp.org.pk/sme fd/circulars/2017/CL4.htm
IH&SMEFD Circular No. 05 of 2017	25 Aug. 2017	http://www.sbp.org.pk/sme fd/circulars/2017/C5.htm

Source: State Bank of Pakistan.