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ACCESS TO FINANCE FOR SUSTAINABLE CONSUMPTION AND PRODUCTION PRACTICES BY SMALL AND MEDIUM-SIZED ENTERPRISES IN PAKISTAN

This briefing summarises main findings of a desk analysis, literature review and interviews conducted on the topic of access to finance for Sustainable Consumption and Production (SCP) practices by small and medium-sized enterprises (SMEs) in Pakistan. The analysis was conducted as part of work in support of the EU SWITCH-Asia programme, by the SWITCH-Asia SCP Facility.

SCP IN PAKISTAN'S SME SECTOR

While Pakistan's population has grown considerably in the past decades, now exceeding 225 million, its economic growth has been slow compared to other South Asian countries. Agriculture is still its most important economic sector, while manufacturing has grown in importance. **Environmental protection laws for industry exist, but monitoring and implementation schemes are lacking. Consequently, air and water pollution and natural resource degradation have risen**, imposing heavy costs on human health and ecosystems. The main focus of Pakistan's policies in support of SMEs has been their contribution to economic growth and poverty alleviation. Yet overall, investment into SMEs is low, as is their technology level. Financing for SMEs makes up only 6,6% of private sector credit.

SMEs are a highly relevant contributor to environmental degradation. SMEs constitute nearly 90% of all the enterprises in Pakistan; employ 80% of the non-agricultural labour force; and their share in the annual GDP is 40%, approximately (SMEDA 2021). They often do not invest into environmental management systems and resource use remains inefficient. Companies are increasingly clustered in industrial estates, causing highly concentrated pollution and environmental degradation for surrounding areas. Yet currently, industrial estates often lack essential environmental infrastructure (for example common effluent treatment plants and landfills) and clear allocation of responsibilities for environmental management and SCP (World Bank 2019). Failing to meet importing countries' environmental and social standards threatens Pakistan's competitiveness, particularly in the textiles sector.

Mainstreaming SCP in the SME sector is thus urgently needed in Pakistan. SCP has been promoted since the 1990s but has not yet been mainstreamed due to challenges like institutional and capacity limitations, difficulties in coordinating between government agencies and between levels of government, limited incentives and public accountability for environmental management and gaps in the regulatory framework (World Bank 2019). Here, the focus on industrial estates could prove efficient: worker's safety, pollution management and clean energy investments could prioritise these, thereby minimising their unit costs. Pakistan's has put forward a detailed Action Plan on SCP in 2017 which explicitly considers provinces and the federal level.

Access to investment and working capital is another factor that affects SMEs' ability to professionalise and expand their SCP practices and services. The following presents an overview of **financing opportunities** for SMEs and their SCP-related activities and summarizes **recommendations to Development Finance Institutions** for increasing (access to) relevant funding. Further recommendations are made to foster the SME sector and SCP mainstreaming in general.

FINANCING OPTIONS

SMEs can tap into two types of financing for their investments into SCP practices:

- **General:** *Financing that does not have a specific (environmental or social) purpose beyond promoting the SME sector*. The State Bank of Pakistan has been promoting SMEs' modernization and innovation in several ways (see box 1) but many barriers keep actual financing from living up to expectations. SME finance makes up only about 6-7 percent of total domestic private sector financing and the number of SME borrowers is limited to around 180,000 (compared to a total of around 3.3 million SMEs in Pakistan, Sloan et al. 2020). Oftentimes, SMEs rely on private contacts to finance their investments and operations. This excludes those (potential) entrepreneurs that lack these types of connections and resources.
- **SCP-specific:** *Financing that is specifically earmarked for SCP-purposes, taking into account particular characteristics and financing needs of the implementing companies and their SCP measures*. The profile of SCP financing is rising in Pakistan, although the general awareness on financial inclusion is still a stronger issue in MSME financing. Nevertheless, Pakistan's central bank "State Bank of Pakistan" (SBC) joined the World Bank's IFC Sustainable banking network in 2015 and issued Green Banking Guidelines in 2017, giving sustainability a higher profile in the banking sector. Additionally, the theme gained further high-level political support as Pakistan, jointly with the United Kingdom, Canada, Germany and the United nations Development Programme (UNDP) announced a "nature performance bond", hinting towards high policy ambitions for sustainable finance. A green bond was issued by Pakistan Water and Power Development Authority in May 2021. It plans to offer more green debt over the next two years. This supports plans to increase renewable and hydroelectric generation to 60% of total electricity by 2030. Several of the important commercial banks offer specific financing for "modernization" of production lines (re-financed by SBC), which can include environmental upgradation.

Action taken by State Bank of Pakistan to promote SME / green finance

Policies for green finance

The Voluntary Green Banking Guidelines (2017) provide a framework for Pakistan's financial sector – specifically banks/DFIs that are nationally regulated within the SBP's remit – to develop approaches for environmental risk management; development of innovative financial products and alignment of existing products with sustainability objectives; and financial institutions' internal impact reduction, particularly through resource efficiency measures (Sloan et al. 2020).

Green Banking Guidelines – at a glance

- Responsibilities and institutional recommendations; environmental risk management
- Recommended for banks: e.g., Green Business Facilitation Policy and Strategy, Green Product Development, Green Advisory Service, Water Conservation, Green Earmarking, Green Marketing; own impact reduction.
- Explicitly referenced are SMEs and the importance of financing modern, resource-efficient technology.
- Annexures: environmental laws and international agreements; list of opportunities for financing environmentally friendly activities.

Current re-finance schemes for SME modernization / innovation

- Long Term Financing Facility for Plant & Machinery: Long-term local currency finance for imported and locally manufactured new plant and machinery to be used by the export-oriented projects (not SCP-specific).
- Refinance Facility for Modernisation of SMEs: Financing for purchase of new plant & machinery for existing units and setting up of new SME units (not SCP-specific).
- Textile Upgrade Fund and Mark-Up Subsidy: Investment Support for Textile Industry.

- Subsidized Scheme for Financing Power Plants using Renewable Energy: Lending to address energy shortage and climate change through promotion of renewable energy, extended until 06/22.
- "Innovative" SME Assan Financing Scheme, where under certain conditions, Government of Pakistan provides risk coverage of 40 to 60 percent to participating banks against losses (depending on loan size), launched in August 2021.

Existing financing options can be grouped into the following categories:

Banks: The majority of Pakistan's 24 commercial banks have started conducting basic environmental due diligence and aligning lending practices accordingly. Several banks are financing renewable energy and energy efficiency, especially through government supported refinancing schemes. Some banks are also financing other investments that could be considered "green" within their current SME lending portfolios. Some banks are working on developing new products for SMEs beyond renewable energy and energy efficiency. However, many financial institutions are only starting to implement the Green Banking Guidelines. Especially environmental risk management and green business facilitation beyond renewable energy and energy efficiency are still in early stages (Sloan et al. 2020).

Microfinance Institutions: Pakistan exhibits a large and growing sector of MFIs. According to the Pakistan Microfinance Network, microfinance banks (MFBs), (non-bank) MFIs and rural support programmes (RSPs) served a total of 7.25 million borrowers with a total of PKR 305.75 billion (USD 1.994 billion) at the end of 2019 (Basharat et al. 2020). MFBs contributed around 71% of the gross loan portfolio (GLP) of all microfinance providers (MFPs). Further, the five biggest MFPs jointly provided almost 54% of the market, in terms of GLP. In recent times, the government, as well as the industry, introduced new legislation and codes for responsible financial practices (e.g. the Microfinance Industry Code of Conduct, the National Financial inclusion Strategy (NFIS) 2023 Action Plan, the Fair Treatment of Consumer (FTC) Regime of the State Bank of Pakistan). However, these policy initiatives put an emphasis rather on general business practices than on sustainable finance. Although some of the Green banking Guidelines refer to MFBs as well (particularly section 4 on green business facilitation and section 5 on operational realignments for the reduction of banks' own impacts), MFIs are not in focus (Sloan et al. 2020).

Non-bank financial institutions (NBFIs): In comparison to the banking sector, NBFIs are playing a rather small role in the financial landscape of Pakistan (Khowaja et al. 2020). In its monthly review of November 2020, the Securities and Exchange Commission of Pakistan counted a number of 359 NBFIs, with total assets amounting to PKR 1,564.33 billion (USD 10.21 billion) (SECP 2020). Regarding the sectoral allocation of NBFI funding, the Pakistan NBFI & Moderaba Association reports that the highest single sector exposure is transport & communication, with investments in private and commercial vehicles amounting to 64% of investment financing in 2018-2019. Further sectors with high exposures are services, the chemical, fertilisers & pharmaceutical sectors and the textile sector (NBFI & Moderaba Association of Pakistan 2020).

Investors: Private investments, and particularly venture capital, are at a nascent stage in Pakistan. The amount of venture capital (VC) funding per capita in Pakistan has been USD 0.06 per capita from 2016-2018 (Syed & Bokhari 2019). Although the country is still lagging behind peer countries such as Nigeria (USD 0.18) or Bangladesh (USD 0.07), it increasingly receives VC funding from international as well as national investors. In support of its national entrepreneurs, the Ministry of information Technology & Telecommunication enacted the Digital Pakistan Policy in 2018, featuring policies such as tax exemptions to start-ups. Sustainability focussed actors, including accelerators such as Accelerate Prosperity or supporting institutions like Stimulus or Cleantech Republik are coordinating SCP-related activities in Pakistan and are involved in international sustainable entrepreneurship schemes.

Multi/bilateral: The Dutch Fund for Climate Development (DFCD) is open to financial institutions in Pakistan and will provide development grants; equity for construction and operational debt to projects related to climate-resilient water supply and sanitation; improved well-being, economic prospects, livelihoods, inclusion; climate-resilient land use and ecosystems; and lower GHG emissions. KfW and ADB are providing funds to local Pakistani MFIs and banks to extend credits to MSMEs. Further opportunities for Pakistan's financial institutions to access financing earmarked for green and climate-related objectives are likely to continue expanding (Sloan et al. 2020).

However, gaps and barriers on both the demand and supply side of finance exist:

Demand-side barriers

- **Lack of tailored capacity building and financing for SMEs:** SMEs do not have sufficient access to capacity building services to identify SCP measures. Moreover, it is difficult for them to access formal finance. Many lack (the skills to create) proper financial records and securities required for collateral and face hurdles like corruption, less tax concessions, limited regulatory support and high interest rates. Hence, SMEs remain underfinanced and rely on own resources, funds from friends and family or small-scale loans (Shah 2018), often at extremely high interest. There are no specific rules and regulation for SMEs to disclose their information which makes investors reluctant to finance SMEs (CPEC / SDPI 2016). Given perceived **high financing costs and administrative hurdles** under which SMEs compete against larger companies, SCP is partly regarded as additional cost rather than a means to increase long-term prospects of a business. Investments can appear as unfavourable in their risk-return profiles.

Supply-side barriers

- A **small ticket size** and **high transaction costs** of SCP-related activities of SMEs renders many investments uninteresting for certain kinds of financiers such as larger investors and banks – a problem that has become known as "missing-middle" in the SME financing context.
- **Limited green business facilitation and integration of environmental risk management into banks' core activities:** Banks generally struggle to define and align internal product development processes with green investment objectives, especially as these objectives relate to sector-specific environmental risk assessment and lending decisions (Sloan et al. 2020).

Gaps in facilitation and matchmaking

- Lack of awareness of or compliance with international standards on SCP practices and investments leads to suboptimal SCP-related financing practices and little space for increased integration of Pakistan's SMEs into global supply chains, where (proof of) cleaner production is increasingly important. The space of operable markets thus remains small for SMEs.
- Although the Government of Pakistan issued the Green Banking Guidelines in 2017, there is need for further training on and facilitation of SCP practices for both, financing institutions as well as SMEs, e.g. programs for capacity development, SCP-targeted incentive structures and support in regulatory affairs.

RECOMMENDATIONS TO DEVELOPMENT FINANCE INSTITUTIONS

Both general SME finance and specific SCP finance for SMEs need to be further strengthened in Pakistan, if SMEs are to successfully transition to SCP practices. Development finance institutions (DFIs) can play an important role in shaping conducive framework conditions. Existing literature (see chapter "Sources") highlights the following recommendations:

Understanding SME business cases that promote SCP and their financing needs

- Examples of commercially successful SCP-relevant business cases exist in other South Asian countries, including case studies by the SWITCH-Asia programme. Given the increasing importance of SCP, it would be advisable for DFIs to **analyse their setups and success factors**, in order to be **well-positioned to act as financiers**; this is similar to the last decade of investments in renewable energy and energy efficiency, where DFI capacity has grown considerably.
- SMEs investing into SCP practices often have unique needs. DFIs should dedicate efforts into understanding these and also build up their knowledge on financially directly or indirectly relevant impacts (like supply chain requirements, cost structure, reputational risk, etc) as well as the larger policy context (Paris Agreement, SDG 12, Green Deal, etc.) to be able to develop targeted and impactful programmes in line with the EU's policy priorities.

Supporting capacity building and knowledge exchange

- DFIs can support national awareness-raising campaigns, training programmes around green financing and SCP for regulators, FIs, intermediaries and SMEs as well as pilot initiatives and demonstrator projects.
- DFIs could also provide in-depth technical assistance to partner banks, focusing on developing activities in line with the Green Banking Guidelines, especially in support of environmental risk assessment and green business facilitation.
- Through their projects and funding priorities, DFIs can foster development of private SCP technology and service suppliers (beyond pilots).
- DFIs could facilitate knowledge sharing among stakeholders on green financing needs and opportunities across Pakistan with particular attention to disseminating effective environmental risk management and green business facilitation approaches.

Developing new financial instruments / programs

- Support design of tailored products that enable green investments by SMEs while responding to their specific investment needs and available financial data and collateral.
- Set up a dedicated Clean Production facility with local FIs.
- Establish equity participation fund (with government seed funding and private follow-up capital) to identify, facilitate and finance high growth potential small and medium enterprises through easy availability of equity financing. The fund could target green-field projects, early stage / high growth SMEs and mature / established businesses.
- Credit Guarantee Scheme for SMEs sector may be prioritised and synchronised with priority sectors through initial government seed money. This initiative will increase the number of SMEs accessing loans from financial institutions, create an environment for banks, based on the realization of potential and fair competition, to develop institutional capacities for SME financing, increase commercial activity, employment generation, productivity, and economic growth.
- When channelling funds through local institutions, DFIs can also require that these develop programmes that seek to solve the financing gap for specific high-impact SCP practices, for example for waste management or wastewater treatment. These could also be sector-specific, or address specific industrial clusters. This targeted financing could be rendered even more effective if paired with national or state legislation targeting at improving sustainability.

Improving access to finance for SMEs

- DFIs can support domestic financial institutions in the standardization of the credit granting process to decrease administrative costs related to small ticket sizes. Focus could be on promoting digital credit application tools and clear sustainability benchmarks.
- Government should reduce mark-up on the existing SME financing and may take the burden of excess mark up out of this facility. Introduce low mark-up financial products for SMEs.
- Foster proper discloser of information of SMEs so that risk can be minimized.
- Foster Islamic financing - conventional banking is not accepted by a large diaspora in Pakistan.

Ambitions to promote the development of the SMEs sector and SCP mainstreaming also need to be raised. For example, more effective inter-agency coordination and complementary public-private sector dialogue would improve the institutional framework for the strengthening SMEs and greening of industries (World Bank 2019). The system of pollution charges and taxes should be updated with a much greater focus on public disclosure. DFIs could contribute to such efforts through collaboration with regulators and private stakeholders.

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See Excel table for more information on specific financial instruments.