OTC Document

How to Approach Banks

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2 Introduction to SMEDA

Small and Medium Enterprises Development Authority (SMEDA) is an apex SME development agency working under the Ministry of Industries and Production (MoI&P), Government of Pakistan. In pursuit of its mission, SMEDA has adopted an integrated strategy that comprises SME sectors & clusters development, Business Development Services (BDS), and Policy advocacy to protect and promote SME interests.

SMEDA offers a broad spectrum of business development services to SMEs, which include prefeasibility studies, identification of experts, and consultants, delivery of need based capacity-building programs in addition to business guidance through help desk services.

3 Purpose of the Document

This document is a demonstrative guide for new / start-up entrepreneurs as well as for existing business owners/managers who are interested in information regarding 'How to Approach Banks'. The guide demonstrates ways and means of obtaining financing from banks, negotiating terms and conditions associated with it, assessing financial needs and analyzing payment methods.

Small and medium entrepreneurs lack adequate resources to make major decisions regarding the selection of an appropriate financial institution and the manner in which they approach financial assistance. Before you go for formal financing through a financial institution you need to explore all the available resources internally that can fulfill your current need of financing. You need to know the exact purpose & amount of financing required by your business.

4 Assessing Financial Needs

Is borrowing the only available solution for your business? For knowing this, you need to assess your initial requirements for external financing and go through the advantages and disadvantages of borrowing. It is important to learn about various methods of generating cash flows internally from your business through higher productivity of fixed and current assets of your business.

Financing:

The act of raising or providing funds / cash for continued business operations.

Financial institutions:

Formal organizations; banks and leasing companies, etc. that provide financing to businesses.

A business can be financed through either equity (personal investment), debt (borrowing from external sources) or a combination of both debt and equity. For further details, please refer to SMEDA's OTC document "**Financing your Business**" available at www.smeda.org.pk.

5 State Bank of Pakistan (SBP)

State Bank of Pakistan governs banking operations of all banks operating within the country through a set of policies and regulations, known as Prudential Regulations. There is a unique list of Prudential Regulations for lending to SME businesses that provide guidelines to banks on how to lend to SMEs. These guidelines include direction on loan amounts that can be offered to SMEs, collateral requirements, etc. SMEs are defined as follows by SBP Prudential Regulations:

SIZE	NUMBER OF EMPLOYEES	ANNUAL SALES TURNOVER
Small	Up to 50 (Including contract employees)	Up to Rs. 150 million
Medium	51-250 (Manufacturing & Service) 51-100 (Trading)	Above Rs 150 million, up to Rs 800 million (All types of Medium Enterprises)

State Bank of Pakistan has also introduced number of financing schemes for promotion of SME financing. SMEDA and SBP have taken various initiatives to increase awareness amongst SMEs, build their capacities and remove gaps between the banks and SMEs. SBP has recently developed a **"Policy for Promotion of SME Finance"** to facilitate SME financing. For more information regarding SBP's financing schemes for SMEs, please visit their website at www.sbp.org.pk.

6 Formal Financing Sector

Pakistan's formal financing sector consists of banks that offer a wide range of products according to a business's financing requirements; such as:

6.1 Long Term Financing

Long-term / Term Financing refers to loans that have a payback time of longer than a year and can be availed by the borrower to acquire fixed assets (immovable properties i.e. land and buildings and vehicles for commercial use). The loan carries a predetermined length of time (tenure), with repayments made in installments.

6.2 Working Capital Financing

Majority of businesses cannot fund their working capital needs or operating cycle using internally generated cash and rely on internally generated cash flows and / or external funds to finance the shortfall. It is also common in a small business that the owner will inject his own cash (also known as equity) to pay the suppliers. Financial institutions have come up with various products, also known as "working capital" loans, to finance their working capital gap. Working capital loans are generally for two to three years.

6.3 Short Term Credit/Over Draft Facility

Short-term debt is a loan with a payback time of one year or less. In business, short-term debt includes any outstanding obligations that are due within a year for which Banks may also provide overdraft facility to its regular and credible customers with good credit history.

6.4 Revolving Credit

This type of loan is also short-term in nature and does not have a fixed number of payments, as in the case of installment loans (i.e. long term, working capital and short term). Once the loan limit is approved, the borrower is free to withdraw amounts to the extent of that limit. The borrower can withdraw and repay the amount as many times as he wishes to; but has to pay mark-up on the amount actually used for a certain time. A common example is the credit card facility used as personal loans.

6.5 Trade Finance

Trade finance includes financing for trade, and it relates to both domestic and international commerce and trade transactions. Banks and financial institutions can facilitate these transactions by financing the trade through lending, the issuance of Letters of Credit (LC), export credit financing, bank guarantee, bills of exchange purchased, trust receipts factoring, export credit and insurance.

LC is a written undertaking by a financial institution in favor of the supplier/seller to pay him the amount of imported/purchased goods, in case the actual importer/buyer fails to pay the liability. LC enables a customer to import/purchase goods without making advance or immediate payment from personal resources.

6.6 Lease Financing

This type of facility helps the borrowers to acquire equipment and machineries for their businesses on lease; the lease is long term in nature and the repayment is made in installments.

SMEDA has developed a database of **SME Financing Products** offered by banks to the SME sector; please visit SMEDA website (www.smeda.org.pk) to access the database.

NOTE: Please see Annexure A; details of interest charges by banks for their lending services.

7 How to Approach Banks?

SMEs find it difficult to approach banks for financing due to a lack of understanding regarding the banks' criteria for evaluating loan proposals. When approaching a bank with a financing request you must be willing to share your business information to gain the bank's trust regarding proper utilization of funds and their payback.

A Bank analyses a SME application for loan based upon the following parameters:

7.1 Sector Analysis

Sector analysis is an assessment of the economic and financial condition and prospects of a given sector of the economy. Sector analysis provides the banks with an idea about how well other companies in the sector are performing. Factors such as; demand and supply gap, opportunities, threats and future viability of the businesses within the sector, provide sector health indicators for sector evaluation.

7.2 Business Analysis

As a borrower, you must ensure that your business's performance is efficient; operations are not only profitable but also generate sufficient cash to cover all financial commitments. The amount of cash a company generates from the revenues it takes in, must be greater than the costs associated with long-term investment on capital items and other expenses.

7.3 Assessment of the Entrepreneur

Most institutions like to know that you have a good record of operating a business successfully. It is difficult to convince a banker to lend you money if you are a beginner, or if you are starting a business activity with untried products and unknown customers or suppliers in countries you have never dealt with before.

Your references and credentials are very effective in gaining the lenders' confidence. However, if you are declared bankrupt or carry forward bad debt, it will be difficult for your bank to convince their loan committee or board to approve the loan. Moreover, even if your history is clean as a banking customer, it is helpful to have a reference of a reputable sponsor. This might be a well-known person in business, your trade association or even your customer or supplier i.e. in the case of value chain financing.

7.4 Adequate Shareholders' Funds / Equity

Simply speaking, you must not over-commit to other lenders, and should have a reasonable proportion of your own capital in the business. The more capital you have invested in your business; the better situation you are in to reflect a strong financial position in terms of your equity capital investment. Generally speaking, 30% to 40% of the business must be financed through equity in order to induce a lenders' confidence in your business.

7.5 Adequate Security

The borrower may not obtain credit from a bank if all assets are already pledged to other lenders. There must be some assets available to be given as security. Secured debt may attract lower interest rates due to the added security; however, credit history, ability to repay, and expected returns for the lender are also factors affecting markup rates.

7.6 Purpose of Loan

The purpose of loan is your underlying reason for seeking a loan. It is used by the lender to make decisions on the risk involved and may even impact the interest rate that is offered. So your purpose of loan must be clear, adequate and justifiable on the basis of your financial requirement in order to convince the lender for loan processing.

8 Presenting Your Request for Financing

The need for a business plan cannot be stressed enough as an effective tool of planning and monitoring your business activities. When you approach a bank with your financing request, it is safe to assume that the banker has no idea about you or your business operations. Therefore, it is helpful to provide your banker with a business plan for details and information. For more information regarding 'How to Make a Business Plan', please visit SMEDA website.

Furthermore, there are some additional tools that should be used to strengthen your business case, increase your confidence and effectively improve your chances of getting your loan request approved by the bank e.g.:

8.1 Use your network and prior knowhow

You can use your relationships with associations and chambers for presenting your good business repute before the bank. You need to take information from your bank to know about their lending rates and provide you with a schedule of their charges and service fees.

Tip:

The way you approach a bank or other lending institution is all-important. Know whom you are going to deal with.

8.2 Notify your intentions

Give notice of your intentions, via an appointment, letter or fax stating who you are,

Tip:

It is better to discuss your financing requirements with your current bank of business; you are in a better position to negotiate terms due to your credit history and record.

what you want from them and why. It is usually preferable to meet the person in charge of SME lending or trade financing. Banks have specialized facilities and focal persons for SMEs.

8.3 Be well prepared

Unless you and your banker know each other well, state who you are, what you do; how much money you need and what your purpose is. You should provide a copy of your financial statements (balance sheet, profit-and-loss account, budget, and business plan etc.) as well as an introductory brochure of your company.

8.4 Seek Advice

The SME customer service representative will guide and advise you on various payment methods, ways of financing your transactions and security/guarantee for your borrowings etc. You can also ask about any possibilities to cover or reduce risks of currency and interest rate fluctuations. The bank can also assist you in preparation of your loan documents and business proposals through their officers or a third party consultant.

8.5 Be cautious

Make an informed decision, as banks sometimes propose the types of credits or payment methods they are most familiar with, that are more profitable or present least risk to them. Ask about costs, both front-end and hidden charges (costs, fees and charges in addition to the interest rate). Do not hesitate to ask for a copy of the standard or a sliding scale of rates for their services and seek guidance on how these rates will affect your transaction.

Tip:

Resist borrowing more than you need, or for too long, or at too high an interest rate.

8.6 Avoid comparison

There is nothing wrong in trying to get to know the banking sector and wanting the best deal but you should avoid giving the impression that you are also exploring viable options with other banks. The success of a good borrower-lender relationship builds largely on trust, which is developed over time.

Tip:

A banker may not appreciate you wandering around for the best deal, visiting several other banks and drawing comparisons between them.

9 Annexure A

Sr. #	RATES & CHARGES	COMMENTS
1.	**Interest Rate**	Price paid for the use of lenders' money and expressed as percentage of borrowed amount/amount due. Interest rate is usually charged annually while it can be calculated on monthly and semi-annually basis.
2.	**Account Maintenance Charges**	Amount charged by the bank for maintenance of your bank account, for example, charges for account maintenance certificate.
3.	**Renewal Charges**	Charges received by the bank on renewal of any service.
4.	**Processing Fee**	Fees charged for processing of loan application.
5.	**Cancelation Fee**	Charges received by the bank on cancelation of any banking service.
6.	**Bank Commission**	Commission taken by the bank on transactions with some foreign bank on behalf of the account holder or on Letter of Credit etc.
7.	**Communication Charges**	Fees charged against any correspondence between bank and the customer via email, SMS, mail courier etc. or with other banks on behalf of the customer.
8.	**Bank Statement Charges**	Charges for taking a bank statement from the bank.
9.	**New Facility / Enhancement**	Fees charged upon any new or enhancement of an existing facility or services.
10.	**Transfer Fee**	Charges taken on the transfer of funds from one bank to other.
11.	**Amendment Charges**	Charges taken upon any amendment in facility or services.
12.	**Services Charges**	Charges taken by the bank in lieu of providing general services.
13.	**Penalty**	Charges, fee or fine on non-payment of due amount to the bank.
14.	**Letter of Credit**	Charges taken by the bank on issuance, amendment, advising, commission, service charges, collection, confirmation/cancellation, sales tax, fed, or any discrepancy etc.
15.	**Foreign Exchange Charges**	Charges on transaction in foreign exchange currency. For example: Foreign Bills Purchased /Collection, Issuance (Traveller's Cheques) Foreign Currency.