



# Completion Report

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Project Number: 34327  
Loan Numbers: 2066/2067  
December 2009

## Pakistan: Small and Medium Enterprise Sector Development Program

Asian Development Bank

## CURRENCY EQUIVALENTS

Currency Unit – Pakistan rupee (Pre/Prs)

		<b>At Appraisal</b>	<b>At Program Completion</b>
PRe1.00	=	\$0.0175	\$0.01228
\$1.00	=	PRs57.2	PRs81.40

## ABBREVIATIONS

ADB	–	Asian Development Bank
BDS	–	Business development services
BSF	–	Business Support Fund
CFC	–	Common facility center
CIB	–	Credit Information Bureau
CPMU	–	core program management unit
KRA	–	key result area
LIP	–	labor inspection policy
LPP	–	labor protection policy
MOF	–	Ministry of Finance
MOIP	–	Ministry of Industries and Production
MOL	–	Ministry of Labour and Overseas Pakistanis
PCR	–	project completion report
PD	–	program director
SBP	–	State Bank of Pakistan
SDP	–	sector development program
SME	–	small and medium-size enterprise
SMEDA	–	Small and Medium Enterprise Development
SMESDP	–	Small and Medium Enterprise Development Program
SOP	–	Standard operating procedures
TA	–	technical assistance
TUSDEC	–	Technology Upgradation and Skills Development Company

## NOTES

- (i) The fiscal year (FY) of the Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2009 ends on 30 June 2009.
- (ii) In this report, "\$" refers to US dollars.

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## CONTENTS

	<b>Page</b>
BASIC DATA	i
I. PROGRAM AND PROJECT DESCRIPTION	1
II. EVALUATION OF DESIGN AND IMPLEMENTATION	2
A. Relevance of Design and Formulation	3
B. Program and Project Outputs	3
C. Program and Project Costs	8
D. Program and Project Disbursements and Schedule	8
E. Implementation Arrangements	9
F. Conditions and Covenants	10
G. Related Technical Assistance	10
H. Consultant Recruitment and Procurement	11
I. Performance of Consultants	11
J. Performance of the Borrower and the Executing Agency	12
K. Performance of the Asian Development Bank	12
III. EVALUATION OF PERFORMANCE	13
A. Relevance	13
B. Effectiveness in Achieving Outcome	14
C. Efficiency in Achieving Outcome and Outputs	14
D. Preliminary Assessment of Sustainability	15
E. Impact	16
IV. OVERALL ASSESSMENT AND RECOMMENDATIONS	16
A. Overall Assessment	16
B. Lessons	16
C. Recommendations	18
APPENDIXES	
1. Policy Matrix for the Small and Medium Enterprise Sector Development Program	19
2. Small and Medium Enterprise Sector Development Program Achievements and Key Issues during Its Implementation	25
3. Program Framework	44
4. Status of Compliance with Small and Medium Enterprise Sector Development Program	47
5. Assessment of Overall Program and Technical Assistance Loan Performance	57

## BASIC DATA

### A. Loan Identification

1.	Country	Pakistan
2.	Loan Numbers	2066, 2067
3.	Program Title	Small and Medium Enterprise Sector Development Program
4.	Borrower	Islamic Republic of Pakistan
5.	Executing Agency	Ministry of Finance
6.	Amount of Loan	
•	Loan 2066	¥16,436,520,000 (\$152 million equivalent) from ADB's ordinary capital resources
•	Loan 2067	SDR12,501,000 million (\$18 million equivalent) from ADB's Special Funds resources
7.	Program Completion Report Number	PCR: PAK 1155

### B. Loan Data

1.	Appraisal	
–	Date Started	15 September 2003
–	Date Completed	4 October 2003
2.	Loan Negotiations	
–	Date Started	17 November 2003
–	Date Completed	19 November 2003
3.	Date of Board Approval	19 December 2003
4.	Date of Loan Agreement	10 February 2004
5.	Date of Loan Effectiveness	
•	Loan 2066/2067	
–	In Loan Agreement	5 July 2004
–	Actual	5 July 2004
–	Number of Extensions	none
6.	Closing Date	
•	Loan 2066	
–	In Loan Agreement	27 June 2007
–	Actual	30 June 2008
–	Number of Extensions	1
•	Loan 2067	
–	In Loan Agreement	30 June 2009
–	Actual	TBD <sup>a</sup>
–	Number of Extensions	none
7.	Terms of Loan	
•	Loan 2066	
–	Interest Rate	ADB's London interbank offered rate (LIBOR)-based lending facility

<sup>a</sup> Loan financial accounts are still open as of PCR preparation. Request for extension of loan closing date from 30 June 2009 to 30 September 2009 is underway at the time of PCR preparation.

- Maturity (number of years) 15 years
- Grace Period (number of years) 3 years
- Loan 2067
  - Interest Rate 1% per annum during grace period and 1.5% per annum thereafter
  - Maturity (number of years) 32 years
  - Grace Period (number of years) 8 years

8. Disbursements  
a. Dates

	Initial Disbursement	Final Disbursement	Time Interval
Loan 2066	23 July 2004	27 June 2008	47 months
Loan 2067	8 November 2004	16 October 2009	60 months <sup>a</sup>
	Effective Date	Original Closing Date	Time Interval
Loan 2066	5 July 2004	30 June 2007	48 months
Loan 2067	5 July 2004	30 June 2009	72 months

<sup>a</sup> Per data as of 17 December 2009, and subject to update based on the final liquidation of imprest fund.

Category	Original Allocation	Last Revised Allocation	Amount Added / (Canceled)	Net Amount Available	Amount Disbursed	Undisbursed Balance
<b>Loan 2066 (¥)</b>						
01-SME Sector Development Program	16,354,337,400	16,354,337,400	0	16,354,337,400	16,354,337,400	0
02-Front End Fee	82,182,600	82,182,600	0	82,182,600	82,182,600	0
<b>Total</b>	<b>16,436,520,000</b>	<b>16,436,520,000</b>	<b>0</b>	<b>16,436,520,000</b>	<b>16,436,520,000</b>	<b>0</b>
<b>Loan 2067 (SDR)<sup>b</sup></b>						
1-Consulting Services	4,381,000	1,740,486	(2,640,514)	1,740,486	1,428,001	312,485
2-Training and Seminars	1,431,000	132,247	(1,298,753)	132,247	160,012	(27,765)
3-Business Support Fund	4,089,000	4,089,000	0	4,089,000	1,608,813	2,480,187
4-Surveys (SME Finance Component)	90,000	30,032	(59,968)	30,032	0	30,032
5-Program / Project Implementation (CPMU)	799,000	799,000	0	799,000	103,422	695,578
6-Interest Charge	347,000	347,000	0	347,000	73,437	273,563
7-Unallocated	1,364,000	1,364,000	0	1,364,000	0	1,364,000
8- Imprest Fund <sup>c</sup>					251,080	251,080
<b>Total</b>	<b>12,501,000</b>	<b>8,501,765</b>	<b>(3,999,235)</b>	<b>8,501,765</b>	<b>3,624,763</b>	<b>5,128,080</b>

<sup>b</sup> Figures provided were as of 4 November 2009 Batch Report run date as financial accounts are still open.

<sup>c</sup> Outstanding Imprest Advance equivalent to \$350,472.98 as of 17 December 2009.

Note: Totals may not tally due to rounding of numbers.

9.	Local Costs (Financed) 2067	
-	Amount (\$)	2,875,063
-	Percent of Local Costs	26.17%
-	Percent of Total Cost	14.73%

### C. Program and Project Data

#### 1. Program and Project Costs (\$)

Cost	Appraisal Estimate	Actual
<b>Loan 2066</b>		
Foreign Exchange Cost	152,000,000	149,106,742
<b>Total</b>	<b>152,000,000</b>	<b>149,106,742</b>
<b>Loan 2067</b>		
Foreign Exchange Cost	7,910,000	5,404,226
Local Currency Cost	10,090,000	2,875,063
<b>Total</b>	<b>18,000,000</b>	<b>8,279,289<sup>a</sup></b>

<sup>a</sup>Per data as of 17 December 2009, and subject to update based on the final liquidation of the imprest fund.

#### 2. Financing Plan (\$)

Cost	Appraisal Estimate	Actual
<b>Loan 2066 (¥)</b>		
First tranche release	3,244,050,000	3,244,050,000
Incentive tranche release	3,244,050,000	3,244,050,000
Second tranche release	3,244,050,000	3,244,050,000
Third tranche release	6,622,187,400	6,622,187,400
<b>Total</b>	<b>16,354,337,400</b>	<b>16,354,337,400</b>
<b>Loan 2067 (\$)</b>		
Implementation Costs		
Borrower Financed	10,000,000	— <sup>a</sup>
ADB Financed	18,000,000	5,404,226
<b>Total</b>	<b>28,000,000</b>	<b>5,404,226</b>
IDC Costs		
ADB Financed	500,000	73,437
<b>Total</b>	<b>500,000</b>	<b>73,437</b>

<sup>a</sup>Data unavailable as of PCR preparation.

ADB = Asian Development Bank, IDC = interest during construction.

#### 3. Cost Breakdown by Program and Project Components

Component	Appraisal Estimate	Actual
<b>Loan 2067 (¥)</b>		
01-SME Sector Development Program	16,354,337,400	16,354,337,400
02-Front End Fee	82,182,600	82,182,600
<b>Total</b>	<b>16,436,520,000</b>	<b>16,436,520,000</b>
<b>Loan 2067 (SDR)</b>		
1-Consulting Services	4,381,000	1,428,001
2-Training and Seminars	1,431,000	160,012
3-Business Support Fund	4,089,000	1,608,813
4-Surveys (SME Finance Component)	90,000	0
5-Program / Project Implementation (CPMU)	799,000	103,422
6-Interest Charge	347,000	73,437
7-Unallocated	1,364,000	0
<b>Total</b>	<b>12,501,000</b>	<b>3,373,685</b>

#### 4. Program and Project Schedules

Item	Appraisal Estimate	Actual
<b>Loan 2066 (¥)</b>		
First tranche release	upon loan effectiveness	23 July 2004
Incentive tranche release	within 7 months of first tranche release	27 June 2005
Second tranche release	by 30 June 2005	21 December 2006
Third tranche release	by 31 December 2006	27 June 2008

#### Loan 2067 (SDR)

Item	Appraisal Estimate <sup>a</sup>		Actual	
	Start	Completion	Start	Completion
Date of Contract with Consultants			4 April 2005	21 January 2009
Training and Seminars			10 June 2005	30 June 2009 <sup>b</sup>
Business Support Fund			12 September 2005	30 June 2009 <sup>b</sup>
Surveys			2 January 2006	30 June 2009 <sup>b</sup>
Program/Project Implementation			14 November 2006	30 June 2009 <sup>b</sup>
Equipment and Materials			17 December 2005	30 June 2009 <sup>b</sup>

<sup>a</sup> RRP has no procurement plan.

<sup>b</sup> Completion date indicated was as of original Project closing date. Dates may still vary as Project financial accounts are still open as of PCR preparation.

#### 5. Program Performance Report Ratings

Implementation Period	Ratings	
	Development Objectives	Implementation Progress
<b>Loan 2066</b>		
From 31 December 2003 to 30 June 2005	Satisfactory	Satisfactory
From 01 July 2005 to 31 December 2008	Highly Satisfactory	Satisfactory
<b>Loan 2067</b>		
From 31 December 2003 to 30 June 2005	Satisfactory	Satisfactory
From 01 July 2005 to 31 December 2006	High Satisfactory	Satisfactory
From 01 January 2007 to 31 October 2008	High Satisfactory	Unsatisfactory
From 01 November 2008 to 30 September 2009	Highly Satisfactory	Satisfactory

#### D. Data on Asian Development Bank Missions

Name of Mission	Date	No. of Persons	No. of Person -Days	Specialization of Members <sup>a</sup>
Loan Fact-finding	19 May to 4 June 2003	2	34	a, c
Loan Pre-Appraisal <sup>c</sup>	15 Sep to 4 Oct 2003			
Loan Negotiations	17-19 Nov 2003	4	12	a, b, c, d
Inception Mission	13-23 Sep 2004	2	22	e, f
Loan Review Mission 1 <sup>d</sup>	13-18 Dec 2004	2	12	e, f
Loan Review Mission 2 <sup>d</sup>	13-27 Apr 2005	3	45	e, f, g
Loan Review Mission 3 <sup>d</sup>	28 June to 5 July 2005	3	24	e, c
Loan Review Mission 4 <sup>d</sup>	29 Aug to 13 Sep 2005	2	32	e, f
Loan Review Mission 5	16-22 March 2006	3	21	e, f
Loan Review Mission 6	9-17 May 2006	2	18	e, f
Loan Review Mission 7 <sup>d</sup>	30 Mar to 12 Apr 2008	2	28	h, i
Loan Review Mission 7	27 Aug to 3 Sep 2008	1	8	h
Loan Review Mission 7	17 Jun to 5 Jul 2009	3	34	h, i, j

<sup>a</sup> a = financial sector specialist, b = principal country programs specialist, c = counsel, d = senior financial control specialist, e = senior financial sector specialist, f = investment officer, g = principal procurement specialist, h = economist (financial sector), i = assistant project analyst, j = assistant disbursement analyst

<sup>b</sup> Mission details not available

<sup>c</sup> Vice-President (Operations 1) approved on 24 October 2003 the upgrading of the Pre-Appraisal Mission to Appraisal Mission.

<sup>d</sup> The Pakistan Resident Mission provided support to the missions in the field.

Note: Between May 2008 and June 2009, consultations with project staff were held on various occasions in the context of review missions for other projects.

## I. PROGRAM AND PROJECT DESCRIPTION

1. The Small and Medium Enterprise Sector Development Program (SMESDP) was approved by the Board of Directors of the Asian Development Bank (ADB) on 19 December 2003<sup>1</sup> to improve the contribution of small and medium-size enterprises (SMEs) to economic growth, employment, and poverty reduction in Pakistan. The Program's objectives were to be achieved through reforms, investments, and innovative initiatives. The Program had three main policy areas (Appendix 1): (i) improving the SME policy environment; (ii) improving market-based SME access to business development services (BDS); and (iii) improving market-based access to and delivery of SME finance.

2. The SMESDP comprised four sets of inputs and activities:

- (i) a policy loan of the equivalent of \$152 million from ADB's ordinary capital resources;<sup>2</sup>
- (ii) a project loan of SDR12.5 million that covered three subprojects to support SME and labor policy formulation and implementation, market development of SME business services (the Business Support Fund), and market development of SME finance;
- (iii) a partial credit guarantee facility of \$65 million through ADB's private sector operations to leverage market-based financing of SMEs; and
- (iv) a technical assistance (TA) grant of \$0.25 million to support coordination of the program.

3. The SMESDP became effective on 5 July 2004, 6 months after its approval and was completed last 30 June 2009. The original financial closing date was 30 September 2009. The policy loan, equivalent to \$152 million at the time of appraisal, was fully disbursed in four tranches between late July 2004 and late June 2008. Of the SDR12.5 million project loan, about SDR4 million was canceled in 2007 as part of the overall review of the Pakistan portfolio. Of the remaining SDR8.5 million, only SDR3.5 million, or less than 30% of the original loan amount, had been disbursed at the time this project completion report (PCR) was prepared in December 2009. The financial accounts of the project loan were still open at the time of PCR preparation, pending resolution of various payment issues. This PCR will cover only the policy loan and the project loan. Even though Project Administration Instruction (PAI) 6.07A, para. 14, stipulates that only one PCR is prepared for multi-sector and sector loans, a separate PCR for the PCG component will be prepared by ADB 12 to 24 months after completion.<sup>3</sup>

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<sup>1</sup> ADB. 2003. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Pakistan for the Small and Medium Enterprise Sector Development Program*. Manila (Loan no. 2066-PAK, for ¥16,436.52 billion [\$152 million equivalent]), approved on 19 December).

<sup>2</sup> The policy loan was to be released in three core tranches and one incentive tranche. The first two core tranches and the incentive tranche have been released, with each providing \$30 million of support. The first core tranche was released on 23 July 2004. The incentive tranche was released on 26 June 2005. The second core tranche was released on 19 December 2006. The third core tranche, equivalent to ¥6.6 billion, was released in June 2008. As the loan is denominated in yen, the amount of the third core tranche is ¥6,622,187,400.

<sup>3</sup> According to PAI 6.07A, "commencing a PCR based on the ADB loan closing date may not be appropriate. The whole project, and not just ADB disbursements, must be either complete or significantly complete." The same PAI 6.07A, para. 2, also states PCRs "are usually prepared 12–24 months after project completion." In para. 4 it says "the overall must be at a stage that permits the PCR Mission to determine if the immediate objectives (purpose) of the project have been achieved or are likely to be achieved".

## II. EVALUATION OF DESIGN AND IMPLEMENTATION

	Activity	Performance Indicators and Targets	Performance		Relevance of Design and Formulation	Efficiency in Achieving Outcome and Outputs	Effectiveness in Achieving Impact	Preliminary Assessment of Sustainability
<b>Policy Output 1: Improve SME Policy Environment</b>	KRA 1.1 Develop SME Policy	- Task force prepares SME policy in consultative process by June 2005. - Government implements SME policy	Fully Satisfactory	Partly Satisfactory	Relevant	Less Efficient	Less Effective	Generally Sustainable
	KRA 1.2 Establish Effective Labor Protection and Inspection Policies	- Task force established to develop LPP and LIP (October 2003) - Government issues LPP and LIP, and commences implementation (June 2005) - Government revises LPP and LIP parts of the Factories Act (December 2006)	Fully Satisfactory					
	KRA 1.3 Enhance SMEDA's Effectiveness and Outreach to SMEs	- SMEDA to (i) assume policy advisory and facilitator role, (ii) establish effective internal controls, (iii) perform in accordance with performance benchmarks and BP, (iv) approve and revise business rules (June 2005), (v) publish business registration and licensing guidelines in Urdu (June 2005), (vi) establish SME database (December 2006) and conduct sample surveys for policy impact analysis, (vii) prepare BP and SOP for CFC program (June 2004), and (viii) perform consistent with its BP and CFC BP and performance benchmarks.	Partly Satisfactory					
<b>Policy Output 2: Improve Market-Based SMA Access to BDS</b>	KRA 2 Enhance SME Competitiveness Through Private Sector Services	- MOF to select private sector establishment committee for SME BSF finalizing of (i) memorandum of articles for incorporation for BSF, and (ii) BP and SOP for BSF board - BSF established (June 2004) - BSF to perform consistent with the BP and SOP semiannual reviews, starting June 2005	Satisfactory					
<b>Policy Output 3: Improve Market-Based Access to and Delivery of SME Finance</b>	KRA 3.1 Improve Regulatory and Credit Information Infrastructure and Build Private FI Capacity	- Regulations for SME and consumer finance - SBP effectively lender of last resort to SME Bank - Improved credit information system (December 2006) - Feasibility study on secured transactions (June 2005)	Fully Satisfactory	Satisfactory				
	KRA 3.2 Restructure and Privatize SME Bank	- SME Bank implements agreed restructuring plan. - SME Bank implements agreed privatization plan. - Number of FIs and volume of credit to SMEs - Delivery of courses in SME finance	Partly Satisfactory					

BDS = business development services, BP = Business Plan, BSF = Business Support Fund, CFC = common facility center, FI = financial institution, KRA = key result area, LIP = labor inspection policy, LPP = labor protection policy, MOF = Ministry of Finance, SBP = State Bank of Pakistan, SME = small and medium enterprise, SMEDA = Small and Medium Enterprise Development, SOP = Standard Operating Procedures.

Source: Staff's Analysis

## A. Relevance of Design and Formulation

4. The SMESDP comprised reform components across very different policy areas. Most of these components were *relevant* both at appraisal and completion to Pakistan's development challenges. ADB's engagement through the program was justified in two ways. It was timely. Structural reforms initiated in 1997 had put the economy on a path of economic expansion and fast urbanization and, given that SMEs accounted for 80% of urban employment, their ability to absorb labor and contribute to growth had increased. Secondly, the SMEs could not fulfill this role without additional support to develop their potential.<sup>4</sup> Previous government policy to promote SMEs had been ineffective. The program remained *relevant* at the time this PCR was completed.

5. The government's 10-year development plan for 2001-2011, its National Medium-Term Priority Framework for 2007–2010, and its Poverty Reduction Strategy Paper II (PRSP-II)<sup>5</sup> all designated the promotion and development of SMEs as a key area of public policy intervention. However, they lacked policy implementation frameworks to achieve that objective. In this sense, the SMESDP objectives were and continue to be consistent with both ADB's country partnership strategies and government development plans. As intended, the Program helped fill this policy-making void and paved the way for the government's SME Policy 2007.

6. The Program design comprised reform components or outputs that benefit SMEs and have significant economy-wide effects. Labor policy reforms, for example, are good for all businesses, not only SMEs.<sup>6</sup> Other components supported broad national reform agendas, including the development of credit information-sharing institutions, which is an important step in building up Pakistan's banking sector. Most program components benefited from lessons from previous experience; in the case of innovative components such as BSF and guarantees, cross-country experience was embedded in the design. Some of these are discussed below under the result areas of the three policy outputs. Appendix 2 presents a detailed output-by-output assessment of the policy areas and the Program's result areas.

## B. Program and Project Outputs

### 1. Policy Output 1: Improve SME Policy Environment

7. The SMESDP was designed to address long-standing weaknesses in institutions and policies that restricted the SMEs' ability to benefit from Pakistan's opening up to international trade. Areas of stakeholder-identified constraints included labor relations, the taxation framework, trade capacity, and access to finance and credit markets. The SMESDP recognized these as chronic problems that previous reform attempts had failed to solve, mostly due to poor coordination between ministries. An extensive discussion of all activities is presented in Appendix 2. This policy output comprised the following key results areas:

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<sup>4</sup> The Pakistan economy grew rapidly from the late 1990s to the 2007. Privatization and fiscal consolidation enabled the government to increase development spending. This, coupled with gradual liberalization in trade and finance (including shifting the role of the state in banking from operator to regulator), had supposedly increased investment efficiency. The manufacturing sector was expanding, with acceleration in capital formation. Credit to the private sector was growing and so were exports. The spurt in economic growth helped lower public debt service and government debt–gross domestic product ratios.

<sup>5</sup> The first Poverty Reduction Strategy Paper also recognized this need.

<sup>6</sup> Clear and effective labor market rules that produce orderly and cooperative collective bargaining practices have been crucial to successful industrialization in other developing countries.

**a. Key Result Area (KRA) 1.1: Develop SME Policy.** During the preparation of the SMESDP the Government emphasized that to coordinate reform efforts from various ministries it was crucial to establish a high-level policy document to convey a common policy vision for SME development. It was also recognized that the drafting of this vision would have to benefit from extensive stakeholder feedback. Thus, in the context of the preparatory work for the SMESDP and of its implementation, the Government initiated a wide stakeholder consultation process, designed an SME Policy and initiated its implementation. The explicit expectation in all this work was that all agencies involved in SME-related activities would use this policy statement to guide their plans and policy efforts. The Small and Medium Enterprise Development Agency (SMEDA), aside from undertaking the analytical work necessary for future evaluation of policy actions, was given the role of monitoring the SME policy implementation, and of reporting on it through an SME annual report. The SME Policy has become a widely recognized policy document in Pakistan, and its implementation has generally been sustained throughout the Program and later. The performance of the SMESDP under this KRA was highly satisfactory.

**b. KRA 1.2: Establish Effective Labor Protection and Inspection Policies.** During the preparation of the SMESDP, abuse of power in labor inspections was identified as one of the significant impediments to SMEs. The enforcement of nontransparent and rigid labor rules was a perceived root cause of significant rent-seeking in the economy. Labor laws were significantly outdated prior to the SMESDP. Previous efforts to modernize and streamline rules and inspection procedures had no success. That state-of-affairs in labor legislation basically had both parties to employment relations worse off. Employers would see regulations as obstacles in organizing production. On the other hand, workers regarded the limitations imposed in labor laws as the only means of protection against employer misconduct. Through the SMESDP, the Government initiated a very challenging and long-term reform path (with a timeframe that would likely go beyond the completion of the SMESDP) focusing on effective enforcement of much clearer labor rules, and through that way build flexible, but stable, labor relations in Pakistan. The result of this effort was the production of a labor protection policy (LPP), and a labor inspection policy (LIP). Both were approved by the Prime Minister and became effective on 31 August 2006. The LPP conveys a clear understanding of the purpose of labor protection, and of its positive impact on labor productivity. The new LIP (based on the LPP) is meant to help constrain labor inspectors and curb the abuse of power that was pervasive in Pakistan. One important aspect of labor protection reform that was explicitly included in the SMESDP had, however, already been implemented in June 2006: the 1936 Factories Act was amended at that date, through the Finance Act (2006), incorporating overtime-related aspects of the LPP. Most importantly, this amendment enabled a large part of the manufacturing sector, especially whose activities were intensive in female labor, to operate various shifts under the condition that transportation facilities are made available. Beyond the immediate targets of the SMESDP, the Project loan further supported the MOL in funding studies that explored a range of related issues. These have contributed to building recognition for a concrete approach to address the hugely important challenge of reducing the complexity of labor laws in Pakistan (and resulting compliance costs), and as a result the Government embarked on a wide range of legislative work. Taking into consideration the performance targets set out for this KRA, and the sequence of additional reform initiatives set in motion, progress in this KRA has been highly satisfactory.

**c. KRA 1.3: Enhance SMEDA's Effectiveness and Outreach to SMEs.**

Although SMEDA obtained status as an authority in August 2002, the SMEDA Ordinance in effect limited the institutional development of SMEDA. As envisaged in the SMESDP, SMEDA revised its business and administration rules, which was effective in positioning SMEDA in a firm policy advisory, development, and coordination function of SME support activities. SMEDA's first 5-year business plan was approved in December 2005. Since 2006, SMEDA's activities are guided by these annual business plans, and are reported in detail through its annual reports. The content of these annual business plans has continued to reflect the intention of reforms supported in the SMESDP to (i) enhance SMEDA's focus on policy advice, and to (ii) limit its direct provision of BDS to SMEs only in those regions where potential private sector service provision is absent. The specific role of monitoring the implementation of the SME Policy enhances SMEDA's leadership in policy advice, and complements its other related functions. Under the SMESDP, SMEDA established an SME database and undertook a baseline survey scientifically sampled on the Census of Economic Establishments from the Federal Bureau of Statistics. Since the creation of this database, SMEDA regularly undertakes sector analyses. The survey exercise is to be repeated every 2 years using appropriate resampling methodologies. The intertemporal benchmarking of results will enable assessments of the impact of the SME Policy and other policy interventions on business conditions for SMEs. As SMEDA significantly increased its profile in policymaking and knowledge dissemination, its previously assigned role of extending direct BDS outreach to SMEs through common facility centers (CFCs) was transferred by the Government to the Technical Upgradation and Skill Development Company (TUSDEC). This was consistent with SMEDA's refocus on SME policy development, and supported by the SMESDP. MOF and ADB requested from TUSDEC a business plan and Standard Operating Procedures (SOPs) for the CFC program. These were proposed in September 2006, upon which the MOF approved funding for the CFC feasibility studies. The CFC business plan laid out a sequencing of steps to establish four centers with financial and physical facilities in already established clusters (geographic agglomerations) of SMEs, whereby (i) one CFC project would be established and resourced first; (ii) one project management unit (PMU) would be set up for the four CFC projects, in parallel with the first project; and (iii) detailed feasibility assessments would be done for the other CFCs, incorporating lessons from the first CFC. But as of October 2009, only one of the four planned CFC projects — the Ceramics Development and Training Complex — had been established. Proposals on three other CFCs are still being discussed by the Planning Commission and the Ministry of Finance. This is a substantial and serious delay that puts at risk the completion of this activity altogether. The lack of satisfactory implementation of the CFC Program puts at risk the objectives of this key results area, on which the SMESDP is rated only partly satisfactory.

**2. Policy Output 2: Improve Market-Based Small and Medium Enterprise Access to Business Development Services**

8. The SMESDP was designed on the premise that establishing a dynamic, unsubsidized, market for private BDS was a proven tool that could help enterprises in Pakistan become more competitive. During the project preparatory technical assistance stage, stakeholders emphasized that BDS were used only infrequently by SMEs in Pakistan because they were a novelty in a management culture dominated by family-run businesses. They reported that most SMEs were not aware of the need for BDS or of its potential benefits, or were reluctant to invest in services of unproven value, or felt that their needs were not matched by the services

available. Providers were limited and appeared to have difficulty signaling the quality of their work. Activities under this component are discussed in Appendix 2. This policy output comprised the following KRA:

**a. KRA 2: Enhance SME Competitiveness Through Private Sector Services.** Under the SMESDP, the SME Business Support Fund (BSF) was established to jump-start the BDS market, under section 42 of the Companies Ordinance Act of 1984. The Project Loan was budgeted to (i) support the establishment of the BSF through consulting services, and (ii) provide the funds for a cost-sharing grant facility and BSF's operating expenses for 60 months. The BSF was conceptualized as a financial support scheme to assist SMEs in accessing BDS of their choice, including a large variety of knowledge services outsourced. The SME BSF was made subject to independent performance audits. SMEs were required to submit proposals to SME BSF, which would then be evaluated on a first come, first served basis. Recruitment of BSF staff and operations could only start in April 2006 and the BSF's management team implemented throughout 2007 the necessary work to (i) operationalize the BSF concept, and (ii) overcome initial delays caused by the difficult start-up referred to above. Given the Government's and ADB's focus on ensuring discipline in portfolio administration, the closing date of the Project Loan could not be changed; this in effect reduced the implementation period of the BSF to 38 months. The Performance Review of the BSF for FY2009 showed good progress in terms of the number of grant approvals and actual disbursements, and that instances on non compliance with SOPs and the business plan were reduced. The BSF operated broadly in line with its business plan and SOPs in the three fiscal years. In sum, the BSF rode the "learning curve" of how to operationalize a fairly practical mechanism for the delivery of BDS matching-grants in Pakistan, facing the challenge of being the first initiative of its kind in the country. Strictly on the basis of the performance indicators and targets in the Program Framework (Appendix 3), and considering the fact that the timeframe of the BSF component to achieve those was in effect reduced (due to initial delays in starting BSF operations) the SMESDP is rated satisfactory in this KRA.

### **3. Policy Output 3: Improve Market-Based Access to and Delivery of Small and Medium Enterprise Finance**

9. Access to long-term finance had long been seen as a prime obstacle to the development of SMEs in Pakistan. Although this view is common in policy discussions in the country, policy solutions have not always been laid out clearly. Some stakeholders put the blame on outreach problems or on the belief that existing informational and regulatory underpinnings of formal financial intermediation end up steering bank lending away from SMEs. This policy output area comprised two KRAs (all related activities are discussed in Appendix 3):

**a. KRA 3.1: Improve Regulatory and Credit Information Infrastructure and Build Private Financial Institutions' Capacity for SME Finance.** Since FY2004, the State Bank of Pakistan (SBP) undertook major reforms to support non collateral-based lending for SMEs and individuals by issuing prudential regulations for SME finance and consumer finance. Also, under the SMESDP, a public-private partnership solution was pursued to develop credit information sharing in Pakistan, which involved a revenue sharing system between SBP and the Pakistan Bankers' Association (PBA). Through this collaboration with the PBA, the Credit Information Bureau (CIB) facility was first made available online in 2003, through which participating banks and nonbanks could submit credit data and receive creditworthiness reports via dial-up internet

connection with CIB. In 2005, under the SMESDP, a new system was developed to allow the reporting period to be shortened to within 10 days from the date of due settlement. Also, the reporting threshold was eliminated by regulation, which resulted in the expansion of the coverage of the CIB to all bank exposures. A data-capturing software application had to be rolled out to all member banks and nonbanks in September 2005, involving new procedures on how to report the data to the enhanced CIB. Since May 2006, FIs in Pakistan have been able to generate separate credit information reports on consumer and corporate borrowers, irrespective of the size of outstanding amount of exposure. In the second tranche progress report of December 2006, it was recognized that the achievements under this KRA had exceeded original expectations by far. The performance of the SMESDP under this KRA is rated fully satisfactory.

**b. KRA 3.2: Restructure and Privatize SME Bank.** The SBP was a shareholder of the SME Bank until January 2005, and thereafter (upon divestiture to the MOF) it provided a number of special credit lines to this bank. It was thus perceived, *de facto*, to operate as a lender of first resort to the SME Bank. This was believed to affect the managerial effort within the SME Bank. Under the SMESDP, the Government agreed to restructure the SME Bank and bring it to an equal footing with other private commercial banks. A transaction committee was set up by the Privatization Commission in February 2006 to oversee the privatization of the SME Bank and recommend a party for prequalification. The Board of the Privatization Commission recommended in May 2006 the privatization of the SME Bank, and a specific privatization plan to bring the bank to the point of sale (i.e., public invitation of expressions of interest). In March 2007, as part of its restructuring plan in preparation for privatization, the SME Bank completed the settlement of all credit lines to SBP. This put an end to the special lender of first resort relationship between SBP and the SME Bank. Bidding was first targeted for June 2007 to coincide with the original closing date of the policy loan under SMESDP. However, this objective was not achieved as it became clear that further labor separation needs would impose additional costs to any potential buyer (as it had been originally factored in by the scope of the SMESDP). This made privatization less attractive, and the details of the proposed operation had to be reviewed. In 2008, the transaction committee submitted its recommendation for privatization of the SME Bank on “as is where is” basis for approval of the board of directors of the Privatization Commission. Also, both an information memorandum and a public information memorandum were produced. The first quarter of 2008 was targeted for a public invitation for expressions of interest. But because of the political uncertainty (and its effects on investor confidence), the timing for a bidding invitation was deemed inadequate. In April 2008, the new Government publicly announced the decision to include the SME Bank in its new privatization plan, and the Privatization Commission approved the recommendation from the transaction committee to bring the SME Bank immediately to the point of sale. Expressions of interest were publicly requested on 14 April 2008. This public invitation was placed in newspapers and posted on the PC website, together with a public information memorandum. A deadline for bids was set at 17 May 2008. This announcement was disseminated in the media and through the internet. The Privatization Commission received 19 expressions of interest, but not all met the pre-qualification criteria. A new invitation for bids was issued in the expectation that more reputable and qualified bidders could express interest in the SME Bank, but without success. As the process languished, and Pakistan began to face a macroeconomic crisis affecting investor confidence in the country's institutions and privatization deals in general, the prospects for finding a bank willing to take over ownership of the SME Bank

significantly reduced. As of end-2009, the SME Bank remains state-owned. Thus, even though the performance indicators and targets have been met under this KRA, the SMESDP is rated partly satisfactory, given that the scope of the SMESDP was explicit in the objective of achieving the privatization of the SME bank. However, from a sectoral viewpoint, SBP's active and non-distortionary role in promoting SME finance over the last 5 years should be recognized.

### **C. Program and Project Costs**

10. The program loan of \$152 million equivalent (¥16,436,520,000) to support policy reforms was fully disbursed by June 2008. The equivalent of \$12 million earmarked and covenanted in the loan agreement for the implementation of the CFC Program has yet to be used in full.

11. The project loan of SDR 12,401,000 (\$18 million at the end of 2003) equivalent was structured in three subprojects<sup>7</sup> to support implementation of the policies and institutional reforms designed under the program loan. Subproject 1 was to support formulation of SME policy and labor policy. About 80% of the SDR 332,000 resources under Subproject 1 were disbursed. Subproject 2 to promote market-based development for SME BDS through the SME BSF was allocated SDR 4,730,000 to be disbursed during a 60-month implementation period. It is important to emphasize that the disbursement goals became a moving target because allocation under Subproject 2 was denominated in SDRs. In December 2004, the allocation of 4,730,000 SDR in this component was equivalent to PRs 432,171,399. In mid-November 2009, it was equivalent to PRs 630,496,651, an increase of 45%. At the end of the project, ADB has disbursed only 42% of the originally intended funds, corresponding to 38 months of implementation, i.e., 63% of the originally envisaged implementation period. If pending claims are accepted by ADB, which is itself dependent on the conclusions of the ongoing performance audit, this could rise substantially.

12. Subproject 3 supported market-based development for SME finance, including (i) regulatory policy development, credit information, and capacity building for financial institutions; and (ii) SME Bank restructuring. For Subproject 3, the original allocation was SDR 4,929,000 million, most intended to fund capacity development activities of financial institutions. Only SDR 925,318 was utilized and SDR 3,999,235 was cancelled in early 2009. SBP implemented Subproject 3. It established an SME department to carry out the tasks under this component. Its major achievements were (i) organizing a conference on SME financing issues and strategy to create awareness among bankers, the financial community, and stakeholders of SME financing needs and to introduce international best practices in SME financing, and (ii) conducting training and capacity building workshops.

### **D. Program and Project Disbursements and Schedule**

13. The program loan was released in four tranches, including one incentive tranche between the first and the second tranche. The first and the incentive tranches of \$30 million equivalent each (¥3,244,050,000 each) were released on 23 July 2004 and 27 June 2005, respectively. The incentive tranche was delayed by 3 months by an extended negotiation process for a large consulting contract that included recruitment of the head of the SME business unit of SME Bank. The second tranche of \$30 million was released on 21 December

<sup>7</sup> For purposes of this PCR, Subproject 1 comprise the following loan categories: 1A, 2A, 1B, and 2B. Subproject 2 comprise loan categories 1C, 3A, 3B, and #b, while Subproject 3 includes loan categories 1E, 1D, 2D, and 4.

2006, delayed by almost a year, because of the numerous challenges encountered by the government in beginning operations of the CFC program, the SME BSF, and the Board approval of the SMEDA business plan. The release of the third and final tranche of \$61 million in June 2008 marked the completion of reforms supported under the program loan, with full compliance of nine tranche release conditions, substantial compliance with one tranche release condition, and waiver of one pending third tranche release condition that related to the audit of the CFC program. This was accompanied by an assurance that ADB would continue conducting appraisals on the implementation of the CFC program and by a government commitment to implement it in full. The loan agreement stipulates that \$12 million equivalent from the second and third tranches would be specifically allocated and transferred to TUSDEC for the CFC program (para. 20 of the loan agreement). Thus far, only about \$3 million has been transferred. The lack of progress under this component was raised as a serious concern when the third tranche release was processed in June 2008.

14. The project loan was to be implemented over 5 years, beginning in July 2004 and ending in June 2009. Subproject 2 of the project loan suffered delays at inception, including a bad start due to poor performance by the first international facility manager hired. Because a second international consultant had to be engaged and an operation plan conceived and proposed for the BSF, this subproject only began implementation in April 2006, 22 months late. The BSF activity called for a slow, careful start to disbursement so that all internal and due diligence systems could be developed and tested. To avoid systematic malpractice and abuse, it also required constant refinement of approval processes, internal governance in due diligence and identification, and even a form of accreditation of BDS providers and of applicable normal BDS rates to reduce chances for collusion between SMEs and BDS providers.

15. Procedural and documentary requirements for SME applications also had to be adapted to the Pakistan context. Performance audits and subsequent recommendations were expected to play a crucial role in this process. As conceptualized, the BSF management was supposed to learn much about how a matching-grant facility for BDS should operate in Pakistan. This, however, is a process that generally takes a few years of operations and annual performance audits are crucial to this learning process. As a result of delays and these many constraints, ADB disbursed only 42% of the funds allocated under Subproject 2 in a truncated period of actual operations of only 38 months.

## **E. Implementation Arrangements**

16. The Ministry of Finance (MOF) was the executing agency and was in charge of the core program management unit (CPMU). The implementing agencies were (i) the Ministry of Industries and Production, (ii) SMEDA, (iii) the Ministry of Labor, (iv) the BSF, (v) the SBP, and (vi) SME Bank. The CPMU was responsible for overall program planning, coordination, monitoring of sector-specific policy reforms, report milestones, and carry out financial management procedures like disbursements. The CPMU was also expected to do what was necessary to bring implementation problems to the attention of higher authorities to speed decision-making and resolution. The CPMU was thus required to champion a wide scope of objectives in challenging areas of reform.

17. The CPMU comprised of the program and project director, manager, finance manager, and utility staff. The director had overall responsibility for implementing the SMESDP, providing guidance on the implementation of the institutional development component, and ensuring conformity with the action plan and the project's policy framework. The manager was responsible for project management, contract administration, and consultant supervision. Major

tasks included (i) overall project planning and supervision of implementation; (ii) timely recruitment of consultants; (iii) supervision of contracts, contract management, and loan administration; (iv) supervision of the monitoring, evaluation, and reporting process; (v) ensuring compliance with ADB's policies, procedures, and guidelines; and (vi) ensuring compliance with the loan covenants.

18. Awarding the role of executing agency to the MOF proved to be a design mistake, however, particularly because most of the reform challenges were to be tackled by agencies of the Ministry of Industries (SMEDA and TUSDEC), the Ministry of Labor, or State Bank of Pakistan. The ownership potential was clearly with these agencies, not the MOF. A high turnover of project directors in the CPMU made it difficult for MOF to coordinate or even remain conversant with the many different areas of work under what was a complex program. Communication between agencies in the different ministries and the CPMU was never effective enough to overcome implementation challenges. The high-level coordination bodies established in the SMESDP to monitor its reform agenda very seldom met. In fact, the last such meeting was in 2006. Ownership varied considerably between the CPMU's succession of project directors. In 2008 and 2009, without any support or intervention from the project director, several agencies had to deploy their efforts with Pakistan's Planning Commission, which is not one of the program's implementing agencies, or directly with the MOF. Much the delay that afflicted the CFC program resulted from repeated misunderstanding and a lack of proper information sharing between MOF and the Planning Commission on the real source (i.e. the Program loan proceeds) and the utilization of funds. TUSDEC repeatedly emphasized, correctly, that the funds had already been disbursed in full by ADB to the government but the project director was far less active in clarifying these issues than the stakeholders of the CFC program would have liked.

19. By design, the SMESDP left most of the procurement and disbursements rules that should apply to the SME BSF undefined, due to the novelty of the initiative. This led to a long period of project implementation without any claims or withdrawal applications being presented. This component was in effect using resources disbursed to the government, budgeted against resources previously sourced from the program loan. The first claim related to funding of the "matching-grants" scheme of the BSF that was presented to ADB by the CPMU in August 2008, more than 2 years after start of operations.

## **F. Conditions and Covenants**

20. The program and project loan agreements were signed on 10 February 2004 and became effective on 5 July 2004. The government generally complied with the loan covenants set out at appraisal (see Appendix 4). The program included 33 policy actions. Nine policy actions were complied with at the time of loan approval, 2 actions were specified as conditions for the incentive tranche release, and the second and third tranches included 11 policy actions each. Overall, 31 actions were fully complied with, one was substantially complied with, and one was waived. The status of compliance with SMESDP loan covenants is in Appendix 4. Generally, the CPMU and the implementing agencies failed in the timely submission of audited accounts reports to ADB as per the Loan Agreement (schedule 5, para. 23).

## **G. Related Technical Assistance**

21. A TA grant for the equivalent of \$250,000 from the ADB-funded TA program was approved to support improving the business environment for SMEs. This included developing an SME policy, improving the integration of SMEs into the formal economy, and developing the

labor protection and inspection policies. The TA became effective on 28 January 2004 for a 4-year period and closed on the original closing date of 31 December 2008. Cumulative disbursements as of 31 December 2008 were \$58,358, representing a disbursement rate of 23.34%. Although disbursements from these allocations were low due to the delay in mobilizing the consultants, the TA managed to undertake a few key activities on a more conservative budget than originally estimated.

## H. Consultant Recruitment and Procurement

22. The project loan allowed for the financing of 203.5 person-months of international and 231 person-months of domestic consultancy by the MOF, SME Bank, the BSF, SMEDA, and the SBP. The project manager of the CPMU was a domestic consultant hired to provide 48 person-months of service between July 2005 and June 2009. Consultants were recruited by ADB and the borrower according to ADB's *Guidelines on the Use of Consultants* and other arrangements for recruitment of national consultants acceptable to ADB.

23. The lack of orientation and training of the CPMU staff and implementing agencies on ADB's procurement and disbursement guidelines, practices, and procedures was a significant hurdle in project implementation.

24. Procurement-related issues were a major difficulty. While a Project Administration Memorandum (PAM) was drafted during the Program inception mission, it was never utilized effectively. The PAM could have helped the implementing agencies and the CPMU more constructively. Lack of basic knowledge about procurement rules and how to present withdrawal applications to ADB to replenish the imprest account severely hurt implementation—and especially disbursement—until the end of the project. This was aggravated by the lack of financial management capacity that was repeatedly illustrated by the CPMU. As a result of these factors, the inability of the implementing agency to carry out procurement and meet ADB's disbursement rules and regulations continued into the last year of the program, as did errors and mistakes in filing withdrawal applications, which required abnormally high levels of support from the ADB resident mission.

25. During most of the project loan implementation, very few claims were made for some of the SMESDP components, the BSF being a good example. Activities were funded by direct use of the initial advances to the various imprest accounts set up at program inception or by budget allocations made available by MOF and approved at the beginning of each fiscal year on the basis of proposals (budget of activities) from the CPMU. The latter referred to various tranche releases under the program loan as a justification for the budget allocation.

## I. Performance of Consultants

26. The overall performance of the consultants performance is rated *partly satisfactory*. The first international consultant for Subproject 2 was unable to design the component in a way that mobilized the SMEDA, the MOF, and the Ministry of Industries and his contract was terminated. The second international expert was much more successful at jump-starting this initiative. On the other hand, little progress was achieved under Subproject 3. The consulting firm, Bankademie, was hired to implement capacity building activities for financial institutions but failed to conceptualize training modules that could effectively mobilize the interest of SME financiers. As a result, momentum was lost. The domestic consultant hired to be the project manager implemented the terms of reference satisfactorily. This included becoming the BSF

manager on an interim basis when that was required. Feedback from the different implementing agencies indicates that this manager was generally supportive and helpful.

#### **J. Performance of the Borrower and the Executing Agency**

27. The performance of the borrower and of the executing agency was *partly satisfactory*. This is mainly because they failed at crucial moments for the program in 2008 and 2009 to coordinate activities, keep up the momentum for reforms, or support the efforts of implementing agencies. An example illustrates the problem. Despite the interest and ownership demonstrated by TUSDEC, the implementing agency of the CFC Program, and despite the fact that funds have been provided to the government through the second and third tranches of the program loan, TUSDEC has received only a portion of necessary program funds. As a result, only one of the four CFC projects has been established. This is a significant setback for the program loan's objectives.

28. The breach in the loan agreement that the CFC Program delays created were raised several times formally and informally from June 2008 onwards, but not much progress was made. Several agencies have had to deploy their efforts during 2008 and 2009 directly with the Planning Commission (not an implementing agency of the SMESDP) or MOF without any support or intervention of the Program Director of CPMU. A significant part of the delays in the CFC Program was simply due to the lack of proper understanding and misinformation on the source and use of funds. The CPMU could have been far more active in resolving the problems.

29. The lack of orientation and training of the CPMU staff and implementing agencies on ADB's procurement and disbursement guidelines, practices, and procedures were a significant hurdle in the implementation of the Project. The implementing agencies (TUSDEC and SMEDA under the Ministry of Industries, and the SBP) have generally performed satisfactorily, and with clear signs of ownership.

#### **K. Performance of the Asian Development Bank**

30. As consultant selection, other procurement and withdrawal processes under this Program were fairly standard, there was no special orientation or training by ADB for the staff of CPMU, throughout the implementation of the SMESDP. This was a shortcoming on ADB's part, with hindsight. There was no follow-up by ADB on the use of the PAM, and in general, ADB's project administration and oversight were remote in nature. Much of the communication was formal in nature, and there was no working rapport established between ADB staff and the CPMU. There were long periods without a review mission.

31. The slow progress under the Project loan came under greater scrutiny as part of the Government-ADB joint effort to improve overall portfolio performance in Pakistan in late 2006-early 2007. The original closing dates were June 2008 for the program loan and June 2009 for the project loan. As the Project loan did not show satisfactory contract awards and disbursements against the lapsed time, ADB's recommendation to the Government was to partially cancel the Project loan. However, the ADB loan ledger did not reflect the real activity under SMESDP, to an extent that was beyond what is the norm in project loans. This was due to the significant delays in reporting and claiming expenditures by the implementing agencies and the miscategorization of disbursements. More regular and informal (i.e. email as opposed to the formal fax or written communication) exchanges as well as periodic review missions would have helped detect problems.

32. Further, some SMESDP components were innovative, for instance in the case of the BSF. The procurement and disbursements rules that would normally apply to the BSF were left undefined in the SMESDP due to the innovative nature of this component. This, however, was predicated on an assumption that the government and ADB would collaborate more closely during the Project implementation. The performance of the BSF component was weaker partly because the PAM for the loan was not utilized, which not only represented an implementation risk but also meant that the BSF or CPMU had no guidance on how to use the imprest account system. As a result, there were long periods of project implementation with no claims or withdrawal applications.

33. The BSF component for some time was using resources disbursed by the government, which were budgeted against funds previously sourced from the Program loan. Once discussions in July 2008 helped the CPMU realize this, the pace of presentation of withdrawal applications changed dramatically. More periodic follow-up and collaboration in 2005-2007 would have helped the implementing agencies.

34. ADB's performance in implementation is therefore rated *partly satisfactory*. It assumed that the executing and implementing agencies knew the general disbursement procedures, and did not take active ownership in the implementation of the Project. The unique nature of the BSF should have evoked greater interest in learning from its implementation. As a result of the interconnected reasons noted above, which resulted in a disconnect between the actual performance and reporting, ADB's focus was more on improving overall portfolio performance and not as much on helping the implementation of this specific Project. A more vocal and proactive role by the executing/implementing agencies could have helped. For instance, there have been other executing/implementing agencies of ADB-supported projects which took a far more active role in ensuring that their activities were supported during the joint portfolio improvement process.

### III. EVALUATION OF PERFORMANCE

#### A. Relevance

35. Both the scope and design of SMESDP are considered *relevant*. In general, the outputs that the SMESDP aimed to achieve are important to Pakistan's development goals. Most components have the potential to expand the access of Pakistani enterprises to a range of productive inputs like labor and finance. SMESDP supported government development strategies that seek to mitigate the disadvantages of small size or informality that most Pakistan enterprises face. But by attempting to achieve a very wide array of outputs across six very different and complex key results areas, the program and its implementation and coordination capacity were spread too thinly. In this way, it lost some of its overall relevance through its diminished ability to be effective in each of the chosen areas of reform.

36. The performance indicators and targets chosen to assist in measuring and evaluating whether the SMESDP is meeting or has met its ultimate goals, purpose, or objectives are less clear than the guidelines of the Design and Monitoring Framework currently requires them to be. For example, it's difficult to define exactly what private sector contribution to gross domestic product is or how an increase in the share of total value added in the economy that is generated by privately-owned enterprises would measure anything related to the 'Goal' of the SMESDP. A similar argument could be made about another performance indicator shown in Table 1: "government reduces fiscal risks through disengagement from ownership in financial institutions". These issues make it more difficult to ascertain the impact of the SMESDP. Thus,

in terms of evaluability, the SMESDP is also constrained by less than clearly defined impact and outcome objectives.

## **B. Effectiveness in Achieving Outcome**

37. Against the original indicators of effectiveness in achieving proposed outcomes, the SMESDP is rated *less effective*. In the Program Framework, the SMESDP's targeted outcomes were labeled "Purpose and Objectives" and measurable through two indicators: (i) "the export volume of exporters with annual turnover up to \$5 million" and (ii) the volume of lending from financial institutions to SMEs exceeds 25% of total loans provided in the economy. No concrete timeframe was provided, however. Considering a time lapse of only 5 years from loan effectiveness to this PCR, it is too soon to rate its effectiveness. In addition, the first indicator is not easily produced and its accuracy in measuring increases in SME competitiveness may be seriously impaired by composition effects. This is because the more competitive SMEs become the more of them would cross the annual turnover threshold of \$5 million and cease to be considered by the indicator. Highly competitive SMEs would not be included in the indicator's measurements precisely because their competitiveness would have greatly improved. In any case, no institution in Pakistan compiles this indicator.

38. From September 2004 to March 2008, the percentage of loans originated by credit institutions in Pakistan to SMEs has oscillated between 17% and 15% of the total outstanding. At the end of first quarter of 2009, outstanding credit to SMEs credit stood at Rs. 349.1 billion, which is about 11.5% of the total credit of the banking industry. The SBP attributes this decline to rising inflation, tight monetary policy, power outages, a credit crunch, and nonperforming loans. All these disproportionately damage the creditworthiness of SMEs and bank interest in lending to them. In the last two years, Pakistan's economy has undergone a macroeconomic crisis triggered by rapid capital outflows and misadjusted exchange-rate levels, followed by the international economic slowdown. The credit origination of Pakistan banks naturally suffered from this financing distress, which may have disrupted their ventures into SME finance. At the end of March 2009, the banking sector had 217,662 SME borrowers, about 4.7% of the total. This represents a slight increase over March 2006.

## **C. Efficiency in Achieving Outcome and Outputs**

39. The SMESDP was *less efficient* in achieving its outcomes. The discussion above emphasized that the SMESDP was less effective in achieving its proposed outcome, as benchmarked against the performance indicators and targets originally set in design. The resources mobilized under the SMESDP combined a number of components that are, in nature, institutional reforms, and thus not suitable for the typical financial analyses that underpin efficiency assessments in investment projects.

40. The concrete outputs that the SMESDP aimed to achieve can be presented in three main policy areas and six key result areas (KRAs):

- **Policy Output Area 1.** Improve SME policy environment, which includes developing SME policy (KRA 1.1), establishing effective labor protection and inspection policies (KRA 1.2), and enhancing SMEDA's effectiveness and outreach to SMEs (KRA 1.3).

- **Policy Output Area 2.** Improve market-based SME access to business development services, which comprises the enhancement of SME competitiveness through private sector services (KRA 2).
- **Policy Output Area 3.** Improve market-based access to and delivery of SME finance, which includes improving regulatory and credit information infrastructure and building private financial institution capacity (KRA 3.1), and restructuring and privatizing the SME Bank (KRA 3.2).

41. In Policy Output Area 1, the performance indicators and targets of KRA 1.1 and KRA 1.2 have all been achieved. The incomplete implementation of the CFC program puts the development objectives of KRA 1.3 at risk, despite the fact that the other indicators and targets were met. The performance of the SMESDP along this policy output area is only *partly satisfactory*.

42. The performance indicators and targets for the only KRA in Policy Output Area 2 have also been satisfactorily met. The original objective was for the performance audit reviews of the SOP to continue pushing the BSF management in the right direction but also to continue improving on those SOP. The discussions and assessments would have generated greater benefits had the BSF continued. But the initial delays in setting up the BSF cut the 60-month implementation period almost in half. The BSF did perform satisfactorily during the 38 months of implementation.

43. The performance in Policy Output Area 3 was *satisfactory*. All indicators and targets for KRA 3.1 were met early by the end of 2006.<sup>8</sup> Serious doubts were raised on performance in KRA 3.2 by the lack of an actual transaction, even though the restructuring and privatization plans of the SME Bank have been implemented in full and the SME Bank was brought to the point of sale by June 2008. The sale of SME Bank was not a performance indicator in the Program Framework but the expectation was implicit in the scope of the SMESDP and the resources made available through the program to make the bank a sustainable, market-based source of SME finance. This questions whether the SMESDP used all of its resources efficiently. The SMESDP decision-making process failed to explore all options available to overcome the most significant hurdle—the difficulties and costs in restructuring the skills of most of the employees inherited from the original merger. While the Program loan proceeds could have been used to pay for some of the pre-privatization costs (including labor separation), there were other competing fiscal priorities due to the emerging food and fuel crisis. These developments in tandem with the lack of progress in relation to the CFC program basically point to the conclusion that resources under the program loan were disbursed but not fully used for the intended purposes. The SMESDP was *less efficient* in achieving its outputs.

#### **D. Preliminary Assessment of Sustainability**

44. Most policy reforms undertaken through the policy loan should be *sustainable*, especially those in Policy Output Area 1. The exception would be the implementation of the CFC program. The government's industrial support systems and practices have revealed themselves inadequate to take such a complex effort forward, to coordinate decisions from different agencies, or even to keep communications open between ministries.

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<sup>8</sup> This included the completion of a study to strengthen the Secured Transactions Framework. The study aimed at enhancing the SMEs' access to formal financial intermediation by establishing a system of security interest creation on moveable and immovable assets for small borrowers in urban and rural areas. Based on the study, the necessary amendments in the legal framework have been suggested to the government.

45. In Policy Area 3, the standstill on the privatization of the SME Bank shows that the SMESDP reform efforts may never yield the intended benefits on KRA 3.2. On the other hand, the institutional reforms achieved at an early stage in implementation of KRA 3.1 have proven sustainable so far.

46. Combining policy reforms with what the project loan aimed to accomplish, however, would lower the sustainability rating of the overall program. It is unclear whether the government on its own will sustain the CFC or the BDS programs. Notwithstanding these challenges, the overall thrust of what the program intended to achieve, namely to facilitate the growth of SMEs, is likely to be *sustainable*.

## **E. Impact**

47. The "Goal" of the SMESDP Program Framework was to improve economic growth, employment, and poverty reduction. The only indicator set to assess the effectiveness in achieving impact ("Goal") that was clearly time-framed established that by 2011, with the contribution of the SMESDP, poverty rates would be reduced from 33% to 15%. Given that poverty rates were around 23% in 2005 at the end of latest period of high economic growth in Pakistan, this SMESDP target could have been attained had growth trends continued. But the last 3 years of economic distress have probably increased poverty rates. It is unlikely that a poverty rate of 15% will be achieved by 2011.

## **IV. OVERALL ASSESSMENT AND RECOMMENDATIONS**

### **A. Overall Assessment**

48. The SMESDP was generally implemented as designed, with three exceptions. The CFC program is not being implemented by the originally mandated implementing agency. By some measures only one quarter of the implementation framework has been achieved by the end of the SMESDP. The BSF suffered initial delays and for this reason did not benefit from the full 60 months of implementation originally envisaged. The plans to restructure and privatize the SME Bank were implemented in full till the point of sale, but the prospects of its privatization are uncertain at least until the macroeconomic challenges facing Pakistan are fully resolved.

49. Overall, the SMESDP is rated *partly successful* (Appendix 5), despite having achieved more than 80% of the output performance indicators and targets included in the Program Framework. While the program loan disbursed all of its tranches, the resources have not been used for the intended purposes either effectively or efficiently.

### **B. Lessons**

50. The scope of the SMESDP was wide and inputs from the program loan and project loan intertwined and cut across several areas of complex, challenging reforms. This risked spreading coordination capacity too thinly from the outset and imposed a steep learning curve on any entity attempting to administer the project administration. These risks ended up causing additional difficulties during implementation, and perhaps this wideness and complexity of scope should be avoided in future ADB operations.

51. Awarding the role of executing agency to the MOF was clearly a mistake in project design, since most of the activities were to be delivered by the Ministry of Industries, the Ministry of Labor, or the State Bank of Pakistan. The high turnover of project directors in the CPMU made it hard for the MOF to coordinate the many different work areas across the SMESDP. The communication lines between agencies of the ministries involved and the CPMU

were never effective in helping the implementing agencies overcome their many implementation challenges. The high-level coordination bodies established to monitor the SMESDP reform agenda seldom met. In the future, awarding of coordination roles to one of the various agencies involved in projects of this nature should be done based on ownership potential, as recognized during the preparatory work and design.

52. The lack of utilization of a PAM for the project led to implementation difficulties, particularly in disbursements. This was exacerbated by the insufficient financial management capacity in the CPMU. The inability of the implementing agencies to undertake procurement and meet ADB's disbursement rules and regulations continued into the last year of the program, as did errors and mistakes in filling withdrawal applications, which required abnormally high levels of support from the resident mission. The fact that, by design, the SMESDP left undefined most of the procurement and disbursements rules that should apply to the SME BSF component led to a long period of project implementation without any presentation of claims or withdrawal applications. This component was using resources disbursed to the government, budgeted against funds previously sourced from the program loan. One lesson is that undertaking a procurement risk assessment exercise during preparation of the SMESDP would have highlighted the potential for some of the problems highlighted above. Perhaps, a specific capacity development component dedicated to mitigate these risks could have been designed in response. But these problems are not only a result of an underestimation of procurement risks; by a significant measure they are also due to the lack of close project implementation and monitoring effort by ADB.

53. Due to changes between 2003 and 2006 at ADB, the responsibility for project administration was transferred across several departments in headquarters and back and forth between headquarters and the resident mission in Pakistan. The lack of review missions for most of 2006 and 2007, and lack of the informal, deeper, and frequent interaction that naturally develops once project officers mobilize on the ground to discuss implementation challenges with the respective agencies had a number of consequences:

(i) For most of the implementation period, the ADB loan ledger did not record the actual progress of the project or reflect the reality on the ground. Dedicated review missions would have detected the loan ledger deficiencies and would have helped improve project performance.

(ii) Most of the exchanges that occurred between the CPMU and the ADB were formal in nature and focused on disagreements in ledger records. These communications failed to clarify that substantial activity was actually underway on the project loan's biggest component, the SME BSF, even though ADB records showed zero for both contracts awarded and disbursements. The fact that there were substantial delays at inception of this component (the SME BSF) should have triggered a heightened attention in ADB project administration rather than less.

(iii) Subproject 3.2 on Regulatory Policy Development, Credit Information Development, and Capacity Building for Financial Institutions had shown very little progress from the start of implementation. When the contract with the consulting firm was cancelled due to lack of interest from financial institutions in the training packages, the effort lost momentum. In hindsight, the unutilized funds could have been cancelled right away. Instead, this significant contract remained active in the ADB loan ledger until late in 2008, and was recorded under the wrong subproject item (SME Bank Restructuring Support). The specific lesson learned here is that there is no substitute for review missions. If signs indicate that a loan or a component is likely to be unsuccessful,

ADB should dispatch a review mission to discuss the matter and, if agreed, take decisive action to cancel the unused portion of the loan.

54. Including the CFC program in the SMESDP as a component to be funded directly by intergovernmental transfers, indirectly sourced from several tranche releases of the program loan, tested whether the government's financial management and control systems could properly implement these activities. Instead of funding this program through a project modality, ADB aimed to harmonize its support with the government's system and thereby reduce the transaction costs associated with differences in procedural requirements. The SMESDP earmarked funds from the second and tranche for the CFC program and included design details as policy conditions in the program loan and as implementation milestones in the project loan to keep fiduciary risks and ensure original intentions and objectives were achieved. The second and the third tranches were disbursed but TUSDEC received only a portion of the funds from the MOF, with long delays and in a sporadic fashion. Only one of the four CFC projects had been established by the time this PCR was prepared. The breach in the loan agreement that these delays represent was raised several times formally and informally from June 2008 onwards but not much progress has been made.

### **C. Recommendations**

55. The innovative components of the SMESDP tested different project implementation solutions and were an attempt by ADB at more direct forms of policy intervention in industrial support. But if ADB is looking to support the Government of Pakistan in the future through lending modalities that go beyond the traditional list of policy reforms packaged in tranche releases, both the Government and ADB must first learn the lessons of SMESDP.

56. The degree to which a project's effectiveness depends on how decisive and sustained the implementation effort is should not be underestimated, irrespective of how well the project may have been designed. Review missions are even more important in bringing about the rapport and informal information exchange through emails or phone conversations that establish full, open, detailed communication that is so crucial to effective project administration. Much room exists for effective interaction with the implementing agencies even in missions for parallel projects.

57. The Project Performance Reporting system can be a good tool to identify problems in a portfolio of projects, especially low disbursements, and trigger the mobilization of additional implementation efforts or, at the least, project reviews. But portfolio cleanup efforts should not translate into the mechanical identification of cancellation candidates in a table of project entries (that conveys little about the real project situation on the ground) without a proper review. The implementation experience of the SMESDP should also be discussed in the context of the development of the PPR system.

#### **1. Program and Project Related**

58. **Timing of the Project and Program Performance Evaluation Report.** For an accurate evaluation of the impact of the SMESDP's components and allow the effects of the current macroeconomic crisis on indicators of impact and outcome to fade, a project performance audit report should be prepared in about 3-4 years from the time of this PCR. This audit should not be confined to the original indicators in the Program Framework.

**POLICY MATRIX FOR THE  
SMALL AND MEDIUM ENTERPRISE SECTOR DEVELOPMENT PROGRAM**

1 <sup>st</sup> and Incentive Tranche Conditions	1 and IT	2	3	Status at Tranche Release	Status as of June 2009 (with the information made available to ADB by the Government)
KRA 1.1: Develop SME Policy					
1. Government to establish task force including private sector stakeholders to develop SME Policy	x			The Government established a task force under the Ministry of Industries and Production. The task force represents line ministries and agencies at the federal and provincial levels, as well as the private sector. It met in April 2004 to establish 4 working committees in charge of developing draft policies for (i) business environment; (ii) access to resources and services; (iii) SME finance; and (iv) feedback, evaluation, and monitoring. Assisted by an international SME policy expert, the committees completed their assignments. SMEDA presented the assignments in regional seminars in January and February 2005, obtaining nationwide stakeholder feedback. Based on the feedback and international good practice, SMEDA drafted a modern SME law. The draft law was presented to high-level policy makers and approved in 2007. Economic Census finalized and published, on which SMEDA configured the SME Baseline Survey. SME Policy is under implementation, which is monitored by SMEDA. Annual reports on SME issues have been published in both English and Urdu.	Task-force members have seldom convened since the approval of the SME Policy.
2. Government to (i) submit detailed process and time bound action plan and resource plan for consultative preparation and implementation of SME policy; (ii) issue SME policy specifying the role of the private and public sector in SME development; and (iii) implement action and resource plan		x			SME Policy is under implementation, which is monitored by SMEDA.
3. Statistics Division of the Ministry of Economic Affairs and Statistics to publish Economic Census		x			Economic Census is being used for analytical exercises.
4. Government to implement SME policy in accordance with the priorities set out in the time bound action and resource plan, including publication of first annual report on SME development in Urdu			x		SME Policy is under implementation, which is monitored by SMEDA.
KRA 1.2: Establish Effective Labor Protection and Inspection Policies					
5. Government to notify in the public Gazette the constitution of a task force in the MOL, responsible for developing national LPP and LIP; and task force to endorse action plan for passage of the LPP and	x			MOL was mandated to prepare a labor protection policy and labor inspection policy to (i) promote business opportunities, (ii) enhance productivity, (iii) improve competitiveness, and (iv) ensure that workers	Complied with.

1 <sup>st</sup> and Incentive Tranche Conditions	1 and IT	2	3	Status at Tranche Release	Status as of June 2009 (with the information made available to ADB by the Government)
LIP				are adequately protected. On 26 September 2003, MOL established a task force to develop the policies for cabinet approval by June 2005. The task force was comprised of representatives from federal line ministries, provincial labor departments, Pakistan Employers' Federation, Pakistan Federation of Trade Unions, All Pakistan Federation of Labor, and Workers Employers Bilateral Council of Pakistan. MOL recruited an international labor policy expert to accelerate the work of the task force, which had been slowed by frequent changes of senior officials at MOL in 2004. To ensure effective stakeholder consultations, SMEDA supported MOL in further policy work.	
6. Cabinet to approve and publish LPP and subsequently LIP and to advise implementation by provincial governments		x			Complied with.
7. Task force to initiate awareness-raising workshops on LPP and LIP at the provincial level			x		Complied with. Feedback was instrumental in the launching of further studies.
8. Government to prepare a draft amendment to the Factories Act to reflect LPP and LIP as required, and Ministry of Law to have vetted draft amendment			x		Complied with. Factories Act was amended through the Finance Act of 2006.
<b>KRA 1.3: Enhance SMEDA's Effectiveness and Outreach to SMEs</b>					
9. SMEDA Board to appoint a full-time professional CEO and CEO to assume office	x			Established in 1998, SMEDA obtained the status of an authority in August 2002. However, the SMEDA ordinance conferred far-reaching powers upon its board, curtailing effective delegation of day-to-day management to the CEO. The Government agreed to review SMEDA's business rules and performance benchmarks to ensure effective delegation of powers to the CEO, as well as effective performance review. SMEDAs; full-time CEO assumed office on 8 October 2003. The CEO established the secretariat for the SME policy task force in February 2004, reaffirming SMEDA's SME policy advisory role. SMEDA made laws, regulations, and sector studies and review available in English. These outputs are being made available in the local language on SMEDA's website. In February 2004,	Complied with.
10. SMEDA to (i) prepare final draft of SMEDA's 5-year business plan; and (ii) establish in-house secretariat for SME policy task force	x				Complied with.
11. SMEDA Board to (i) approve business rules; (ii) revise business rules based on experience; (iii) approve SMEDA business plan; and (iv) approve 5-year business plan and standard operating procedure for Cluster Development-CFC Program		x			Complied with.
12. SMEDA to perform consistent with SMEDA and CFC business plans and meet benchmarks of both plans		x			The responsibility was transferred from SMEDA to TUSDEC. TUSDEC, however, failed to fulfill the CFC business plans due to lack of funding.
13. SMEDA to publish essential business registration and licensing guidelines in Urdu		x			Complied with.

1 <sup>st</sup> and Incentive Tranche Conditions	1 and IT	2	3	Status at Tranche Release	Status as of June 2009 (with the information made available to ADB by the Government)
14. SMEDA to establish (i) SME database and analysis based on results of Economic Census, and (ii) mechanism for periodic sample surveys to enable analysis of policy issues and measure impact of policy actions			x	SMEDA prepared a 5-year business plan which was presented to its board. The plan reflects SMEDA's enhanced focus on policy advice and limitation of BDS to SMEs, where the potential for a private sector service provider is absent.	Complied with.
15. Government, through Steering Committee, to conduct independent performance and financial audit of CFC Program by firm associated with international audit firm			x		Not complied with, as only one of the four CFCs has been implemented.
Policy Outcome 2: Improve Market-based SME Access to BDS					
KRA 2: Enhance SME Competitiveness Through Private Sector Services					
16. Government to constitute private sector led task force to establish the SME BSF for finalizing the memorandum and articles of association for incorporation under Section 42 of the Companies Ordinance, the business plan, and the SOP	x			SME identified a wide variety of areas for external support, including (i) marketing, market research, and market information; (ii) technical quality management, especially for exporters; (iii) technical processing; and (iv) strategic planning, which is impossible to anticipate for a public service provider. As services in the public sector are usually supply driven and lack professionalism, SMEs have an unmet demand for private, market-based services.	Complied with.
17. BSP to perform consistent with the business plan and SOP, approved by its board of directors upon incorporation		x		The BSF was incorporated on 21 April 2005. The private sector directs the company's board, holding six of the nine seats (with public sector representatives holding the 3 others). The international facility manager has been recruited, and began to work on 16 May 2005. The business plan and standard operating procedures were endorsed by the board.	Complied with.
18. Government, through Steering Committee, to conduct independent performance and financial audit of BSF by firm associated with international audit firm			x		Complied with.

1 <sup>st</sup> and Incentive Tranche Conditions	1 and IT	2	3	Status at Tranche Release	Status as of June 2009 (with the information made available to ADB by the Government)
Policy Outcome 3: Improve Market-based Access to and Delivery of SME Finance					
KRA 3.1: Improve Regulatory and Credit Information Infrastructure and Building Private FI Capacity					
19. SBP to issue prudential regulations for SME finance and consumer finance	x			SBP and the Government have made substantial progress in establishing a market-based financial system. This includes a systemic movement away from state-owned financial institutions and mandatory credit. With the privatization of Habib Bank and Allied Bank in 2004, the private sector now controls about 80% of banking system assets. Most of the development financial institutions, including SME Bank, are being restructured, privatized, or liquidated. Currently, Government-owned specialized banks control only 4% of banking system assets. During FY2004, SBP initiated major reforms in prudential regulations for SME finance and consumer finance to support noncollateral-based lending for SMEs and individuals. Credit to these two segments of the economy grew by 72% and 128%, respectively, while overall credit grew by 30% during the same period. The share of bank loans to the SME sector increased from 14% to 17%.	Complied with.
20. Agreement between Government, SBP, and SME Bank to terminate all SBP loans to and shareholding at SME Bank in the approved restructuring plan	x				Complied with.
21. SBP to have terminated equity participation in SME Bank	x				Complied with.
22. SBP to (i) review performance of FIs in SME Finance; (ii) revise prudential regulations if necessary; and (iii) conduct feasibility study and		x			Complied with.

1 <sup>st</sup> and Incentive Tranche Conditions	1 and IT	2	3	Status at Tranche Release	Status as of June 2009 (with the information made available to ADB by the Government)
prepare action plan for expanding outreach of credit information coverage to enterprises and individuals					
23. SBP to (i) conduct workshops/meetings to raise awareness among FIs on innovative approaches for SME finance; and (ii) assist FIs in building dedicated SME finance capacity		x			Not fully implemented, as there was no interest
24. SBP to initiate implementation of credit information action plan including roles for public and private sector based feasibility study			x		Complied with.
25. SBP to have become lender of last resort through full repayment of all SME Bank credit lines to SBP			x		Complied with.
KRA 3.2: Restructure and Private SME Bank					
26. Government and SME Bank Board to approve, in consultation with ADB, Restructuring Plan consistent with restructuring targets (including branch and staff reduction targets, results of the portfolio audit and agreement to sell SME Bank to the private sector)	x				Complied with.
27. SME Bank to (i) announce branch reduction plan consistent with restructuring targets, (ii) offer VSS to all regular staff, and (iii) repay First Tranche agreed amount to SBP to reduce SME Bank's liabilities	x				Complied with.
28. SME Bank to have implemented Restructuring Plan consistent with restructuring targets for (i) reduction of recovery branches, (ii) limitation of new business branches, (iii) completion of HR audit and reassignment of staff, (iv) limitation of number of nonregular staff, (v) rationalization of employment of regular staff,	x				Complied with, with the exception of the plans for rationalization of regular staff.

1 <sup>st</sup> and Incentive Tranche Conditions	1 and IT	2	3	Status at Tranche Release	Status as of June 2009 (with the information made available to ADB by the Government)
and (vi) appointment of the head of the SME business unit					
29. SME Bank to (i) have implemented Restructuring Plan consistent with restructuring targets; and (ii) repay Second Tranche agreed amount to SBP to reduce SME Bank's liabilities		x			Complied with.
30. Government to (i) prepare, approve and initiate implementation of SME Bank Privatization Plan; and (ii) conduct independent performance and financial audit of SME Bank by firm associated with international audit firms		x			Complied with.
31. Government to have followed sequencing and timing of the Privatization Plan to bring SME Bank to the point of sale			x		Complied with.
32. SME Bank to (i) have implemented Restructuring Plan consistent with restructuring targets; and (ii) repay Third Tranche agreed amount to SBP to fully repay SME Bank's liabilities to SBP			x		Complied with.
33. Government to ensure that an independent performance and financial audit of SME Bank is conducted by a firm associated with international audit firms			x		Complied with.

BSF = Business Support Fund, CEO = chief executive officer, CFC = Common Facility Center, FIs = financial institutions, HR = human resources, IT = Incentive Tranche, KRA = key result area, LIP = Labor Inspection Policy, LPP = Labor Protection Policy, MOL = Ministry of Labor, SBP = State Bank of Pakistan, SME = small and medium enterprise, SMEDA = Small and Medium enterprise Development Authority, SOP = standard operating procedure, VSS = Voluntary Separation Scheme., 1 = First Tranche, 2 = Second Tranche, 3 = Third Tranche  
Tranche Period: First and Incentive Tranche were from July 2004 to June 2005, Second Tranche were from June 2005 to December 2006, and the Third Tranche were from December 2006 to June 2008.  
Source: ADB and Government of the Islamic Republic of Pakistan.

## SMALL AND MEDIUM ENTERPRISE SECTOR DEVELOPMENT PROGRAM ACHIEVEMENTS AND KEY ISSUES DURING IMPLEMENTATION

1. The SMESDP comprises reform components across very different policy areas and most of its reform components were highly relevant to the development challenge of Pakistan, both at appraisal and completion. In at least two of its key result areas, the SMESDP opened up pathways of challenging reform work that is perceived to be key to the development challenge of the country for years to come.

2. Pakistan's business climate was in 2003 perceived to be a major deterrent of Pakistan's competitiveness and development of SMEs. It resulted in "*a combination of high labor costs, high capital intensity per worker, and low productivity*".<sup>1</sup> This feedback was confirmed in the extensive consultations that took place in preparation of the SMESDP, which identified a number of problematic issues: predatory practices of government officials in labor and tax inspections, poor enforcement of labor laws, poor access to and reliability of infrastructure services, and cumbersome import and export clearance procedures, etc. In proposing to take some of these problems on, the SMESDP aimed "*at filling an important gap in the strategic agenda of the Government and the ADB, complementing ADB's interventions in Pakistan in rural and microfinance and capital market development, and providing market-based access to services*".

3. One way to assess whether it was indeed crucial to develop and implement SME promotion policies in Pakistan through the SMESDP is to look at the international experience in this regard. Many governments around the developing World have indeed spent an increasing share of their budgets and policy efforts in a wide variety of initiatives to support SMEs. In the most clear and neutral of policy examples, common arguments tend to emphasize the disadvantage of firm size in dealing with problems that also affect larger economic agents. Normally, concrete challenges are identified as hindering SME's productivity and growth (like access to finance, or regulatory barriers), and specific policy efforts are in result devised to either (i) remove (or reduce the costs imposed by) those problems, or (ii) provide a specific parallel advantage to small scale firms (usually subsidized inputs, or tax treatment rules), hoping to in this way level the playing field. But in reality, in most public policy discussions, strong positions are conveyed both in favor and against SME support programs,<sup>2</sup> and there is usually very little clarity in way of policy conclusions.<sup>3</sup> It is simply very difficult to use documented international experience to ascertain whether a program of SME promotion policies, i.e. policy initiatives that aim to benefit SMEs more than large companies, was adequate to the current development challenge of Pakistan.

4. On the other hand, the specific design of the SMESDP comprises a number of reform components or outputs that can hardly be argued to benefit SMEs more than larger companies. For example, concrete labor policy reforms benefit all businesses in an economy, not only

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<sup>2</sup> Sometimes, it is argued that SMEs employ a large proportion of the population, and that because of that subsidizing SMEs will lead to increased rates of employment growth. Defenders of this position argue that SMEs are potentially more flexible, more dynamic and more productive than large firms, but significantly constrained by market failures. The counterargument is that the required policy responses generate distortions that affect the allocation of resources and productivity in the economy, and that there's plenty of scope for regulatory arbitrage (bigger enterprises splitting their production units into smaller formal units in order to benefit from whatever subsidized inputs result from the SME specific policies implemented by the Government).

<sup>3</sup> There is a wide diversity of policy initiatives around the World under the same label of SME policies or support programs despite little being known empirically about the effectiveness of SME support policies, or between size of enterprises and productivity, innovation, survival rates, employment growth or poverty reduction potential. It is now generally accepted that in many developing countries, SME policies are not properly monitored, and rigorous analyses of results are missing.

SMEs.<sup>4</sup> Some other components of the SMESDP can be justified in the context of key reform agendas in Pakistan, like the development of credit information sharing institutions, which is a key step in financial/banking sector development.<sup>5</sup> For this reason, it seems much more appropriate to ascertain the adequacy of the formulation process on an output by output basis. That's what the next section of this report does. In any case, most components of the SMESDP benefited from lessons extracted through previous experience (in the case of innovative components, cross-country experience is embedded in design), and these are discussed below according to the key result areas of each of the three policy output areas.

## A. Outputs

### 1. Policy Output 1: Improve SME Policy Environment

5. The SMESDP was designed to address long-standing weaknesses in institutions and policies that were perceived to constrain the ability of SMEs' to benefit from Pakistan's opening up to international trade. Stakeholders could identify these constraints at various levels, such as in labor relations, the taxation framework, trade capacity, and access to finance and credit markets. The SMESDP recognized though that these had been long-standing problems that past policy reform attempts had been able to address, in large part due to inter-ministerial coordination failures.

6. **Key Result Area (KRA) 1.1: Develop SME Policy.** During the preparation of the SMESDP the Government emphasized that to coordinate reform efforts from various ministries it was crucial to establish a high-level policy document to convey a common policy vision for SME development. It was also recognized that the drafting of this vision would have to benefit from extensive stakeholder feedback. Thus, in the context of the preparatory work for the SMESDP and of its implementation, the Government initiated a wide stakeholder consultation process, designed a SME Policy and initiated its implementation. An SME task force was created in 2004<sup>6</sup> with various working committees to define the SME policy core priorities for Pakistan and assign specific implementation roles to various ministries and Government agencies.<sup>7</sup>

7. The working committees were tasked to establish a common definition of SMEs, formulate counterbalancing measures to eliminate disadvantages of size imposed by the business environment, identify steps to remove unnecessary regulations, conceptualize SME public support mechanisms, improve support delivery mechanisms, and establish policy evaluation and review systems. Each working committee focused in one of the following core issues:

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<sup>4</sup> The establishment of clear and effective labor market rules that productive orderly and cooperative collective bargaining practices in an economy have been key ingredients in countries that successfully industrialized.

<sup>5</sup> Basically, asymmetric information problems are pervasive and particularly severe in credit transactions in developing economies like Pakistan, where borrowers usually lack collateral and credit histories. Developed credit information bureaus producing safe information (from a financial privacy regulation standpoint) as inputs to credit decisions in financial institutions are known to be low-cost institutional solutions to promote financial deepening in developing countries. This has been repeatedly verified empirically around the World, and can be safely argued to be a relevant policy bet in Pakistan as well.

<sup>6</sup> Notification No. 1(68)/2003-Inv-III of 29 January 2004 of the Ministry of Industries and Production.

<sup>7</sup> To address cross-cutting issues in the dialogue, the SME task force included major stakeholders from the private sector and diverse ministries and levels of government, and subdivided them into four working committees to carry out technical analyses and design proposals for the way ahead.

- (i) business environment—eliminating regulatory obstacles that impair SMEs' capacity to enter into formal markets in the Pakistan economy;
- (ii) access to finance—increasing SMEs' access to formal finance by addressing information problems that impair pricing of financial contracts in formal intermediation;<sup>8</sup>
- (iii) access to resources and services—improving the delivery mechanisms for assistance and the access to resources, business development services, qualified human resources, and technology; and
- (iv) SME monitoring and evaluation mechanisms—developing mechanisms to assess and monitor the effectiveness of assistance provided to SMEs.

8. Assisted by an international SME policy expert, the working committees completed their assignments in December 2004. The Small and Medium Enterprise Development Authority (SMEDA) presented the results in regional seminars. Based on the feedback and assisted by international expertise, SMEDA has prepared a modern SME policy and a modern SME Law, which were presented to senior policymakers in the beginning of August 2005.<sup>9</sup> The SME Policy was approved by the Prime-Minister, became effective on May 2006, and was approved by the federal cabinet in January 2007. It is publicly known as the SME Policy 2007 and it emphasizes the supportive role of the Government in promoting market-based growth of SMEs along three pillars: (i) market-based access to finance, skills, and entrepreneurship development; (ii) reduction of bureaucracy and red tape; and (iii) easier entry into the formal economy. The process undertaken to produce this policy framework was well sequenced and structured, and the content of the SME Policy is deemed to be very relevant. This also underpins the initial and clearly high levels of ownership signaled in policy circles.<sup>10</sup>

9. The explicit expectation in all this work was that all agencies involved in SME-related activities would use this policy statement to guide their plans and policy efforts. SMEDA, aside from undertaking the analytical work necessary for future evaluation of policy actions, has been given the role of monitoring the SME policy implementation, and of reporting on it through every year's SME annual report. The first SME development annual report was finalized and published in Urdu and in English in June 2008. It was meant to give an account, to SME policy stakeholders, of the "business conditions" that SMEs face. The latter was partly based on a SME baseline survey of 1,500 SMEs, which also constitutes a benchmark for all future impact evaluation exercises.<sup>11</sup> The SME Policy is a widely recognized policy reference in Pakistan, and currently under implementation.<sup>12</sup> The performance of the SMESDP under this KRA was very satisfactory.

<sup>8</sup> Among others, the question of lacking documentation and banks' technical capabilities to assess credit risk.

<sup>9</sup> The purpose of enacting the SME law was to reinforce the importance in implementing the content of the SME policy. The SME law was expected to be submitted to the Cabinet for approval after publication and dissemination of the SME policy. Although the passage of the law was not a condition under the SMESDP, it was an implementation milestone of the SMESDP that was repeatedly delayed. As of October 2009, the SME law has not been enacted.

<sup>10</sup> In terms of SME Policy implementation, the National Committee on Small & Medium Enterprises (NCSME) was established, with the minister of industries, production & special initiatives as chair. Members included the minister of state for economic affairs, the SBP governor, the chairman of the Central Board of Revenue, and selected private sector representatives. The first meeting of the NCSME was held on 15 August 2007 in Islamabad to formally launch the 2007 SME policy and initiate its implementation.

<sup>11</sup> The interviews were outsourced to a private firm (Gallup), and the SMEs are sampled based on the census of establishments published in 2005 by the Federal Bureau of Statistics (policy condition 4) using a comprehensive questionnaire.

<sup>12</sup> These reports were, however, never presented to the NCSME. The NCSME was expected to meet in June 2008, but this never happened. Given the currently high level of awareness in policy circles for the SME Policy and the wide recognition of the leadership of SMEDA in SME development issues, there may be no need for such an additional institutional structure like the NCSME.

10. **KRA 1.2: Establish Effective Labor Protection and Inspection Policies.** During the preparation of the SMESDP, abuse of power in labor inspections was identified as one of the significant impediments to SMEs. This did not only reinforce what several investment climate assessments to Pakistan had highlighted, but also gathered consensus amongst the stakeholders of the SMESDP. Basically, the enforcement of nontransparent (also a consequence of the complexity in labor legislation, which was said to be written in language that was not understood by a large part of the labor force and business owners) and rigid labor rules were a perceived root cause of significant rent-seeking in the economy. Labor laws were significantly outdated prior to the SMESDP. Previous efforts to modernize and streamline rules and inspection procedures had had no success.

11. That state-of-affairs in labor legislation basically had both parties to employment relations worse off. Employers would see regulations as obstacles in organizing production, arguing that dealing with all the regulatory limitations imposed in hiring, dealing (e.g. organization of production time) and firing workers absorbed a significant part of their effort and resources. On the other hand, workers regarded the limitations imposed in labor laws as the only means of protection against employer misconduct.

12. Preparatory discussions to the SMESDP recognized the benefits of basic labor standards for a good, and above all, productive work environment. That policy dialogue highlighted the importance of nurturing fair and stable working relationships to sustain increases in labor productivity and the profitability of enterprises over time. These benefits were not well understood in Pakistan's collective bargaining dialogue. Through the SMESDP, the Government tried to induce a consensus around the idea that the way forward in labor relations should not be about negotiating a balance between regulation and no regulation, or about adding more regulations to protect labor from employer misconduct. Instead, the SMESDP and the Government attempted to lay forward a very challenging and long-term reform path (with a timeframe that would likely go beyond the completion of the SMESDP) focusing on effective enforcement of much clearer labor rules, and through that way build flexible, but stable, labor relations in Pakistan. The objective of this effort under the SMESDP was to help formulate measures for less interventionist labor inspection measures (e.g., development of self-inspection), while protecting workers' interests through clearer labor protection rules.

13. A task force was created in September 2003 by the Ministry of Labor (MOL) to develop the policy framework in consultative mode.<sup>13</sup> MOL recruited an international expert and a domestic labor policy expert to facilitate the work of the task force.<sup>14</sup> The result of this effort was the production of a labor protection policy (LPP), and a labor inspection policy (LIP). Both were approved by the Prime Minister and became effective on 31 August 2006. The LPP conveys a clear understanding of the purpose of labor protection, and of its positive impact on labor productivity. The new LIP (based on the LPP) is meant to help constrain labor inspectors and curb the abuse of power that was pervasive in Pakistan. In this policy dialogue process, the task

<sup>13</sup> It comprised representatives from federal line ministries, provincial labor departments, Pakistan Employers Federation, Pakistan Federation of Trade Unions, All Pakistan Federation of Labor, and Workers Employers Bilateral Council of Pakistan. The task force, with support from SMEDA and labor policy experts recruited under the project loan, held wide-ranging consultations with stakeholders. Several workshops on the draft policies were held in the last quarter of 2005 in Islamabad, Karachi, Lahore, Peshawar, and Quetta.

<sup>14</sup> Delivering the LPP and LIP was a challenging process given the limited capacity at MOL. Strong support from SMEDA, labor policy experts, and the Ministry of Finance (MOF) from May 2005 onwards helped maintain the momentum of policy-making, by ensuring timely and effective stakeholder consultations, and assisting in the preparation of relevant policy issue papers, policy proposals and an action plan for implementing the policies in the provinces. Also, during implementation of the SMESDP in 2004 and 2005, several senior staff changes in the MOL imposed a significant delay in the implementation of the LPP and the LIP.

force was also given the function of evaluating the implementation of the LIP and LPP. Concrete implementation plans were approved in November 2007. One important aspect of labor protection reform that was explicitly included in the SMESDP had, however, already been implemented in June 2006: the 1936 Factories Act was amended at that date, through the Finance Act (2006), incorporating overtime-related aspects of the LPP. Most importantly, this amendment enabled a large part of the manufacturing sector, especially those activities intensive in female labor, to operate various shifts under the condition that transportation facilities are made available.

14. Beyond the immediate targets of the SMESDP, the Project loan further supported the MOL in funding studies that explored the following related issues: (a) linkages between working conditions and labour productivity; (b) linkages between living conditions and labour productivity; (c) establishment of a national labor relations institute. These have contributed to building recognition for a concrete approach to address the hugely important challenge of reducing the complexity of labor laws in Pakistan (and resulting compliance costs). As a result, the Government embarked on a wide range of key legislative work. For example, it drafted an Employment and Service Conditions bill that, upon enactment, will help bring Pakistan's legal framework into conformity with International Labour Organization conventions ratified by the Government. MOL, with support from the World Bank, also revised and repackaged 42 labor laws into six draft laws, which were submitted through the legislative process of Pakistan. These include the: (i) Industrial Relations Ordinance, which was submitted to the Cabinet in January 2006; (ii) Employment and Service Conditions Act (ESA), which has been under consideration by the Ministry of Law and Justice since January 2006; (iii) Occupational Safety and Health Act (OSHA), which is in the conceptual stage; (iv) Human Resource Development (HRD) Act; (v) Labor Welfare Act; and (vi) Social Securities Act.

15. The ESA and OSHA follow directly from the LPP and LIP. The expectation from the stakeholders of these reforms is that, as a result of these comprehensive revisions, the Factories Act, 1934 can be repealed altogether, as the reforms will be reflected in the ESA and OSHA. Concurrently, labor policy experts have prepared and communicated an implementation plan for introducing policy implementation in the provinces. Of the six laws listed above, Government's priority is focused on the first three.

16. The Government annulled the Industrial Relations Ordinance of 2002 and replaced it the Interim Industrial Relations law 2008 as an interim arrangement and with a sunset clause for March 2010. The sunset clause has in effect led the Government to focus its legislative efforts on this area of reform. The consultations with the stakeholders are about to be completed and the draft (drawing mostly on the draft submitted to the Cabinet in 2006) will then be sent to the Ministry of Law for vetting before submitting to the Parliament for approval. Naturally, the deadline is March/April 2010. The draft ESA and OSHA are now going through the last stages of consultation and comments are being incorporated. The process for the approval of the HRD Act was in the meantime interrupted, with the recognition for the need to establish a HR policy. A preliminary draft of this policy has already been finalized, but it will likely go through a long process of approvals, and in that way delay the enactment of the HRD Act. Taking into consideration the performance targets set out for this KRA, and the sequence of additional reform initiatives set in motion, progress in this KRA has been fully satisfactory.

17. **KRA 1.3: Enhance SMEDA's Effectiveness and Outreach to SMEs.** Although SMEDA obtained status as an authority in August 2002, the SMEDA ordinance provided far-reaching powers to its board, which included operational responsibilities. This in effect limited the day-to-day management of SMEDA's chief executive officer (CEO), and in this way the

institutional development of SMEDA. The appointment of a full-time professional CEO in October 2003 was thus a key milestone in the policy effort to improve the governance and business focus of SMEDA. As envisaged in the SMESDP, SMEDA revised its business and administration rules to ensure effective delegation of authority for day-to-day business to the CEO, which was effective in positioning SMEDA in a firm policy advisory, development, and coordination function.

18. SMEDA's first 5-year business plan was approved in December 2005. Since 2006 that SMEDA's activities are guided by these annual business plans, and are reported in detail through annual reports. The content of these annual business plans have continued to reflect the intention of reforms supported in the SMESDP to (i) enhance SMEDA's focus on policy advice, and to (ii) limit its direct provision of BDS to SMEs only in those regions where potential private sector service provision is absent. The specific role of monitoring the implementation of the SME Policy enhances SMEDA's leadership in policy advice, but also complements its other related functions. In concrete, aside from undertaking the analytical work necessary for future evaluation of policy actions in support of SME development, SMEDA also undertakes some direct interventions along the other thematic areas of the SME policy, like being the deliberate focal point for SME feedback, addressing issues of access to finance and related services, or SMEs' access to business development resources. The Report on SMEs in Urdu has been published.

19. In 2008, SMEDA developed project proposals on SME Promotion Council, Institute of SMEs, and Entrepreneurship Development Institute, which have been finalized and submitted to the Government for funding. One information gap that the SMESDP and the Government recognized from the onset to be a problem and a constraint on effective policy design efforts, was the absence of comprehensive statistics on SMEs. Data on Pakistan SMEs, collected in a systematic manner and that could be used for more in-depth analysis simply did not exist. In those circumstances, it was very difficult for policy institutions to understand the sector-specific, or size-specific, institutional difficulties that constrained SMEs, guide outreach efforts, or evaluate over time the impact of interventions to support SMEs. But although the SMESDP recognized the urgency in developing an SME database that could be used for monitoring and evaluation purposes, one crucial constraint had to be overcome: there was no extensive database of business establishments in order to adjust SME surveys and sampling exercises to.<sup>15</sup>

20. On 23 May 2006, the Statistics Division of the Ministry of Economic Affairs and Statistics published the economic census for 2005,<sup>16</sup> which provided a consistent base for further data collection exercises on SMEs. Under the SMESDP, SMEDA established an SME database and undertook a baseline survey scientifically sampled on the Census of Economic Establishments from the Federal Bureau of Statistics. This survey comprises information from a representative sample of 1,500 manufacturing, trade, and services firms (with a focus on women entrepreneurs) located in 18 districts across the country. The database has information on the age of SMEs, size of each workforce, investments with and without including land and building, and sales revenue. Since the creation of the database, SMEDA regularly undertakes sector analyses that use this and other sources of information.<sup>17</sup> The survey exercise is to be repeated

<sup>15</sup> The last comprehensive survey of enterprises had been undertaken in 1980s.

<sup>16</sup> Ministry of Economic Affairs and Statistics, Government of Pakistan. 2006. *Economic Census for 2005*. City of Islamabad. URL. The census is available at [http://www.statpak.gov.pk/depts/fbs/publications/ec\\_2005/ec\\_2005.html](http://www.statpak.gov.pk/depts/fbs/publications/ec_2005/ec_2005.html)

<sup>17</sup> For example, detailed sector strategies for enhancing competitiveness have been prepared for seven priority sectors based on the institutional knowledge acquired through the survey, which basically helped to better understand the operational concerns of SMEs across sector of economic activity.

every 2 years using appropriate resampling methodologies. For example, a new survey will be conducted in 2010. The intertemporal benchmarking of results will enable assessments of the impact of the SME Policy and other policy interventions on business conditions for SMEs.

21. As SMEDA significantly increased its profile in policymaking and knowledge dissemination, its previously assigned role of extending direct BDS outreach to SMEs through common facility centers (CFCs) was, on 5 December 2005, transferred by the Government to the Technical Upgradation and Skill Development Company (TUSDEC). TUSDEC is a subsidiary of the Pakistan Industrial Development Corporation of the Ministry of Industry, with headquarters in Lahore. This transfer of policy role was justified with the fact that TUSDEC's mandate on technology and skills upgrading fit in better with the CFC concept. This policy decision was indeed consistent with SMEDA's refocus on SME policy development, and in that sense implicitly supported by ADB. This also implied that TUSDEC was deemed more mandated than SMEDA to coordinate the implementation of the CFC program supported under the SMESDP. ADB explicitly accepted this change in implementation arrangements in the SMESDP.

22. MOF and ADB requested from TUSDEC a business plan and SOPs for the CFC program. These were proposed in September 2006, upon which the MOF approved funding for the CFC feasibility studies. It was made clear at that time that further Government commitment would depend on the merits of each proposal, based on the cost and risk-sharing arrangements to be entered into by participating SMEs. It was thus agreed that this assessment would be made through the PC-1 scrutiny process of the Planning Commission. At the beginning of the SMESDP the Government had no experience in setting up such facilities. Hence, given the risks involved in a CFC investment, ADB explicitly supported MOF's cautious approach of scrutinizing the merits of each proposal presented, as the December 2006 Board progress report for the policy loan made explicit (para. 23). The CFC business plan laid out a sequencing of steps to establish four centers with financial and physical facilities in already established clusters (geographic agglomerations) of SMEs, whereby (i) one CFC project would be established and resourced first; (ii) one project management unit (PMU) would be set up for the four CFC projects, in parallel with the first project; and (iii) detailed feasibility assessments would be done for the other CFCs, incorporating lessons from the first CFC. The CFCs were conceptualized to provide targeted process and technology-related services technologies, training and skills development services, and other specialized services<sup>18</sup> Initial capital investment costs were excluded from financial sustainability calculations as they are funded in large part by the Policy Loan. All CFCs are supposed to collect fees in exchange for the services rendered to SMEs, so that at the end of 4 years of operation they can breakeven operationally.

23. TUSDEC's commitment to implement the CFC program was repeatedly demonstrated throughout the project, but on top of the initial delays in approving and transferring funds to the first CFC<sup>19</sup> the Government took a long time to approve the remain three CFCs. In the first half of 2008, at the time that ADB was processing the release of the third (and final) tranche of the Policy Loan (1<sup>st</sup> half of 2008), the Government gave an assurance that the remaining 3 CFCs

<sup>18</sup> Like production input and output testing and inspection services.

<sup>19</sup> The inception of the CFC program was first delayed for two reasons. One, the changes in implementing agency and arrangements triggered a second round of fiduciary due diligence before any transfer of funds could be contemplated. This, coupled with the loss of implementation momentum caused by the high turnover of project directors at the CPMU, led to a long delay in transferring any resources to TUSDEC for the Ceramics Development and Training Complex. Two, MOF and ADB had requested from TUSDEC a business plan and SOPs for the CFC program that were only finalized in September 2006. Only at that stage (end-2006) did the MOF approve funding for the CFC feasibility studies.

would still be approved during FY2008 and requested ADB to waive the policy condition related to this CFC component. The policy condition required the "*Government, through Steering Committee, to conduct independent performance and financial audit of CFC Program by firm associated with international audit firm*". This policy condition had naturally not been complied with by May 2008 and ADB agreed that conducting independent performance and financial audits of the CFC program would be meaningful only after one or two CFCs had been established and operational for at least a year. Hence, ADB waived this policy condition.

**Table 1: Common Facilities Center Program Original Targets**

<b>Time Frame<sup>a</sup></b>	<b>CFC Project Design</b>	<b>Actual Setup</b>
Year – 1 (FY2007)	1	—
Year – 2 (FY2008)	3	1
Year – 3 (FY2009)	—	2
Year – 4 (FY2010)	—	1

CFC = common facilities center.

<sup>a</sup> The fiscal year ends on 30 June.

24. The Government remained confident that the initial delays in approving and transferring the funds to the first CFC had provided valuable implementation lesson and assured ADB that there was no conceptual or legal difficulty with the CFC program. There was therefore a clear expectation that the Government would continue to implement the CFC Program, in the timeframe envisaged by the CFC Implementation Plan, and that ADB would continue monitoring these activities, requesting the independence performance audits, etc.<sup>20</sup> But as of October 2009, only one of the four planned CFC projects—the Ceramics Development and Training Complex—has been established. Proposals on three other CFCs are still being discussed by the Planning Commission and the Ministry of Finance. This is a substantial and serious delay that puts at risk the completion of this activity altogether.

25. Furthermore, the PC recently decided to disapprove the PC-1s for the remaining three CFCs. This is a serious setback, even though, as reported, such decision was not related to any failure in meeting the technical criteria of the PC-1 process. Instead, the Planning Commission raised the possibility that ADB could decide to finance other project with the same funds. TUSDEC requested ADB's clarification on the subject. ADB clarified that even though the Policy Loan had closed in June 2008 with the third and final tranche release, this was done through waiver on the policy condition related to the CFC Program, which was conditional on

<sup>20</sup> The Loan Agreement is explicit: "Para. 20. The Counterpart Funds generated by the proceeds of the Loan shall be used to provide budgetary support for SME sector development as follows: (i) upon release of the First Tranche, for the repayment of SME Bank liabilities to SBP; (ii) upon release of the Incentive Tranche, (A) for the repayment of SME Bank liabilities to SBP and (B) for the cost of SME Bank staff separation packages, including VSS and the human resources audit; and (iii) upon release of each of the Second Tranche and the Third Tranche, (A) for the repayment of SME Bank liabilities to SBP, (B) for the cost of SME Bank staff separation packages, including VSS, and (C) in each case up to \$6,000,000 equivalent for the CFC Program..."

the Government's fulfillment of its commitment to continue implementing the CFC program.<sup>21</sup> The lack of satisfactory implementation of the CFC Program puts at risk the objectives of this key results area, on which the SMESDP is rated only partly satisfactory.

## **2. Policy Output 2: Improve Market-Based Small and Medium Enterprise Access to Business Development Services**

26. The SMESDP was anchored on the premise that the establishment of a dynamic and unsubsidized market for the type of specific private services commonly labeled as "business development services" would allow enterprises in Pakistan to become more competitive. It was explicitly highlighted in the RRP that BDS are a proven tool to enhance the competitiveness of enterprises. Stakeholders during the PPTA phase emphasized that it was key for SMEs to be able to outsource key BDS, so that their managers' time can be focused on the core business, and better cope with the fast-changing external economic realities that are better understood by specialists. The generally low usage of BDS by SMEs in Pakistan was attributed to the novelty of the concept in a management culture that is dominated by family-run businesses.

27. Most SMEs were said to not be aware of the need for BDS or of its potential benefits, and that as a result were reluctant to invest in services of unproven value. In addition, SMEs felt that their needs were not matched by the available supply of BDS. With a limited number of providers and the possible difficulties in establishing mechanisms to signal quality of service, the available BDS providers were not considered to be responsive to SME needs. There seemed to simply too much risk involved in SMEs outsourcing tasks to BDS providers, too much information asymmetry.

28. **KRA 2: Enhance SME Competitiveness Through Private Sector Services.** A SME Business Support Fund (BSF), to be technically and financially supported by the SMESDP, was set up in April 2005 by the Ministry of Finance, under section 42 of the Companies Ordinance Act of 1984, with the objective of developing the BDS market in Pakistan. The Project Loan was budgeted to (i) support the establishment of the BSF through consulting services, and (ii) provide the funds for the cost-sharing grant facility and operating expenses for 60 months. Under the SMESDP, the Government developed a business plan, established standard operating procedures, advertised the position of international and domestic managers and selected these in a competitive process. The BSF was conceptualized as a financial support scheme to assist SMEs in accessing BDS of their choice, including a large variety of knowledge services outsourced. The Government selected a high-powered professional board with a majority of representation (six of nine members) from the private sector to oversee the SME BSF. The SME BSF was also made subject to independent performance audits.

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<sup>21</sup> As reflected in tranche release Board Report in Para 31: "(...) although the delays in organizing the first CFC have affected the design of the remaining three CFC projects, the Government is confident that this delay in approving and transferring the funds to the first CFC has resulted in learning valuable lessons. The remaining CFCs, once approved during FY2008, will be set up according to a timeline. Therefore, conducting independent performance and financial audits of the CFC program will be meaningful only after one or two CFCs have been established and operational for at least a year. Hence, policy condition 5 is not complied with. However, as explained above, there is now no conceptual or legal difficulty with the CFC program per se. Hence, the reform agenda set out in the program will continue to be implemented with respect to supporting SMEs." And in page 15: "(...) The Government has not complied with the remaining action on the CFC program. As outlined in paras. 27–31, there is no policy or legal impediment that is holding up the CFC program. The Government needs more time to evaluate the CFC proposals and transfer funds for the establishment of the three pending CFCs. This delay will not affect the development objectives of the SMESDP."

29. Most BDS that could enhance SME's productivity, market understanding, and access to finance were meant to be eligible for the BSF. The grants were not meant to cover capital expenditure, working capital, or recurrent expenditures. The objective was for BDS services to be customized by private sector providers to meet the needs of SMEs.<sup>22</sup> SMEs were requested to submit proposals to SME BSF, which would then be evaluated on a first come, first served basis. There was no sectoral or explicit geographical focus in the BSF design, neither there was a specific type of BDS being targeted. As a consequence of the BSFs eligibility criteria, only about 500,000 firms in Pakistan could apply to matching-grants facility. This target segment of 500,000 SMEs represents about 16% of the more than 3 Million SMEs of the economy. But with the resources allocated to the BSF, only about 1900 firms could be reached directly, which represents 0.06% of all firms in the economy. This implies that there was very little potential for direct effects from the beginning, and that implementation of this component should have strategized to focus on producing demonstration effects instead.

30. On 15 May 2005, an international BSF manager commenced his assignment, but his performance was deemed to be poor. This manager resigned in September of the same year, and another internationally experienced manager was identified (all this was done on a competitive process, emphasizing the need to select experts with experience in this type of initiatives in other countries), but which only assumed his position on 15 January 2006. Recruitment of BSF staff and operations could only start in April 2006 and as a result of these delays in kick starting the BSF, it took a lot longer to establish a track record of operation that could be sufficient for evaluation during the various 2006 ADB reviews of the SMESDP. Due to the new manager's lack of working experience in Pakistan, and the novelty of the concept of matching-grants in the country, it naturally took a large period of time to adapt internationally-proven practices to the business context in Pakistan. The related 2<sup>nd</sup> tranche policy conditions of the Policy Loan were thus waived and the second tranche released in November 2006.

31. The BSF's new management team implemented throughout 2007 the necessary work to (i) operationalize the BSF concept, and (ii) overcome initial delays caused by the difficult start referred to above. Given that the closing date of the Project Loan would not be changed, the implementation period of the BSF had in effect been reduced to 38 months. Crucial work was done to effectively devise internal due diligence procedures and controls that could reduce the risks of collusion between SMEs and BDS providers, but not restrict altogether the access to the facility for the SMEs that genuinely planned to invest in BDS. Much of this effort entailed the adaptation of practices from international experience of this sort onto the Pakistan reality, which unavoidably was done through trial and error, and constant fine-tuning of operational routines (like reception of applications, appraisals, approvals and disbursements).

32. The BSF's performance audit, undertaken by a private audit firm for the period ending 30 June 2007, was submitted to the CPMU on 31 March 2008.<sup>23</sup> As of that date, 332 projects had received support, with about 40% of beneficiaries being exporters. Information technology consulting accounted for 31% of services requested from the BSF. This performance audit undertaken in March 2008 found that these efforts were allowing the BSF to catch up with

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<sup>22</sup> Eligible Services could be, for example, the development of business plans, improvement of production processes, identification of markets, development of marketing practices, and improvement of the quality of products and services.

<sup>23</sup> The financial audit of the BSF for the fiscal year of 2007 was completed by Riaz Ahmad & Company, a firm associated with Nexia International, a worldwide network of independent auditors, business advisers, and consultants.

the initial outreach targets,<sup>24</sup> but also made observations about compliance with the SOPs. The latter were discussed with the BSF management and recommendations for updating these SOPs and improving operating systems were made by the auditor. The BSF was tasked to take them in consideration.

33. The Performance Review of the BSF for FY2009 showed good progress in terms of the number of grant approvals (increased by 1.14 times in 2009 and 3.5 times in 2008) and actual approvals (increased by 1.76 times in 2009 and 2.28 times in 2008). Also, the approved grants ratio of actual to target increased from 41% in 2007/2008 to 63% in 2008/2009 and from 44% to 99% in terms of number of grants. Instances on non compliance with Standard Operating Procedures (SOP) and Business Plan (BP) were reduced, and BSF's overall performance in this regard improved when compared to the previous year. This is a positive indication of BSF's commitment to improving their standards and services.

**Table 2: Performance Risk Matrix**

	Year ended June 2009	Year ended June 2008
High	6	2
Medium	8	12
Low	0	3

Source: BSF Performance Audit Reports for the Years Ended 30 June 2009 and 30 June 2008. BDO Ebrahim & Co. Chartered Accountants.

34. On BSF's compliance with the SOP and BP, the audit firm prepared a matrix highlighting the degree of risk associated in accomplishing their tasks, which is reproduced above (see table 4). No cases under the low risk category were reported for the fiscal year of 2009, but some cases of high and medium risk were. The six remarks in the high risk category were: (1) in 7 projects (out of 749 cases reviewed by the performance audit), the security deposit differed from the amount strictly prescribed by the SOP; (2) during FY2009, two causal vacancies occurred in the audit committee which remained vacant till year end; (3) in 12 projects, the files did not comprise the Facility Visit Report; (4) in 2 projects, the discrepancies in positions between the CEO and the CFO were not documented in the proposal presented to the Appraisal Committee; (5) in 3 projects, the SMEs initiated the activities before BSF approval of the matching-grant; (6) one resolution made at the 12<sup>th</sup> BOD meeting requesting Clause 52 of the SOP to be amended so that "Financial Controller" can be read as "Financial Controller/Finance Manager" had not been made.

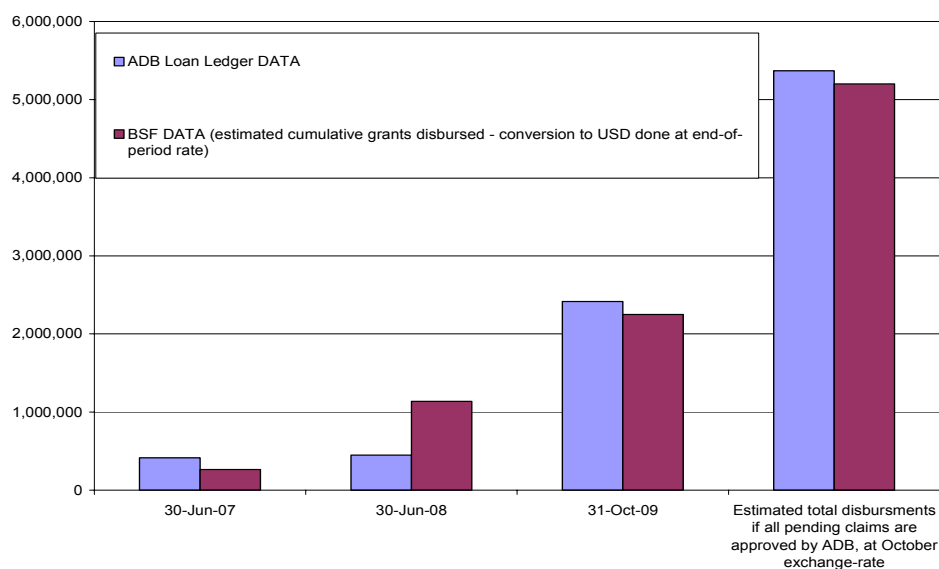
35. The latter are mostly related to the completeness of BSF's internal records and documentary methodologies. These can and were supposed to be improved over the 60 months implementation period. The observations raised by the audit firm were much similar to observations raised and discussed during ADB reviews in July 2009. But overall, no significant findings would merit further investigation, and the BSF operated broadly in line with the BP and SOP in the three fiscal years it operated. But in addition, there seems to be scope for further improvement of the SOPs. As referred above, this subproject only started its implementation in April 2006, i.e. 22 months after the original starting date, and for the initial stages of work there

<sup>24</sup> As described in the tranche release Board Report of June 2008, "...from 1 July 2006 to 30 June 2007, the total amount of grants approved was only 47% of the target, while the number of grants approved was 38% of the target. However, as of 15 March 2008, the cumulative amount of grants approved was 93% of the initial target, and the number of approved grants had reached 85% of the target. The recovery in the performance of disbursements is also noteworthy. For example, the BSF on 30 June 2007 had disbursed only 7% of the initially planned number of grants, but by 15 March 2008 this figure had risen to 90%."

was little disbursement activity to learn from, which was an expected feature of this component of the Project Loan. Indeed, the nature of this activity imposes a careful and slow disbursement start until all internal and due diligence systems can be tested and improved. To avoid systematic malpractice and abuse, this component requires a further and constant refinement of approval processes, internal governance in due diligence and identification (in this case even some sort of "accreditation") of (i) BDS providers, and (ii) applicable ("normal") BDS rates (to reduce chances of collusion between SME and BDS provider).

36. Because procedural and documentary requirements for SME applications had to be adapted to the Pakistan context, the performance audits and subsequent recommendations were expected to play a crucial role in improvements. This was one of the ways the BSF management was supposed to learn about how, in Pakistan, a "matching-grant" facility for BDS needs to operate in order to efficiently achieve its objectives. For this learning process, 5 years of operations and annual performance audits were crucial. It is important to emphasize that because the total allocation under Subproject 2 was denominated in SDRs, the disbursement targets were also somewhat of a moving target. In December 2004, the allocation of 4,730,000 SDR in this component was equivalent to PRs 432,171,399. In mid-November 2009, it was equivalent to PRs 630,496,651 (an increase of 45%). In any case, in 38 months of actual operations (63% of the intended implementation period) ADB disbursed 42% of the SDR funds allocated under this component. This figure can still become 80%, if the pending claims are accepted by the ADB. This itself depends on the final discussions within ADB on the results of the performance audit just undertaken.

**Figure A3: Business Support Fund Activity**



Source: ADB records and staff estimates, and BSF records

37. In sum, the BSF rode the "learning curve" of how to operationalize a "conduit" for the delivery of BDS matching-grants in Pakistan, facing the challenge of being the first initiative of its kind in the country. Strictly on the basis of the performance indicators and targets in the Program Framework, and considering the fact that the timeframe of the BSF component to achieve those was in effect reduced (due to initial delays in starting BSF operations) the

SMESDP is rated satisfactory in this KRA. The RRP of the SMESDP highlighted in the temporary nature of the scheme because the objective was to "jump-start the BDS market". But the Government is exploring other funding options to allow the BSF to continue the operation and at least complete the 60 months original timeframe. If support from other donors is obtained to the BSF, less loss of momentum in supporting the BDS market would occur.

38. This risk has been recognized for some time by the CPMU. When the contract of the BSF manager expired in September 2008, the Project Director of the SMESDP took over the management of BSF on an interim basis to avoid any loss of momentum or accumulated knowledge. In February 2009, the CPMU appointed a new interim manager for the BSF, paid by the MOF. This appointment by the CPMU, in the context of ongoing discussions seeking donor funding to keep the BSF operating, is an encouraging sign of ownership. It would indeed be important that all new operations of this kind by donors avoid repeating the same "learning curve". During its implementation, the expectation grew that, given enough time and exposure, this facility could provide a model for the similar initiatives now being initiated by other donors (e.g. USAID, DFID), and allow them to "leap-frog" over the "learning" stages of the process. A number of interrelated lessons from the BSF effort can be useful for future initiatives. These follow below.

39. One lesson relates to the unintended consequences of BSF management's efforts to make-up for the initial delays in BSF inception, given that these in effect shortened the component's implementation period (ADB made it clear that it wouldn't extend the closing date of the project). Any selectivity concerns were, as a result, considerably reduced as time went by. This has likely defeated the "demonstration" objectives of this component (even if its targets in terms of number and amounts of matching grants awarded are met). Basically, as the management of the BSF aimed to cumulatively reach (with the total allocation under Subproject 2 of the SMESDP) 1900 firms by June 2009, the emphasis on advertising nationally and widening the geographical focus of outreach efforts also grew. The latter effort lost perspective that even if the BSF were to reach 1900 firms in the whole of Pakistan and disburse most of the funds under the SMESDP dedicated to that effect, these 1900 would still be about 0.06% of the total number of firms in Pakistan.

40. The direct effects of the SME Business Support Fund in the Pakistan economy were thus, by construction, necessarily very small. On the other hand, if the SME BSF was instead to produce "demonstration" effects, selectivity (both geographic and type of BDS) would have been crucial. The potential for demonstration effects is basically proportional to the visibility to firms of the benefits reaped by a firm in consequence of hiring BDS. Selectivity and clarity of purpose in this regard would have been crucial. But this type of selectivity could have indeed posed a problem if the immediate and bidding operational objective of the BSF management was to simply increase the number of applications for matching grants that could meet the BSF rules, in order to meet disbursement expectations. In any case, no assessment of the BDS market has been done to obtain feedback on whether the BSF has had any increase in SMEs perception of benefits from BDS or risk aversion to commission and pay a portion of them to BDS providers of unknown quality.

41. A second lesson relates to the lack of coordination with other donor SME support activities, which otherwise could have helped overcome some of the anticipated challenges. One illustration can be provided on this, referring to the lack of coordination within the SMESDP as an example. The BSF was new to Pakistan, and the matching-grant scheme required enterprises to believe that the BSF would meet its 50% cost-sharing commitment at the end of each BDS project. As a result, the BSF faced initially (and understandably) high levels of

hesitation on the part of potential applicants. This hesitation slowly faded away as the BSF became less unknown to the business community in Pakistan. It was indeed important for the BSF to make itself known country-wide and to establish some track record, some visibility. But this required extensive outreach initiatives, which imposed significant costs.

42. On the other hand, several implementing agencies of the SMESDP, like SMEDA and TUSDEC, already deal on a daily basis with a sample of SMEs that self-selects itself from the pool of more than 3 Million firms in the country. The nature of several schemes put in place by SMEDA and TUSDEC allows the SMEs that approach the different initiatives to signal their willingness to risk making costly changes to their business and upgrade their productive capabilities. In the case of TUSDEC, a fee is charged to all SMEs that benefit from its technology-related services. In the case of some initiatives of SMEDA, many SMEs take considerable risk for example, when changing the layout of their factories upon expert advice (e.g. GTZ and JICA have industrial process reengineering projects within SMEDA) in order to obtain gains in process efficiency. In sum, both SMEDA and TUSDEC interact on a daily basis with a sample of SMEs that could have been taken as a direct target for the BSF. In this way, the impact of the various support initiatives could have been amplified, and truly visible demonstration effects triggered. Only in June 2008 were there the first formal contacts in order to establish several memorandum of understanding with these agencies. This is also one example of the limitation imposed on the effectiveness of the SMESDP by the silo-culture that creped into its implementation strategy and practices.

### **Policy Output 3: Improve Market-Based Access to and Delivery of Small and Medium Enterprise Finance**

43. Access to long-term finance had long been held as one of the most impeding problems to the development of SMEs in Pakistan. That consensus is repeatedly voiced in policy discussions in Pakistan, although policy solutions are not always clearly laid out, nor there agreement on the evidence. For example, the empirical evidence on banking system efficiency showed in 2005 that Pakistan's average net interest rate margins were between 2 to 3%, thus about the same levels as in the United States, Thailand, South Africa, Italy or Spain.<sup>25</sup> Some stakeholders on the other hand put the emphasis on outreach problems, or on the belief that existing informational and regulatory underpinnings of formal financial intermediation end up steering banks lending away from the market of SMEs.

44. The SMESDP's approach to this challenge rested on the identification of three main problems. First, The SBP prudential regulations were perceived to be largely oriented toward the corporate and wealthy clientele of FIs, undermining the emergence of innovative and risk-effective products and processes for service delivery to smaller clients. Second, During the preparation of the SMESDP, Pakistan had one public and three privately-owned credit information systems. But the legal framework in Pakistan significantly restricted the effectiveness of private sharing of credit information, i.e. Pakistani law forbade (and still forbids) private entities' comprehensive sharing of third party credit information. Third and last, The ownership and governance structure of the SME Bank was perceived to impose obstacles to SMEs access to finance, which needed to be removed by restructuring and privatizing the SME Bank.<sup>26</sup> Although its contribution to SME finance is very small since the design stage of the

<sup>25</sup> Source: Economist Intelligence Unit.

<sup>26</sup> Early in 2002, the Government had merged two failed development FIs into a new bank, the SME Bank, incorporated as a public limited company. SME Bank inherited PRs9.5 billion (\$158 million) in nonperforming loans (NPLs) from the merger. SME Bank's main mandate was to provide credit to SMEs. However, it held 56% of its net assets in government securities and only 17% of its net assets could qualify as being related to services for SMEs.

program, the Government determined that SME Bank needed to be restructured and privatized so that it could start providing vital services for financing underserved SME "segments".

45. The SMESDP also assumed that even though changing the prudential framework for banks and improving the effectiveness of credit information sharing institutions in Pakistan were necessary conditions for the emergence of innovative lending practices tailored to SMEs, they were not sufficient. In other words, for FIs to gradually reorient their loan origination focus towards the large market of small businesses, (i) this move would need to be unrestricted by arbitrary prudential rules, and (ii) new, more information-intensive lending process would need to be developed. But this<sup>27</sup> was not believed to happen automatically once the informational and regulatory framework becomes "enabling". The SMESDP instead assumed to be necessary to directly develop the awareness and the human resources capacity of FIs through a training component in so-called SME Finance.

46. **KRA 3.1: Improve Regulatory and Credit Information Infrastructure and Build Private Financial Institutions' Capacity for SME Finance.** Since FY2004, the SBP undertook major reforms to support non collateral-based lending for SMEs and individuals by issuing prudential regulations for SME finance and consumer finance. In 2007 the SBP improved asset classification and risk provisioning requirements, including financial services to SMEs.<sup>28</sup> It is generally believed that the development of private credit information bureaus at a certain stage of banking sector development plays a key role in making credit information sharing services much more effective in assisting SMEs' access to formal finance.

47. In view of the legal limitations on the extent of information sharing that private credit information bureaus could market in Pakistan referred to above, a different approach was adopted. Because the SBP was itself not subject to these legal restrictions, a public-private partnership solution was pursued, which involved a revenue sharing system between SBP and the Pakistan Bankers' Association (PBA). This originated the current Credit Information Bureau (CIB) facility of SBP. Through this collaboration with the PBA, the CIB facility was first made available online in 2003, through which participating banks and nonbanks could submit credit data and receive creditworthiness reports via dial-up internet connection with CIB. Any credit transaction exceeding PRs0.5 million had to be reported online within 15 days at the end of the month in which the transaction occurred.

48. In 2005, under the SMESDP, a new system was developed to allow the reporting period to be shortened to within 10 days from the date of due settlement. Also, the reporting threshold was eliminated by regulation, which resulted in the expansion of the coverage of the CIB to all bank exposures.<sup>29</sup> A data-capturing software application had to be rolled out to all member banks and nonbanks in September 2005, involving new procedures on how to report the data to

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<sup>27</sup> Banks' development of lending processes and products that could utilize a combination of qualitative and quantitative skills in determining the cash flow and creditworthiness of borrowers (unrestricted thus by arbitrary prudential rules),

<sup>28</sup> On 31 August 2005, SBP issued revised prudential regulations for corporate, consumer, and SME finance. In October 2005, to enhance the quality of risk classification and provisioning, new prudential regulations were issued that require loans overdue by more than 1 year to be fully provisioned, and loans delinquent by more than 90 days to be 25% provisioned. SBP also issued a regulation requiring a gradual increase of banks' minimum capital from PRs2 billion to PRs6 billion on 31 December 2009. See [www.sbp.org.pk](http://www.sbp.org.pk) for the regulations, the draft banking act, the draft guidelines for Basle II, and quarterly and annual reviews of the banking system.

<sup>29</sup> The resulting increase in traffic in the system demanded a substantial upgrade, and a new system in CIB became fully operational on 1 June 2006. In view of the earlier elimination of the reporting threshold, the fee structure was also lowered.

the enhanced CIB.<sup>30</sup> Since May 2006 then, FIs in Pakistan have been able to generate separate credit information reports on consumer and corporate borrowers, irrespective of the size of outstanding amount of exposure. In the second tranche progress report of December 2006, it was recognized that the achievements under this KRA had exceeded original expectations by far, and that by then the SBP had effectively met the second and third tranche conditions as well as all implementation milestones in the SMESDP related to credit information sharing development.

49. However, how all this implementation progress has in effect improved FIs' effectiveness in assessing other credit exposures and history when providing loans to individuals and SMEs is uncertain. Although well functioning and integrated credit information systems are conceptually believed to provide essential information for lending decisions,<sup>31</sup> the sort of feedback that could have been helpful in assessing practical outcomes went unrecorded. As initially planned, a number of seminars and awareness-building sessions were held and supported by the SMESDP to promote cash flow-based lending. An international consulting firm (the consultant) was contracted on 23 May 2005 to design and conduct a comprehensive capacity-building program for FIs, including customized assistance to FIs that could demonstrate management commitment toward building SME finance as a core business. Nonetheless, implementation problems dictated the later cancellation of that contract. This consulting firm was basically unable to conceptualize training modules that could capture the interest of FI, and implementation momentum was thus lost in this component of the Project Loan.

50. The performance of the SMESDP under this KRA is rated fully satisfactory, despite the lack of follow-up on the training component. The fact that consumer credit and SME lending grew at high rates until mid-2008, and a number a number of commercial banks in Pakistan established SME Finance departments and developed SME specific products (Bank Alfalah, NIP, etc)<sup>32</sup> is a clear sign that banks have the incentive to invest in their SME finance capabilities once the market incentives signal potential profitability. The policy conditions and implementation milestones pertaining to the SME bank under this KRA are discussed below, in the context of the restructuring and privatization of the SME Bank.

51. **KRA 3.2: Restructure and Privatize SME Bank.** The SBP was a shareholder of the SME Bank until January 2005, and thereafter (upon divesture to the MOF) it provided a number of special credit lines to this bank. It was thus perceived to de facto operate as a lender of first resort to the SME Bank. This was believed to affect the managerial effort within the SME Bank until early 2007, reason why under the SMESDP the Government accepted to restructure the SME Bank and bring it to an equal footing with other private commercial banks. In March 2007, as part of the bank's restructuring plan in preparation for privatization, the SME Bank completed the settlement of all credit lines to SBP. This put an end to the special lender of first resort relationship between SBP and the SME Bank. Thus, through the SMESDP, SBP's conflict of interest resulting from its concurrent function of regulator and owner of SME Bank was eliminated.

<sup>30</sup> The design of the new system, and the operation of rolling-out the new electronic interface to all member banks and nonbanks was closely assisted by the PBA. The new system became fully operational in May 2006.

<sup>31</sup> The new Electronic Credit Information Bureau directly improves lenders' ability to take into account loan applicants' credit exposures and history in credit risk appraisal. International experience suggests that, users of (i) qualitative and quantitative information on cash flow and creditworthiness of borrowers; and (ii) sector specific and/or borrower knowledge, benefited from using such services to expand bank lending towards a large number of small businesses.

<sup>32</sup> Information from SMEDA, which monitors the development along the SME Policy 2007.

52. One of the ways that apparent conflict of interest had revealed itself was in the fact that since January 2005, the SME Bank has explicitly been benefited from a waiver of compliance with the minimum capital requirements that the SBP imposes on all other licensed banks. In the interim, the SME Bank had access to the 3-day repo facility of the SBP just like any other bank. The SME Bank has had therefore a privileged access to the lender of last resort procedure put in place by the SBP. Moral hazard concerns were however largely minimized by the several restrictions imposed on business expansion and risk taking management decisions at the SME Bank. These restrictions were supposed to be lifted once the SME Bank was privatized, upon which the SME Bank would be truly at par with all other entities regulated by SBP. Thus, the SMESDP also considered to be important to assist the Government objective of divesting from the SME Bank. The Government and the SMESDP thus sought to send policy signals to the economy, such as that (i) refraining from direct lending to SMEs was a direct implication of the Government's new approach to financial system reform, and (ii) the private financial sector can have a key role in serving SMEs.

53. A number of factors made the privatization of the SME Bank a very challenging proposition. The SME Bank was the product of a merger in 2002 of two failed development financial institutions. Inheriting PRs9.5 billion in nonperforming loans (NPLs) from the merger, the SME Bank was still tasked to provide credit to SMEs, despite employing around 1,000 employees on long-term contracts with little or no banking skills. As part of the SMESDP, the Government determined that the SME Bank was to be restructured and privatized, but to keep the same purpose. In 2003, the SME Bank had 59 branches and a seven-branch leasing subsidiary. Restructuring began in 2004 with the implementation of an attractive separation package for employees and a sustained reduction in the number of branches. From the merger onwards, most branches and staff focused their time on the recovery of the inherited NPL portfolio. At the same time, the SME Bank initiated the program of reduction of the liabilities to SBP referred to above, against liquidation of Government bonds. The difficulties in originating a new and sound loan portfolio that could generate fresh income made the restructuring effort a very challenging one. The reported NPL ratio of the SME Bank for the new portfolio kept growing to levels that by 2008 were about above 20%.<sup>33</sup>

54. A transaction committee was set up by the Privatization Commission (PC) in February 2006 to oversee the privatization of the SME Bank and recommend a party for prequalification. The Board of the PC recommended in May 2006 the privatization of the SME Bank, and a specific privatization plan to bring the bank to the point of sale (i.e., public invitation of expressions of interest). Since August 2006, the SME Bank has been in effect under the control of the PC, which oversees the implementation of the privatization plan prepared by financial advisors engaged (BMA Capital, hired under the Project Loan). Bidding was first targeted for June 2007 to coincide with the original closing date of the policy loan under SMESDP. However, this objective was not achieved as it became clear that further labor separation needs would impose additional costs to any potential buyer (as it had been originally factored in by the scope of the SMESDP). This made the privatization much less attractive, and the details of the proposed operation had to be reviewed. Acknowledging this setback, ADB approved the Government's request for an extension of the closing date of the program loan to June 2008.

55. Different solutions regarding the labor separation issue were discussed in the second half of 2007, and subsequently, a due diligence report covering all revised financial and operational aspects (with estimates for reserve pricing) was completed to support the PC in

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<sup>33</sup> By 2006, the management of the SME Bank had been unable to establish appropriate systems, or credit appraisal skills.

initial decisions, and thereafter in the negotiation. The issue of labor costs had been acknowledged from the design stage of the SMESDP. The RRP had indicated that as part of the adjustment costs of the Program Loan, restructuring the SME Bank would cost around \$152 million, and in that context stipulated the following: "*The first tranche amount will be utilized for repayment of SME Bank's liabilities to SBP. The proceeds of the incentive tranche will be used for the further repayment of SME Bank's liabilities to SBP and reimbursement to SME Bank for the expenditures related to staff separation. The proceeds of the second and third tranches will cover adjustment costs related to SME Bank staff separation and include earmarking of up to \$6 million equivalent each for SMEDA's CFC program.*"<sup>34</sup>

56. The costs of meeting labor separation did prove to be an impediment to the privatization process in 2007. While the Program loan provided for use of the loan proceeds for meeting the costs, two factors had to be weighed in: first, the emerging fiscal challenges due to the global food and fuel crisis meant that there were other competing needs; and second, ADB wanted to ensure that labor separation would take place without any scope for reinstatement.

59. As a consequence, the transaction committee submitted its recommendation for privatization of the SME Bank on "as is where is" basis for approval of the board of directors of the PC. Also, both an information memorandum and a public information memorandum were produced. The first quarter of 2008 was targeted for a public invitation for expressions of interest. But because of the political uncertainty (and its effects on investor confidence), the timing for a bidding invitation was deemed inadequate. On April 2008, the new Government publicly announced the decision to include the SME Bank in its new privatization plan, and the PC's board approved the recommendation from the transaction committee to bring the SME Bank immediately to the point of sale. Expressions of interest were publicly requested on 14 April 2008. This public invitation was placed in newspapers and posted on the PC website,<sup>35</sup> together with a public information memorandum.<sup>36</sup> A deadline for bids was set at 17 May 2008. This announcement was disseminated in the media and through the internet. The PC received 19 expressions of interest, but not all met the pre-qualification criteria. A new invitation for bids was issued in the expectation that more reputable and qualified bidders could express interest in the SME Bank, but without success.

60. The board progress report of June 2008 for the Program Loan considered however that the privatization plan had been implemented in full, with the SME Bank brought to the "point-of-sale", and the Government had accomplished all restructuring targets and milestones of the restructuring plan.<sup>37</sup> As the process languished, and Pakistan immersed in a macroeconomic crisis affecting investor confidence in the country's institutions and privatization deals in general, the prospects for finding a bank willing to take over ownership of the SME Bank greatly diminished. As of end-2009, the SME Bank remains state-owned. Thus, even though the performance indicators and targets have been met under this KRA, the SMESDP cannot be rated satisfactory, given: (i) that the scope of the SMESDP was explicit in the objective of

<sup>34</sup> Paragraph 61 of the RRP.

<sup>35</sup> <http://www.privatisation.gov.pk>

<sup>36</sup> <http://www.smebank.org>

<sup>37</sup> In other words, despite the delays vis-à-vis original targets, the SME Bank had by June 2008: repaid all agreed-upon amounts to SBP; had audited financial statements for the year ended 31 December 2007 acknowledging, in its Section 6, the progress on several restructuring targets and milestones, such as the full adjustment of loan liabilities to the SBP on account of profits, reduction of branches, improvement in provisioning practices, or increases in paid-up capital. Financial statements of the SME Bank for FY2006 were externally audited by A.F. Ferguson and Co. of Pakistan, an affiliate of Price Waterhouse Coopers. Anjum Asim Shahid Rahman (Chartered Accountants), an affiliate of Grant Thornton International, audited the SME Bank's financial statements for FY2007. All financial statements, audited and unaudited, are publicly available in the bank's website.

achieving the privatization of the SME bank; (ii) that the total amount of the Program Loan had been justified on the adjustment costs of the SME Bank restructuring; (iii) the amount of institutional effort (supported by the SMESDP) that went into this process; and (iv) that the resources under the SMESDP were not used to explore all originally scoped possibilities in order to make privatization of the SME Bank a reality.

### PROGRAM FRAMEWORK

Design Summary	Performance Indicators and Targets	Monitoring Mechanisms	Assumptions and Risks
<p><b>Goal</b> Improve economic growth, employment and poverty reduction</p>	<p>Poverty reduced from 33% to 15% in 2011</p> <p>Economic growth increased to 5% p.a.</p> <p>Private sector contribution to GDP increased</p> <p>Government reduces fiscal risks through disengagement from ownership in FIs</p>	<p>National statistics</p> <p>PRSP update reports</p> <p>Government reports</p>	<p>No major adverse geopolitical changes affecting Pakistan's stability</p> <p>Government remains committed to PRSP reforms</p> <p>Positive association exists between private sector growth and poverty reduction</p>
<p><b>Purpose/Objective</b> Improve SME competitiveness</p>	<p>Export volume of exporters with turnover up to \$5 million p.a.</p> <p>Volume of FIs' loans to SMEs exceeds 25% of total loans provided FIs FY 2009</p>	<p>National statistics</p> <p>EPB/MOC reports</p> <p>SBP statistics</p> <p>Economic Census 2004</p>	<p>Business climate does not deteriorate</p> <p>Private sector access to transport, communications, and utilities does not deteriorate</p>
<p><b>Output</b> 1. Improve SME Policy Environment KRA 1.1 Develop SME Policy</p> <p>KRA 1.2 Establish Effective Labor Protection and Inspection Policies</p>	<p>Task force prepares SME policy in consultative process by June 2005</p> <p>Government implements SME policy</p> <p>Task force established to develop LPP and LIP (October 2003)</p> <p>Government issues LPP and LIP, and commences implementation (June 2005)</p> <p>Government revises LPP and LIP parts of the Factories Act (December 2006)</p>	<p>Task force composition and TOR for SME policy</p> <p>SME annual report</p> <p>SME policy document</p> <p>Publication of task force composition and TOR for LPP and LIP</p> <p>Publication of policies</p> <p>Progress reports of CPMU</p> <p>SMEDA strategy and business plan</p>	<p>Continued government support for policy development</p> <p>Effective representation of private sector in SME policy development</p> <p>SMEDA is capable to run the CFC program</p>
<p>KRA 1.3 Enhance SMEDA's Effectiveness and Outreach to SMEs</p>	<p>SMEDA to: assume policy advisory and facilitator role</p> <p>establish effective internal controls</p> <p>perform in accordance with performance benchmarks and BP</p>	<p>SMEDA business rules</p> <p>SMEDA analytical reports</p> <p>external and internal audit reports</p>	

Design Summary	Performance Indicators and Targets	Monitoring Mechanisms	Assumptions and Risks
	<p>approve and revise business rules (June 2005)</p> <p>publish business registration and licensing guidelines in Urdu (June 2005)</p> <p>establish SME database (December 2006) and conduct sample surveys for policy impact analysis</p> <p>prepare BP and SOP for common facility center (CFC) program (June 2004)</p> <p>perform consistent with its BP and CFC BP and performance benchmarks</p>	<p>Progress reports of CPMU</p> <p>Independent performance and financial audit of CFC program by firm associated with international audit firm</p>	
<p>2. Improve Market-based SME Access to BDS KRA 2 Enhance SME Competitiveness Through Private Sector Services</p>	<p>MOF to select private sector establishment committee for SME BSF finalizing (i) memorandum of articles for incorporation for BSF, (ii) BP and SOP for BSF board</p> <p>BSF established (June 2004)</p> <p>BSF to perform consistent with the BP and SOP semiannual reviews, starting June 2005</p>	<p>Independent performance and financial audit of BSF by firm associated with international audit firm (October 2006)</p>	<p>Effective private sector representation in BSF</p> <p>Effective BSF fund utilization and management</p>
<p>3. Improved Market-based Access to and Delivery of SME Finance KRA 3.1 Improved Regulatory and Credit Information Infrastructure and Build Private FI Capacity KRA 3.2 Restructure and Privatize SME Bank</p>	<p>Regulations for SME and consumer finance</p> <p>SBP effectively lender of last resort to SME Bank</p> <p>Improved credit information system (December 2006)</p> <p>Feasibility study on secured transactions (June 2005)</p> <p>SME Bank implements agreed restructuring plan</p> <p>SME Bank implements agreed privatization plan Number of FIs and volume of credit to SMEs</p>	<p>SBP circulars and reports</p> <p>Feasibility study reports</p> <p>Restructuring plan</p> <p>Quarterly progress reports</p> <p>External performance and financial audits</p> <p>Consulting reports</p>	<p>FIs recognize commercial market potential for SME finance and invest in building dedicated capacity to serve this market segment</p> <p>Government commitment to privatization of SME Bank</p>

Design Summary	Performance Indicators and Targets	Monitoring Mechanisms	Assumptions and Risks
	Delivery of courses in SME finance		
<b>Inputs and Activities</b> 1. Program Loan 2. Project loan for a. Policy formulation (i) SME Policy (ii) Labor policy b. SME BSF c. SME finance (i) Regulatory policy, credit information, and capacity building for FIs (ii) SME Bank restructuring	Effective loans (\$152 million OCR/\$18 million ADF) SME policy: 1.5 months international, 11 months domestic consultants Labor policy: 6 months international, 20 months domestic consultants, stakeholder seminars SME BSF: 32 months for international facility manager, 8 permanent domestic staff, fund  SME Finance: 140 months international, 200 months of domestic consultants, stakeholder seminars SME Bank: 24 months international consultant	Program documents and agreements     TA letter agreement signed, consultant fielded	Timely effectiveness  Consultants are selected in an early stage and effectively conduct tasks
3. PCG facility 4. TA for program coordination 5. CPMU and IA staffing and budget	PCG facility (\$65 million); agreements with PFIs TA letter agreement (\$0.25 million) Full functionality of CPMU (238 months domestic consultants) and units under MOF, MOL, MOIP, SMEDA, SBP		

ADF = Asian Development Fund, BP = business plan, BSF = Business Support Fund, BDS = business development services, CPMU = core program management unit, FI = financial institution, IA = Implementing Agency, KRA = key result area, LIP = labor inspection policy LLPP = labor protection policy, MOIP = Ministry of Industries and Production, OCR = ordinary capital resources, PCG = partial credit guarantee, SME = small and medium enterprise, SMEDA = Small and Medium Enterprise Development Authority, SOP = standard operating procedures, TA = technical assistance.

**STATUS OF COMPLIANCE WITH SMALL AND MEDIUM ENTERPRISE SECTOR  
DEVELOPMENT PROGRAM LOAN COVENANTS**

<b>Relevant Section in the Loan Agreement</b>	<b>Particular Covenants per Loan Agreement</b>	<b>Status of Compliance</b>
Section 4.01(a)	The Borrower shall cause the Program to be carried out with due diligence and efficiency and in conformity with sound administrative, financial, environmental, SME development, and professional management practices	Complied with.
Section 4.01(b)	In the carrying out of the Program and operation of the Program facilities, the Borrower shall perform, or cause to be performed, all obligations set forth in Schedule 5 to this Loan Agreement	Substantially complied with. All obligations set forth in schedule 5 of the loan were complied with except that meetings of Steering Committee could not be held semi-annually. Staff was appointed according to requirements of IAs.
Section 4.02	The Borrower shall make available, promptly as needed, the funds, facilities, services and other resources which are required, in addition to the proceeds of the Loan, for the carrying out of the Program and for the operation and maintenance of the Program facilities	Partly complied with. \$18 million was supposed to be allocated to the CFC, however, only \$3 million have been provided as of PCR preparation.
Section 4.03	The Borrower shall ensure that the activities of the departments and agencies with respect to the carrying out of the Program and operation of the Program facilities are conducted and coordinated in accordance with sound administrative policies and procedures.	Complied with.
Section 4.04(a)	The Borrower shall maintain, or cause to be maintained, records and documents adequate to identify the Eligible Items financed out of the proceeds of the Loan and to indicate the progress of the Program.	Complied with.
Section 4.04(b)	The Borrower shall enable ADB's representatives to inspect any relevant records and documents referred to in paragraph (a) of this Section.	Complied with.
Section 4.05	As part of the reports and information referred to in Section 7.04 of the Loan Regulations, the Borrower shall furnish, or cause to be furnished, to ADB all such reports and information as ADB shall reasonably request concerning (i) the Counterpart Funds and the use thereof; and (ii) the implementation of the Program, including the accomplishment of the targets and carrying out of the actions set out in the Policy Letter.	Complied with but late. Reports on the Audited Financial Statements and Performance Reports were submitted late.
<b>Schedule 5</b>		
<b>Project Implementation and Other Matters</b>		
Program Implementation and Coordination	The MOF shall be the Executing Agency for the Program and shall coordinate and manage overall implementation of the Program consistent with the implementation arrangements set out in Appendix 8 to the RRP, administer utilization of the loan proceeds and ensure compliance with all policy-related conditions.	Substantially complied with. Funds allocated for the CFCs were not fully disbursed to TUSDEC.
	2(a) The Borrower shall establish a Steering Committee within one month of the Effective	Party complied with. Steering Committee meeting was established within one month

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
	Date, chaired by the Minister of Finance, and comprising the Secretaries of the Economic Affairs Division, the MOF, MOIP, and the MOL, and the deputy governor of the SBP. The Steering Committee shall meet at least semi-annually to guide and oversee implementation of policy reforms and progress of the Program.	of the Effective Date. However, the Committee could not hold meetings semi-annually due to preoccupation of its chairman and members. Only one meeting could be held in July 2005.
2(b)	The Steering Committee shall establish a stakeholder review process for ensuring adequate private sector feedback on the Program and Project operations. The stakeholders shall represent Pakistan's regional and SME sector interests, including banking and finance, trade, services, manufacturing, and professional, academic and SME business associations proposed by the Executing Agency.	Not complied with. The Steering Committee did not establish a stakeholder review process for ensuring adequate private sector feedback on the Program and Project operations. However, the Business Support Fund, being the major stakeholder, had adequate presentation from private sector. Out of nine members of the Board of Directors six were from private sector including its chairman.
2(c)	The Steering Committee shall establish an audit review process for ensuring adequate performance review of the Program and Project operations and addressing issues raised in financial audits. The audit review process will include members representing the Borrower and professional and academic organizations.	Not complied with. The Steering Committee did not establish an audit review process for ensuring adequate performance review of the Program and Project operations and addressing issues raised in financial audits. However the audit reports of BSF are being reviewed by its Board of Directors and audit reports of other agencies are reviewed by their departmental experts as well as CPMU.
3	The MOF shall establish and maintain a Core Program Management Unit (CPMU) to coordinate, monitor, and supervise program implementation, including compliance with policy conditions and loan covenants. The CPMU shall comprise at least six full time staff, including the Project Director, Manager, SME policy development and labor policy development; Manager, BDS development; Manager, SME Bank restructuring; and two research analysts.	Complied with. CPMU was established by the MOF. Only one Project Manager and one Project Support and Database Officer were appointed. Project was completed satisfactorily.
4	The IAs responsible for the Program shall be: (i) SMEDA for KRA 1.1 and 1.3, (ii) MOL for KRA 1.2, (iii) MOF for KRA2 and KRA 3.2, and (iv) SBP for KRA 3.1. The Borrower shall ensure, through the CPMU, that each IA commits adequate full time staff to ensure implementation of the Program.	Complied with.
<b>Implementation of the Development Policy Letter</b>		
5	The Borrower shall (a) ensure that the policies adopted and actions taken as described in the Policy Letter prior to the date of this Loan Agreement continue in effect for the duration of the Program period and subsequently, and (b) promptly adopt the other policies and take the other actions indicated in the Program as specified in the Policy Letter, including the Policy Matrix, and ensure that such policies and actions continue in effect during and after the Program period.	Complied with.
<b>Policy Dialogue</b>		
6	The Borrower shall keep ADB informed of, and	Complied with. This was done through

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
	the Borrower and ADB shall from time to time exchange views on, the progress made in carrying out the Program.	regular monthly progress reports, exchange of correspondence and periodic visits of the ADB Review Missions during the last year of project implementation.
7	The Borrower shall continue timely policy dialogue with ADB on problems and constraints encountered during implementation of the Program and on appropriate measures to overcome or mitigate such problems and constraints.	Complied with.
8	The Borrower shall keep ADB informed of policy discussions with other multilateral and bilateral agencies that have implications for implementation of the Program, and shall provide ADB with an opportunity to comment on any resulting policy proposals. The Borrower shall take ADB's views into consideration before finalizing and implementing any such proposals.	Complied with.
<b>SME Policy Environment</b>		
9	With respect to the SME Policy at MOIP, the Borrower, through SMEDA, shall ensure (i) wide private sector participation through the establishment of private sector-led subcommittees to identify policy issues and solutions for key areas of the SME Policy; and (ii) consultation with provincial governments and consideration of reforms ongoing at the provincial level as appropriate.	Complied with. Development of SME Policy was through an extensive consultative process. Workshops and consultative meetings were held in 9 regional cities throughout the country. More than 1,000 SMEs participated besides the commercial banks, donor community and NGOs. The representatives of the Federal Ministries/ Divisions and Provincial Governments of Punjab, Sindh, NWFP and Baluchistan also participated in these workshops/seminars.
10	The Borrower, through SMEDA, shall ensure the SME policy shall cover (i) a strategy and action plan; (ii) SME enterprise size definition; (iii) the focus of government support through policy reforms and targeted interventions using services from the private sector; (iv) the role of the private sector in providing services and shaping SME policy; and (v) other priority issues identified by the SME policy committee.	Complied with. The SME Policy 2007 covers all of these objectives.
11	With respect to the task force at MOL, the Borrower shall ensure that (i) an active consultation process with wide stakeholder participation, including representatives of employee and employer groups; (ii) consultation with provincial governments and consideration of reforms ongoing at the provincial level as appropriate; and (iii) that Core Labor Standards are the guiding principles in the formulation of the LPP and the LIP.	Complied with.
12	The Borrower shall ensure that the SMEDA Business Plan is approved by 30 June 2004 and (i) specifies time bound measures for performance for SMEDA consistent with its mandate; (ii) specifies the responsibility of the chief executive officer for operations,	Complied with.

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
	recruitment and all staff actions, and a reporting line to the board of directors, and (iii) includes conflict of interest rules and a code of conduct for staff and directors for all SMEDA operations.	
13	The Borrower shall ensure that the SMEDA business plan for the CFC program shall include detailed market studies and standard operating procedures acceptable to ADB.	CFC was included in SMEDA Business Plan; subsequently, however, CFC was transferred to TUSDEC for implementation.
<b>SME Access to Business Development Service</b>		
14	The Borrower shall ensure that (i) the Business Support Fund (BSF) is incorporated under Section 42 of the Companies Ordinance within 3 months of the Effective Date; (ii) The board of directors of BSF includes nine directors with (A) at least six representatives of the private sector (including representatives of SME business associations, non-governmental organizations, research institutions donor agencies and/or the banking and law professions) one of whom shall be the chairperson, and (B) the remainder representing the Borrower; (provided that any person who is on the board of another public agency shall resign from such board prior to becoming a member of the BSF board); and (iii) immediately following incorporation, the BSF board of directors approves the business plan, standard operating procedures, conflict of interest rules and code of conduct for staff and directors.	Complied late. The BSF is incorporated under Section 42 of the Companies Ordinance. It took longer than 3 months. The BOD of BSF has been formed according to the required conditions where 6 of the 9 Board members are from the private sector including Chairman of the Board, (iii) BSF Board of Directors approved the Business Plan, Standard Operating Procedures, Conflict of Interest Rules and Code of Conduct for staff. The documents were also approved by ADB.
<b>SME Finance</b>		
15(a)	Termination of SBP loans to and shareholding in SME Bank (a) the Borrower shall ensure that SBP's shareholding in SME Bank is terminated through the purchase of SBP-held shares (at nominal value) by shareholders or otherwise.	Complied with. Accumulated balances of Rs.3.276 billion due from SBP on account of its share in profits and losses of the SME Bank have been adjusted against credit lines provided by SBP.
15(b)	SME Bank shall repay Rs.7 billion in loans to SBP in agreed phases over the Program period and the Borrower shall repay the remainder of SME Bank loans to SBP (identified in the Portfolio Audit)	Complied with. Amount of Rs.7.393 billion has been paid to SBP to fully adjust the loan liability.
15(c)	The Borrower shall ensure that ¥3,244,050,000 of the proceeds of the First Tranche and an agreed portion of the Second Tranche shall be retained by SBP as repayment of the SME Bank liabilities.	Complied with.
16	The Borrower shall ensure that SME Bank is restructured in accordance with the Restructuring Plan, the Restructuring Targets set out in the Attachment to this Schedule and the Privatization Plan.	Complied with. The SME Bank was restructured in accordance with the Restructuring Plan, the Restructuring Targets set out in the Attachment to the Schedule and the Privatization Plan.
17	A banking license shall only be issued to SME Bank upon compliance with all applicable SBP	Complied with. Number of recovery branches was reduced to 14 by December

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
	regulations and satisfaction of agreed operational restructuring measures in the Restructuring Plan and the Restructuring Targets for the Incentive Tranche. The agreed measures, inter alia, include agreed (i) reduction of recovery branches (as defined in the Restructuring Targets); (ii) rationalization of employment of regular staff; (iii) reduction of liabilities to SBP and (iv) appointment of the head for the SME business unit.	31, 2006. Voluntary Separation Scheme (VSS) was approved by the Board of Directors of SME Bank on 07 Nov 2003. 707 employees were relieved under the scheme by 31.12. 2005. Human Resource Technical Audit was completed and report submitted to the bank.
18	The Borrower shall ensure that, until SME Bank is sold to the private sector, SME Bank shall exercise its magisterial powers under the Land Revenue Act only as a last resort after ordinary legal recourse and at all times not exceeding the powers given there under. Notwithstanding any other provision of this Loan Agreement or covenants, and except as ADB may otherwise agree, SME SDB disbursements shall temporarily stop if SME Bank fails to achieve the agreed performance indicators in the Restructuring Plan and the Restructuring Targets, until a special financial review mission of ADB shall have carried out a financial and operation review of SME Bank, and an agreement is reached between ADB, SME Bank and the Borrower regarding the recommendations of this mission.	Partly complied with.
19	Notwithstanding any other provision of this Loan Agreement or covenants, and except as ADB may otherwise agree, SME SDP disbursements shall temporarily stop if SME Bank fails to achieve the agreed performance indicators in the Restructuring Plan and the Restructuring Targets, until a special financial review mission of ADB shall have carried out a financial and operation review of SME Bank, and an agreement is reached between ADB, SME Bank and the Borrower regarding the recommendations of this mission.	Partly complied with.
<b>Counterpart Funds</b>		
19	The Counterpart Funds generated by the proceeds of the Loan shall be used to provide budgetary support for SME sector development as follows: (i) Upon release of the First Tranche, for the repayment of SME Bank liabilities to SBP; (ii) Upon release of the Incentive Tranche, (A) for the repayment of SME Bank liabilities to SBP and (B) for the cost of SME Bank staff separation packages, including VSS and the human resources audit; and (iii) Upon release of each of the Second Tranche and the Third Tranche, (a) for the repayment of SME Bank liabilities to SBP, (B) for the cost of SME Bank staff separation packages, including VSS, and (C) in each case up to \$6,000,000 equivalent for the CFC Program.	Complied with.

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
Project Loan	The Borrower shall ensure the timely implementation of the Project under the Project Loan Agreement.	Complied with but late.
Review and Evaluation of the Program	Without limiting the generality of Section 4.05 of this Loan Agreement or paragraphs 6 to 8 of this Schedule, the MOF shall assist ADB by providing relevant data and information in such detail as ADB may reasonably request to facilitate review by ADB of the progress in the implementation of the Program. The CPMU shall provide ADB with consolidated quarterly reports and annual reports assessing progress of the Program and the Project.	Complied with but late. Monthly, quarterly and annual reports were submitted regularly on due dates.
Accounting and Auditing	The Borrower shall ensure that the Borrower, the CPMU, each IA, SMEDA, SME Bank and the BSF shall maintain separate accounts and records for the Loan in accordance with sound accounting principles. Relevant accounts shall be audited annually by an independent auditor in accordance with standards acceptable to ADB, and the Borrower shall provide to ADB certified copies of the audited accounts and financial statements, together with audit reports in the English language promptly after their preparation but not later than six (6) months after the close of the fiscal year to which the accounts refer. The CPMU shall be responsible for consolidating the reports for transmission to ADB.	Complied with but late.
	The Borrower shall ensure that a performance audit shall be conducted on the CPMU, each IA, SMEDA, SME Bank and the BSF annually within six (6) months of the close of each fiscal year by an independent auditor in accordance with standards acceptable to ADB, and the Borrower shall provide copies of the same to ADB in the English language promptly after their preparation. The CPMU shall be responsible for consolidating the reports for transmission to ADB.	Complied with but late.
Program Performance Management System	The Borrower shall set up a program performance management system as agreed with ADB, within six (6) months of the Effective Date, and cause it to be operated throughout the Program period. Under the program performance management system, the Borrower shall also undertake period review of the Program, drawing on the Performance Management Systems Guidelines of ADB, to assess and evaluate the scope, implementation arrangements, benefit monitoring, progress and achievement of the Program.	Not complied with.
<b>Schedule 6</b>		
<b>Execution of Project and Operation of Project Facilities; Financial Matters</b>		
<b>Project Implementation and Coordination</b>		
1.	The MOF shall be the Executing Agency for the Project and shall coordinate and manage	Complied with.

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
	overall implementation of the Project consistent with the implementation arrangements set out in Appendix 8 to the RRP.	
2(a)	The Borrower shall establish a Steering Committee within one month of the Effective Date, chaired by the Minister of Finance, and comprising the Secretaries of the Economic Affairs Division, the MOF, MOIP and the MOL, and the deputy governor of the SBP. The Steering Committee shall meet at least semi-annually to guide and oversee implementation of policy reforms and progress of the Program.	
2(b)	The Steering Committee shall establish a stakeholder review process for ensuring adequate private sector feedback on the Program and Project operations. The stakeholders shall represent Pakistan's regional and SME sector interest, including banking and finance, trade, services, manufacturing, and professional, academic and SME business associations proposed by the Executing Agency.	
2(c)	The Steering Committee shall establish an audit review process for ensuring adequate performance review of the Program and Project operations and addressing issues raised in financial audits. The audit review process will include members representing the Borrower and professional and academic organizations.	
3	The MOF shall establish and maintain a core Project management unit (CPMU) to coordinate, monitor, and supervise Project implementation including compliance with loan covenants. The CPMU shall comprise at least six full time staff, including the Project Director; manager, SME policy development and labor policy development; manager, BDS development; manager, SME Bank restructuring; and two research analysts.	Complied with.
4	The IAs responsible for the Project shall be: (i) SMEDA for Component 1.1, (ii) MOL for component 1.2, (iii) MOF Components 2 and 3.2, and (iv) SBP for Component 3.1. The BSF shall become the IA for Component 2 upon entering into the Project Agreement Undertaking satisfactory to ADB. The Borrower shall ensure, through the CPMU, that each IA commits adequate full time staff for implementation of the Project.	Complied with.
<b>SME Policy Environment</b>		
5	With respect to the SME policy task force at MOIP, the Borrower, through SMEDA, shall ensure, (i) wide private sector participation through the establishment of private sector-led subcommittees to identify policy issues and solutions for key areas of the SME Policy; and (ii) consultation with provincial governments and consideration of reforms ongoing at the	Complied with.

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
6	<p>provincial level as appropriate.</p> <p>With respect to the task force at MOL, the Borrower shall ensure, (i) an active consultation process with wide stakeholder participation, including representatives of employee and employer groups; (ii) consultation with provincial governments and consideration of reforms ongoing at the provincial level as appropriate; and (iii) that Core Labor Standards are the guiding principles in the formulation of the Labor Protection Policy and the Labor Inspection Policy.</p>	Complied with.
<b>SME Access to Business Development Services</b>		
7	<p>The Borrower shall ensure that (i) the Business Support Fund (BSF) is incorporated under Section 42 of the Companies Ordinance within three months of the Effective Date; (ii) the board of directors of BSF includes nine directors with (A) at least six representatives of the private sector (including representatives of SME business associations, non-governmental organizations, research institutions, donor agencies and/or the banking and law professions) one of whom shall be the chairperson, and (B) the remainder representing the borrower; (provided that any person who is on the board of another public agency shall resign from such board prior to becoming a member of the BSF board); and (iii) immediately following incorporation, the BSF board of directors approve the business plan, standard operating procedures, conflict of interest rules and code of conduct for staff and directors acceptable to ADB.</p>	Complied with but late.
8	<p>The Borrower shall ensure that the Business Support Fund (BSF) shall, immediately following incorporation, enter into the Project Agreement Undertaking in favor of ADB setting out the responsibilities of BSF under the Project</p>	Not complied with. The Project Agreement Undertaking was signed by the Government of Pakistan but not the ADB.
9	<p>The Borrower shall ensure that the BSF employs experienced, competent, professional management for the BSF including a facility manager.</p>	Complied with.
10	<p>The Borrower shall ensure that an independent performance and financial audit of the BSF is conducted by a firm associated with international audit firms.</p>	Complied with but late.
<b>SME Finance</b>		
11	<p>The Borrower shall ensure that SME Bank is restructured in accordance with the Restructuring Plan, the Restructuring Targets set out in the Attachment to this Schedule, and the Privatization Plan.</p>	Complied with but late.
12	<p>The Borrower shall ensure that an independent performance and financial audit of SME Bank is conducted by a firm associated with international audit firms.</p>	Complied with but late.

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
13	A banking license shall only be issued to SME Bank upon compliance with all applicable SBP regulations and satisfaction of agreed operational restructuring measures in the Restructuring Plan and the Restructuring Targets for the Incentive Tranche. The agreed measures include agreed (i) reduction of recovery branches (as defined in the Restructuring Targets); (ii) rationalization of employment of regular staff; ((( reduction of liabilities to SBP; and (iv) appointment of the head for the SME business unit.	Complied with but late.
14	The Borrower shall ensure that, until SME Bank is sold to the private sector, the SME Bank shall exercise its magisterial powers under the Land Revenue Act only as a last resort after ordinary legal recourse and at all times not exceeding the powers given thereunder.	Not applicable.
15	The Borrower and SBP shall ensure that loan proceeds for capacity building for SME finance in private sector financial institutions is undertaken only with those financial institutions (participating financial institutions), which have written management commitment to SME finance supported by business and investment plans in form and substance satisfactory to ADB and SBP.	Not applicable.
<b>Program Loan</b>		
16	The Borrower shall ensure coordination of Project activities with policy reforms initiated under the Program.	Substantially complied with.
<b>Accounting and Auditing</b>		
17	Without limiting the generality of Section 4.06 of this Loan Agreement, the Borrower shall ensure that Borrower, the CPMU, each IA, SMEDA, SME Bank and the BSF shall maintain separate accounts and records for the Loan in accordance with sound accounting principles. Relevant accounts, including imprest accounts, shall be audited annually by an independent auditor in accordance with standards acceptable to ADB, and the Borrower shall provide to ADB certified copies of the audited accounts and financial statements, together with audit reports in the English language promptly after their preparation but not later than six months after the close of the fiscal year to which the accounts refer. The CPMU shall be responsible for consolidating the reports for transmission to ADB.	Complied with but late.
18	The Borrower shall ensure that a performance audit shall be conducted on the CPMU, each IA, SMEDA, SME Bank and the BSF annually within six (6) months of the close of each fiscal year by an independent auditor in accordance with standards acceptable to ADB, and the Borrower shall provide copies of the same to ADB in the English language promptly after	Complied with but late.

Relevant Section in the Loan Agreement	Particular Covenants per Loan Agreement	Status of Compliance
	their preparation. The CPMU shall be responsible for consolidating the reports for transmission to ADB.	
<b>Project Performance Management System</b>		
19	The Borrower shall set up a Project performance management system as agreed with ADB, within six (6) months of the Effective Date, and cause it to be operated throughout the Project period. Under the Project performance management system, the Borrower shall also undertake periodic review of the Project, drawing on the Performance Management Systems Guidelines of ADB, to assess and evaluate the scope, implementation arrangements, benefit monitoring, progress and achievement of the Project.	Not complied with. No Project performance management system was set up.

## ASSESSMENT OF OVERALL PROGRAM AND TECHNICAL ASSISTANCE LOAN PERFORMANCE

Criterion	Weight (%)	Definition under ADB Guidelines	Rating Description	Rating Value	SMESDP Rating	Score
1. Relevance	20	Relevance is the consistency of a project's impact and outcome with the government's development strategy for the country, and the Asian Development Bank's strategic objectives at the time of approval and evaluation and the adequacy of the design.	Highly relevant Relevant Partly relevant Irrelevant	3 2 1 0	2	0.4
2. Effectiveness	30	Effectiveness describes the extent to which the outcome, as specified in the design and monitoring framework, either as agreed at approval or as subsequently modified, has been achieved.	Highly effective Effective Less effective Ineffective	3 2 1 0	1	0.3
3. Efficiency	30	Efficiency describes, ex post, how economically resources have been converted to results, using the economic internal rate of return, or cost-effectiveness, of the investment or other indicators as a measure and the resilience to risk of the net benefit flows over time.	Highly efficient Efficient Less efficient Inefficient	3 2 1 0	1	0.3
4. Sustainability	20	Sustainability considers the likelihood that human, institutional, financial, and other resources are sufficient to maintain the outcome over its economic life.	Most likely Likely Less likely Unlikely	3 2 1 0	2	0.4
Overall Assessment (weighted average of above criteria)	Highly successful: Overall weighted average is greater than or equal to 2.7. Successful: Overall weighted average is greater than or equal to 1.6 and less than 2.7. Partly Successful: Overall weighted average is greater than or equal to 0.8 and less than 1.6. Unsuccessful: Overall weighted average is less than 0.8.				Total	1.4

SMESDP= Small and Medium Enterprise Sector Development Program.

Note: Performance rating follows the ADB *Guidelines for Preparing Performance Evaluation Reports for Public Sector Operations*. January 2006.