WWF

International Labour Organization

This project is funded by the European Union

FACILITATION OF GREEN FINANCING FOR LEATHER AND TEXTILE SMEs FROM FINANCIAL INSTITUTIONS IN PAKISTAN

CASE FOR GREEN INVESTMENTS IN LEATHER AND TEXTILE SECTORS

The textile and leather sectors are central to Pakistan's economy and depend on the contributions of small and medium-sized enterprises (SMEs). These enterprises across sectors contribute to around 30 per cent of Pakistan's Gross Domestic Product (GDP) and account for an estimated 80 per cent of all enterprises in the textile/leather sectors (World Bank 2009; IFC et al. 2016). However, the unsustainable use of resources and poor environmental management practices, as evidenced by high levels of water and chemical consumption and contamination, present a major threat to the sustainability of these sectors (Linstead 2015; Pakistan 2007, 2013).

Despite relatively abundant water resources and regular monsoon rains, water shortages are expected in Pakistan (particularly in Karachi as well as around Lahore, Faisalabad, Rawalpindi and Sialkot), with estimates that the country will be water scarce by 2035 (IFC et al. 2016, p.122). These environmental challenges are compounded by a variety of factors including a weak and dispersed regulatory regime to ensure industrial compliance with environmental laws; ground and surface water pollution and overuse; and mounting industrial growth and urbanisation, with only one per cent of wastewater currently treated by textile or leather firms prior to discharge (Hengstmann 2020) into seas and waterbodies (rivers, irrigation channels, etc.). The situation is further exacerbated by the concentration of water-intensive production in several industrial clusters.

In light of these intersecting challenges, WWF-Pakistan's International Labour and Environmental Standards Application in Pakistan's SMEs (ILES) project has set out to improve water and resource management practices and energy consumption in the textile and leather sectors, especially by resource-intensive SMEs, through multi-stakeholder approaches. The means for achieving these goals lies within the establishment of partnerships between various stakeholder groups, including SMEs, public authorities, intermediaries working with SMEs, financial institutions, and multi-national corporations (MNCs).

GREEN FINANCING CHALLENGES FOR SMEs AND FINANCERS

Within the ILES project, the development of a green financing instrument (Green Credit Guidelines) for the textile and leather sectors – with endorsement and use by regulators – would extend capital to SMEs for green investments and build the capacity of key private and public sector actors to implement and monitor progress with meeting green financing objectives. In this document 'green investments' by textile and leather SMEs refer to investments in Sustainable Consumption and Production (SCP), including:

- **Water management**
- **Energy conservation**
- **Wastewater treatment and chemical use reduction**

Stakeholder interviews and a literature review conducted revealed that industry stakeholders, financers and government actors face intersecting challenges in facilitating targeted green financing solutions. In summary, and with reference to global and regional examples, the major challenges with access to green financing for SMEs – the nexus of green financing and SME financing – in Pakistan are summarised in Table 01. This figure identifies major challenges from both the perspectives of (a) financial institutions and (b) (leather/textile) SMEs. The table includes gaps concerning regulatory and legal frameworks, specifically calling on the role of the government in ensuring a conducive environment for SMEs to access tailored financing for SCP purposes.

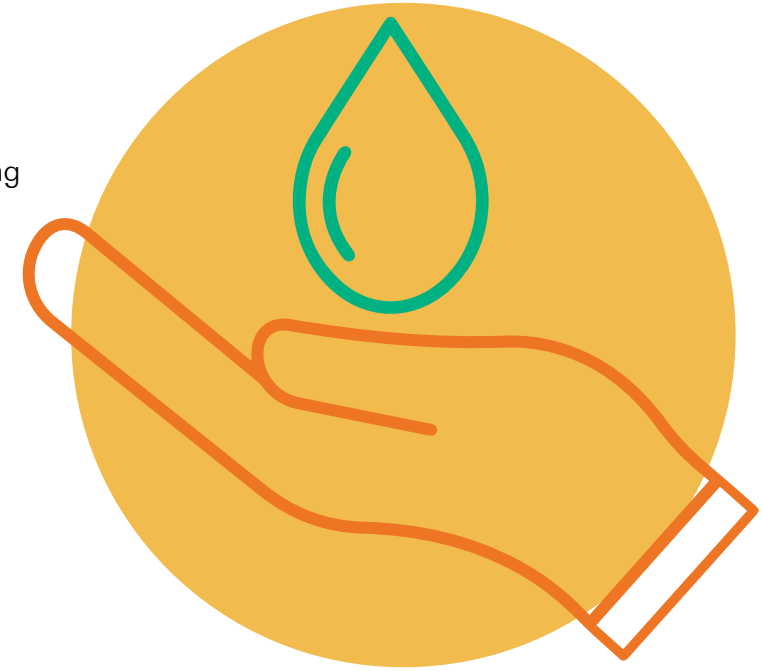


Table 1: Typology of green financing challenges for leather/textile SMEs in Pakistan

For Financial Institutions Supply-side barriers		For Leather/Textile SMEs Demand-side barriers
•Small ticket size of typical sustainable production financing tends to fall below preferred level for investment funds and lenders. •High transaction costs for assessment and due diligence of smaller enterprises. •Potential preference for SCP investments in clusters (e.g. for combined water treatment facility) but banks do not have demand from SMEs in clusters.	**Ticket Size**	•Lack of tailored financial products to meet green investment needs of leather/textile SMEs. •Lack of solutions to support investments by SME clusters, where SCP investments (e.g. water processing of effluent treatment facilities) not always suited to investment and installation by one SME.
•Risk aversion of investors and financers with high return expectations to SMEs, including of foreign investors with lack of common approach to risk profiling. •Lower rate of return for low carbon projects.	**Risk/Return Profiles**	•Higher risks with lower returns for early-stage enterprises due to internal/market constraints. •Lack of willingness to pay by SME decision-makers/management for SCP improvements, with SCP investments seen as added costs rather than valuable investments. •Unfavorable interest rates plus small industries must compete with larger ones under the same conditions. •Reluctance of SMEs to approach banks for financing due to gaps in Islamic banking solutions and the desire to avoid increased liabilities.

For Financial Institutions Supply-side barriers		For Leather/Textile SMEs Demand-side barriers
•Limited understanding of SCP in terms of technology involved, monitoring models and feasibility assessment. •Lack of monetary indicators for returns and expected payback periods for SCP/green investments by SMEs.	**Green-SCP Technologies**	•Lack of assessment frameworks for green-SCP technology and investments, supported by mutually agreed monitoring and verification of streams to validate feasibility. •Absence of aggregation model for technology providers to de-risk financing for and offer SCP technologies to their clients, e.g. via end user financing for textile/leather SMEs.
•Short-term orientation of lending and investment cycles hinders investment in systemic process improvements.	**Time Horizon**	•Longer/unclear time horizon for green-SP investments to capitalise.
•Perception by banks as risky credit with difficult credit assessment and appraisal. •Lack of financial documentation among SMEs makes the job of a Project Manager within a bank challenging in preforming credit risk assessments.	**Security/ Collateral**	•Tend to fail to meet collateral requirements, or prove sufficient track record or credit history.
•Low levels of green finance success stories and clear repayment trajectories among textile/leather SMEs.	**Impact at Scale**	•Internal and market barriers to assessing and developing a green investment plan or technical analysis.

For Financial Institutions Supply-side barriers		For Leather/Textile SMEs Demand-side barriers
•Banks without internal structures and incentives to finance cleaner production by leather/textile SMEs. •Lack of clear definitions and knowledge of 'green finance' and 'green/sustainable investments'.	**Human Capital and Skills**	•Poor financial literacy and awareness of green finance/SCP opportunities. •Limited skills or expertise with accounting, budgeting and planning capacity and poor entrepreneurial mind-sets.
•Lack of mandatory frameworks for green finance for leather/textile SMEs in Pakistan, with regulatory gaps/differences between federal and provincial levels of government (particularly with environmental law and standards). •Limited oversight/feedback from regulators, including to banks that responded to SBP's questionnaire on implementation of Green Banking Guidelines (GBGs).	**Regulatory and Legal Frameworks**	•Lack of market-based incentives/rebates for investment in cleaner production especially challenging for smaller scale SP projects (e.g. disincentive of continual government subsidies for fossil fuels or low effluent charges), complicated by variations in federal versus provincial regulations. •Immediacy of SCP investment (e.g. in wastewater treatment and management) not yet recognised by the private sector. •Low levels of compliance with international standards (e.g. Leather Working Group) threatens export-relevance/value of SMEs.

Accordingly, there are persistent barriers that must be addressed and opportunities harnessed by key players – including the government actors, financial institutions and intermediaries reviewed – in order to make available and disburse capital for SCP investments in the textile/leather sectors.

Summary of key gaps in green financing for textile/leather SMEs

Conducive ecosystem

Coordination gaps exist among ecosystem actors, particularly from the government, financial institutions and intermediaries. Despite promising examples of support provided by regulators, consultants and intermediaries working directly with banks and SMEs, further coordination among and capacity building support to actors is required to align their activities with green financing activities, influenced by due diligence pressures throughout supply chains for effective environmental compliance.

Pipeline of bankable green investment

There is a lack of tailored business advisory and financing for SMEs to learn about and invest in SCP. SMEs in the textile/leather sectors continue to struggle to access tailored financial products and capacity building services to identify and invest in SCP measures.

Green finance products for textile/leather SMEs

There is limited green business facilitation and integration of environmental risk management into banks' core activities. Banks generally struggle to define and align internal product development processes with green investment objectives, especially as these objectives relate to sector-specific environmental risk assessment and lending decisions.

PATHWAYS FOR GREEN FINANCE FACILITATION IN PAKISTAN

Multi-stakeholder collaboration and the buy-in of various public and private sector actors is key to addressing and developing tailored solutions that overcome the challenges faced by both financers and (textile/leather) SMEs, as identified above. Solutions are required that engage actors (including regulators, financers and SME intermediaries) to address the key gaps identified in this paper.

Recommendations

In developing targeted guidelines and financial mechanisms that facilitate access to capital for textile/leather SMEs, tailored solutions are required. Based on identified gaps and with reference to examples of global and regional best practices, potential recommendations for government agencies and regulators, financers and SME intermediaries are mentioned below:

FOR GOVERNMENT

Key recommendations targeting government actors – particularly financial and environmental agencies and regulators – could be acted on through creating a stronger role for the Ministry of Climate Change at the federal level in coordination with environmental protection agencies (EPAs) to the provincial level and the State Bank of Pakistan (SBP), while leveraging the judicial powers of environmental tribunal and others. These recommendations include:

Streamline and strengthen regulatory regime and compliance monitoring.

One measure that interviewed banks indicated support for was a move by regulators to make the implementation of the Green Banking Guidelines (GBGs) mandatory for banks, moving beyond the GBGs' current status as guidelines. Additionally, environmental laws and penalties could be streamlined, specifically across provincial EPAs/EPDs jurisdictions, to support both banks and SMEs for more easy understanding and compliance with these regulations. Stakeholders also note a general need to strengthen coordination between governmental departments (from the national to provincial levels) and banks in translating environmental sustainability impacts or contributions into financial terms that banks can understand and act upon.

Develop incentives for green financing that extend beyond renewable energy (and energy efficiency) financing.

Consultations revealed different perspectives on effective government incentives, for example subsidies or rather, emphasising the more stringent enforcement of environmental laws. Generally, further public sector and government agency efforts could incentivise banks to expand their onward lending to specialised sectors or a wider spectrum of SCP investments, including for textile/leather SMEs.

Support training programmes.

Regulators, financers, intermediaries and SMEs should include the expansion of cleaner/sustainable production institutes and trainings around green financing and SCP. Further efforts by the public sector (including financial regulators) to educate actors on defining and identifying green investments could ensure that all stakeholders have the prerequisite knowledge and capacities to invest in SCP measures. This could involve investing public resources in growing the pool of green finance experts (lawyers, consultants, managers) for the administration of laws and policies for green banking and SCP implementation.

Expand technical assistance to banks to develop activities in line with the Green Banking Guidelines.

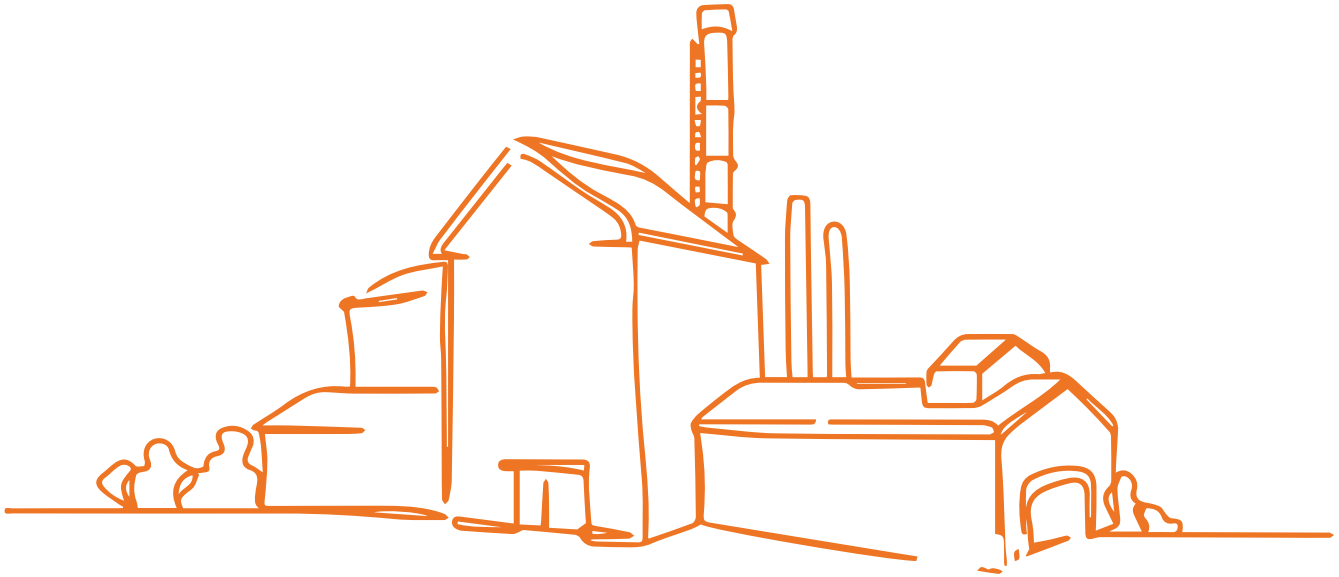
Greater availability of technical assistance, facilitated or supported by the SBP among others, would help to ensure that all banks are in the position to develop and implement green financing policies and processes, especially for green business facilitation and environmental risk management.

Facilitate monitoring, verification and reporting support for banks to assess their green finance portfolios.

In order to address issues that banks are experiencing with assessing the compatibility of their existing lending portfolios with green investments, the government could play a more active role in aggregating data on SME lending portfolios and GBG guideline implementation across banks.

Draft sector-specific recommendations (or mandates) for green financing, including for the textile/leather sectors.

In response to comments from banks interviewed, the Pakistani government (likely through the SBP) could support the development of sector-specific guidance to prioritise, (1) sectors which particularly require financing (assessed based on projected environmental and economic returns); and (2) projects or investments within these sectors that are proven. Here, banks themselves are generally best positioned to develop clear assessment frameworks for expected costs and returns on investments. However, government support could help banks to overcome a general concern with lack of incentives and structures for banks to move beyond setting broad green financing policies to develop their core business in alignment with green banking. Additionally, these sector-specific financing recommendations could benefit from sector-specific environmental quality standards, stemming from the national and provincial EPAs.



FOR INTERMEDIARIES

Preliminary recommendations for intermediaries – targeting entities that work directly with textile/leather SMEs in Pakistan such as industry and trade associations and cleaner production centres are:

Educate SMEs on green financing opportunities and the business case for investing in SCP.

Solutions are needed to ensure that more SMEs, including within the textile/leather sectors, have access to education and capacity building on SCP to adopt relevant technologies and support installation and monitoring. Furthermore, as opportunities for green financing and tailored financial products in the SME sector grow, solutions are required that ensure SMEs across Pakistan, including those in rural areas, are aware of and have access to financing opportunities. This awareness must be paired with strong incentives (including financial incentives) to invest in environmental sustainability as a small business.

Replicate successful capacity building for SMEs within sustainable and cleaner production.

In Pakistan, there are many positive examples of SMEs receiving the support required to assess and mitigate the environmental impacts of their business models, especially with the cleaner production support for these SMEs dating back to 1997. Further efforts could be made to collate these best practices and share them across SMEs operating across the country, and potentially across sectors.

Support the development of tailored financial products for SMEs to invest in SCP.

Considering the low levels of knowledge among financers of the required SCP investments and payback periods, intermediaries who are working directly with SMEs can play an increasing role in aggregating demand and building the business case for financing SCP by SMEs, including within the textile/leather sectors. This could involve data collection or sharing of existing data on desired investments, ticket sizes and payback periods while also supporting banks to develop suitable collateral and other lending requirements that match what information and documents are available to SMEs.

FOR FINANCERS

Importantly, based on desk research and stakeholder interviews, initial recommendations for financial institutions in Pakistan (particularly targeting commercial banks) include:

Integrate environmental risk management into the institution's core business.

Environmental risk management guidelines included in the GBGs are meant to, but not required to, relate to banks' core business, thereby influencing financers' traditional credit risk assessment. However, evidence suggests that the integration of environmental risk management activities has not necessarily influenced lending assessments for clients. Banks have experienced internal barriers to implementing such models across their SME financing or other corporate financing departments. The SBP has indicated its interest in furthering the integration of environmental into credit risk scorecards, potentially through making this a mandatory requirement.

Build internal institutional capacities to respond to environmental risks and green financing opportunities.

As per an interviewee engaged as part of this study, banks in Pakistan previously had Climate Assessment Teams that possessed a solid understanding of environmental laws and were reasonably well positioned to provide advisory services to borrowers. In recent years, banks have largely incorporated these units within their Investment Banking Groups where the employees tend to lack the knowledge and capacities to provide advisory services on topics of green banking. Banks require solutions that build their technical understanding of green financing projects and compliance with environmental regulations. Such solutions could include the creation of more educational and job opportunities within the space of green finance, particularly as it relates to SME financing.

Define green investments and banking while also collating data on current portfolio alignment with green financing.

Stakeholder interviews in particular indicated that some banks likely are already financing what could be considered 'green' investments, for example, financing for energy efficient looms or wastewater treatment plants by textile/leather SMEs. There are various examples from the region of effective establishment of common effluent treatment plants (CETPs) (UNIDO 2018), with the IFC Partnership for Cleaner Textile (PaCT) exploring further opportunities in Pakistan (IFC 2018). Banks could benefit from first defining what are green investments within the bank, then assessing their current portfolio status to identify the degree of alignment with these objectives. This could prove useful in ensuring that banks leverage their core capacities and existing institutional structures in expanding their green banking portfolios.

Design tailored products that enable SCP investments by SMEs, particularly textile/leather SMEs.

Tailored product development, perhaps learning from intermediaries that are familiar with the desired investments, payback periods and financial data available to textile/leather SMEs would ensure that banks are able to tap into the significant business development opportunity posed by green banking in Pakistan.

Share knowledge and best practices among banks on green financing.

This study indicates that banks have primarily been operating in isolation from each other to develop green financing policies and approaches. Interviewed banks noted that working independently from other banks to develop policies and approaches in line with the GBGs has proven somewhat inefficient, especially to first-movers. Based on the gaps identified and with reference to global and regional best practices, a summary of proposed multi-stakeholder recommendations for government agencies and regulators, financers and SME intermediaries identified in this paper is provided below.

Summary of preliminary recommendation areas

Share knowledge and best practices among stakeholders.

Support training programmes around green financing and SCP for SMEs and financers.

Develop environmental risk management into the core business.

Streamline and strengthen regulatory regime for green financing and environmental compliance.

Expand technical assistance to banks for green financing.

Design tailored financial products that enable green investments by SMEs.

CONCLUSION AND NEXT STEPS

In light of these trends and the growing momentum for green financing in Pakistan, the results of this study will be shared with core private and public sector actors (following on from the dissemination workshops). This study will serve the basis for the future development of comprehensive Green Credit Guidelines, supported by tailored financial mechanisms for SMEs to invest in environmental sustainability, particularly in Pakistan's textile/leather sectors.

Following on from this report, core actors will be engaged to collaboratively assess and discuss the results of this gap analysis and the relevance of the preliminary recommendations. These stakeholders, particularly financial institutions, will be enlisted to formulate a green financing instrument (or Green Credit Guidelines), which overcomes the overarching challenges presented in this report and:

- **Improves the buy-in and institutional capacities of financial institutions to absorb and disburse capital through tailored green financing products for SMEs; and**
- **Builds the knowledge and financial management capacities of SMEs to better access and allocate debt-based financing for green investments.**

Acknowledgements

This white paper is based on WWF-Pakistan's study titled 'Needs Assessment Study. Facilitation of Green Financing for Leather and Textile SMEs from Financial Institutions in Pakistan' authored by Maggie Sloan, Jonas Restle-Steinert, Jürgen Hannak and Rainer Agster in 2020.

References

Hengstmann, Dr Reiner 2020: Scoping Study on the European Union Standards in Textile and Leather Sectors in Pakistan. ILO and WWF-Pakistan. Retrieved from https://d2ouvy59p0dg6k.cloudfront.net/downloads/final_eu_scoping_study_1.pdf.

IFC 2016: Pakistan: Staff Report for the 2015 Article IV Consultation, Ninth Review Under the Extended Arrangement, Request for Waivers of Nonobservance of Performance Criteria, and Request for Modification of a Performance Criterion-Press Release; Staff Report; and Statement by the Executive Director for Pakistan.

IFC, NPO Pakistan and Cleaner Production Institute (CPI) 2016: Sustaining Growth Cleaner Production in Pakistan.

IFC 2018a: Gap partners with IFC to cut energy use in Pakistan Textile sector. News & Events. Retrieved from https://www.textilepact.net/news-and-events/gap-partners-with-ifc-to-cut-energy-use-in-pakistan-textile-sector.html.

IFC 2018b: Sustainable Banking Network (SBN) Country Progress Report – Vietnam. Retrieved from http://documents.worldbank.org/curated/en/827551520938968526/pdf/WP-VN-SBN-Country-Progress-Report-Vietnam-PUBLIC.pdf.

Linstead, Conor A. H. 2015: Water Footprint of Key Industrial Sectors in Punjab, Pakistan. WWF Pakistan, SWITCH ASIA Project.

Pakistan, C. P. 2013: City Wide Partnership for Sustainable Water Stewardship in SMEs in Lahore, Pakistan. Lahore: SWITCH-Asia, European Union & WWF.

Pakistan, W. 2007: Pakistan's Water at Risk, A special report. WWF-Pakistan.

UNIDO 2018a: Tannery Effluent Treatment. Leather Panel. Retrieved from https://leatherpanel.org/publications-categories/tannery-effluent-treatment.

UNIDO 2018b:
Kasur Tannery Pollution Control Project – Pakistan. Retrieved from https://leatherpanel.org/content/kasur-tannery-pollution-control-project-pakistan.

World Bank 2009: Bringing Finance to Pakistan's Poor: Access to Finance for Small Enterprises and the Underserved.