National Financial Inclusion Strategy Pakistan

A strategy for building a dynamic and inclusive financial sector to support Pakistan's growth in the 21st century.

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List of Acronyms

AFI	Alliance for Financial Inclusion
B2G	Business to Government
BISP	Benazir Income Support Program
BTCA	Better Than Cash Alliance
CAGR	Compound Annual Growth Rate
CDD	Customer Due Diligence
CNIC	Citizens National Identity Card
DTA	Digital Transactional Account
EIU	Economist Intelligent Unit
EOB	Employee's Old-Age Benefit
G2B	Government to Business
G2P	Government to Person
GoP	Government of Pakistan
HBFCL	House Building Finance Company Limited
ICT	Information and Communication Technology
I-SIP	Inclusion, Stability, Integrity and Protection
ID	Identification Document
KYC	Know-Your-Customer
MFB	Microfinance Bank
MFI	Microfinance Institution
MNO	Mobile Network Operator
MoF	Ministry of Finance
MSME	Micro, Small and Medium Enterprise
NADRA	National Database and Registration Authority
NBFC	Nonbank Finance Corporation
NFIS	National Financial Inclusion Strategy
NIFT	National Institutional Facilitation Technologies
NPL	Non-Performing Loan
NPS	National Payment System
OTC	Over-The-Counter
PPAF	Pakistan Poverty Alleviation Fund
PRISM	Pakistan Real Time Interbank Settlement Mechanism
PSP	Payment Service Provider
PSO	Payment Service Operator
RSP	Rural Support Program
RTOB	Real-Time Online Branch
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SIM	Subscriber Identity Module
SME	Small and Medium Enterprise
USSD	Unstructured Supplementary Services Data
VPS	Voluntary Pension Scheme

Executive Summary

1. Since the early 1990's, Pakistan's financial sector has undergone considerable reforms that have significantly strengthened its soundness, profitability, efficiency and diversity. Until that time, it had been dominated by a handful of nationalized banks that suffered from poor performance and asset quality. By December 2013, the sector was comprised of 38 commercial banks; 10 regulated Microfinance Banks (MFBs); a number of unregulated microfinance institutions (MFIs); 46 nonbank finance corporations (NBFCs); 50 insurance companies of which, 40 non-life insurers, 9 life insurers and 1 non-life reinsurer; and 3 stock exchanges. Banks and MFBs are also involved in branchless banking in partnership with mobile network operators (MNOs). The banking sector, now 85% privately-owned, dominates financial services, representing approximately 90% of total financial sector assets. The banking sector is generally sound (Capital Adequacy Ratio of 15.1%) and profitable (after-tax return on assets and equity of 1.4% and 15.4% respectively, as of June 2014).

2. Pakistan has been a pioneer in championing financial inclusion for over a decade under the committed leadership of State Bank of Pakistan (SBP). There have been a large number of significant milestones which include: the creation of a regulatory framework for MFBs (2001); the expansion and modernization of the online credit information bureau (e-CIB, 2005); a series of measures to strengthen the safety and efficiency of payments, including the establishment of the Pakistan Interbank Settlement System (PRISM) (2008) and the development of inter-operable inter-bank card payments platforms; the adoption of Branchless Banking Regulations (2008, amended in 2011); the adoption of a tiered approach to know-your-customer (KYC) requirements; the establishment of a specialized microfinance credit information bureau (m-CIB, 2009-2012); the launch of a nationwide Financial Literacy Program (2012); and work on an Inclusion, Stability, Integrity, and Protection (I-SIP) methodology (2014). SBP and the Government of Pakistan (GoP) have also sponsored a number of guarantee facilities and subsidized lending schemes aimed at encouraging lending to the underserved. Pakistan's efforts have been recognized internationally. In 2011 and 2012 its microfinance regulations were ranked best in the world by the Global Microscope report, and Pakistan was ranked in the top-ten internationally for its enabling environment for financial inclusion in the most recent Global Microscope 2014.

3. Despite these sustained efforts, the level of financial inclusion remains very low. Just 10.3% of Pakistani adults have an account with a formal financial institution[1], well below both the South Asian average of 33% and the average for all lower-middle-income countries of 41.4%[2]. Fifty-six percent of adults use neither formal nor informal products, and while 36% of adults save, only 4% save with a formal financial institution.[3] Similarly, while one-third of adults borrow money, only 3% borrow from a formal financial institution. The use of mobile money is

[1] Financial Inclusion Insights, 2014.

[2] Findex, 2011. Pakistan is categorized by the World Bank Group as a lower-middle-income country, i.e. one whose per capita gross national income falls between USD 1045 and USD 4125.

[3] Financial Inclusion Insights, 2014. This excludes National Savings, which provides savings to approximately 7.7 million Pakistanis.

growing rapidly, but is still limited to 11% of males and 3% of females[4]. Insurance coverage is estimated at 7%, and only an estimated 7% of adults have a formal pension. The financially included are overwhelmingly male (86%) and predominantly urban (68%). (See Annex 2 for further details regarding financial inclusion of the adult population in Pakistan).

4. After years of steady growth, credit to the private sector has declined in real terms over the past five years. While the total assets and deposits of Pakistan's banking sector have doubled since 2008, private sector credit to GDP has declined from 22% in 2009 to just 14.7% in June 2014. The decline in credit provided to SMEs has been particularly pronounced, falling from 16% of bank lending in 2008 to just 7% in June 2014. The agriculture sector, which represents 21% of GDP and 60% of total employment, accounted for just 6% of total lending. The figures on housing finance are even starker. Of a total population of 180 million people, there are only 76,000[5] housing loans outstanding in the banking sector. Against a backdrop of slow economic growth and rising government borrowing, banks have invested heavily in government securities which now amount to 122% of total bank credit to the private sector. Private businesses receive just 40% of bank credit, and this supply is skewed towards larger enterprises with around 0.4% of bank borrowers accounting for 65% of all bank loans[6].

5. The low level of financial inclusion and the decline in credit to the private sector can be attributed in part to factors which go beyond the scope of financial sector policy and should be addressed in the broader economic, social and political context. These include the following:

- ***The economic cycle***: The decline in credit to the private sector is due in part to cyclical factors. Credit, including to underserved segments such as SMEs and housing, had been growing rapidly prior to the economic downturn in 2008 which was followed by the lowest average five-year period of GDP growth (2.8%) in the past 60 years. The economic downturn resulted in a decline in demand for credit. The economy is now showing signs of improvement, with growth estimated at 4.3% for 2013/14, and private sector credit growth has started to show signs of recovery in recent months.

- ***Business climate***: The challenging economic and business climate, including severe energy shortages and security concerns, has been highly disruptive for businesses, particularly MSMEs, negatively impacting their creditworthiness. There was a sharp deterioration in asset quality post-2008, particularly in the SME and housing sectors, where NPLs now stand at 34% and 29%, respectively. This has understandably dampened banks' risk appetite and resulted in a "flight to quality".

- ***Rapidly rising government debt***: Public sector debt has risen rapidly, with the fiscal deficit rising from under 3% of GDP in 2005 to 8.5% of GDP in 2012/13. Over the same period, private credit declined as a share of banks' total lending from 75% to 45%. Banks' deposit base has continued to grow during this period, but this growth has largely been deployed to a rapid expansion of holdings of government securities, which provides banks with a relatively attractive yield at low risk.

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[4] Financial Inclusion Insights, 2014.

[5] SBP Quarterly Housing Finance Review, 1st Q 2014.

[6] Pakistan 10-Year Strategy Paper for the Banking Sector.

- ***Gender barriers***: Women are largely excluded from the formal financial system. Only 2.9% of adult females have an account with a formal institution, compared to 17% of males.[7] Mobility and social interaction limitations can restrict women's access to financial services. These may be partially addressed by the rapid expansion of digital financial services. However, there is a 42% gender gap in mobile phone ownership and 30% of females do not even have access to somebody else's mobile phones[8]. As women comprise half of the adult population, Pakistan will not be able to achieve an inclusive financial sector unless financial services become truly accessible to all. It will require a concerted and creative effort from both government and the private sector to address ingrained cultural and social barriers that prevent women from participating in the financial sector, and to investigate further the causes of, and potential solutions to, exclusion.[9]

- ***Growing informality in the economy:*** Recent research[10] estimates the size of the informal economy to be 75-91% of the size of the formal economy -much larger than previously estimated. The informal sector appears to be expanding while the formal economy is in retreat. Since banks and other formal financial institutions are reluctant to do business with informal firms, growing informality has contributed to financial exclusion.

6. Other reasons for the low level of financial inclusion are varied, and differ from one market segment to another as outlined in section 5. However, there is a broad consensus among stakeholders on several cross-cutting financial sector issues, notably:

- While SBP has been very proactive in promoting an inclusive financial sector, many of the issues that need to be addressed fall outside of its regulatory mandate. For example, a number of longstanding problems cannot be solved without legislative changes, but important draft bills, including those on secured transactions, deposit insurance, insolvency and credit bureaus, have been in an uncertain legislative process for years. Progress towards a more inclusive financial system has also been slowed because of limited commitment and weak coordination between several government and private sector stakeholders.

- Weaknesses in the basic financial sector infrastructure and the legal and judicial framework discourage lending, particularly to those perceived as riskier borrowers. The supply of credit to underserved markets is further depressed by: poor contract enforcement, serious deficiencies in land titling and registration, the absence of a secured transactions framework and electronic collateral registry for moveable collateral and the inability to enforce collateral outside of the slow and unpredictable judicial system.

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[7] Findex 2011World Bank: The Little Data Book on Financial Inclusion.

[8] Financial Inclusion Insights 2014.

[9] For example, 9 out of 10 households have access to a mobile phone, but in about one-third of instances, female household members are excluded from such household-level access.

[10] Ali Kemel and Waqas Qasim, Pakistan Institute of Development Economics, 2012.

- Lack of capacity in both financial institutions and clients is also a constraint to greater financial inclusion. Most financial institutions have focused on the upper end of the business and retail markets and have not developed the skills, techniques and products required to serve other market segments profitably. Microfinance providers have developed this knowledge for microfinance clients, but there is a large "missing middle" which is currently not being served. On the client side, a basic lack of financial literacy and awareness serves to limit demand for financial products and services.

7. The persistence of financial exclusion in the face of long-standing efforts to promote inclusion points to the need to develop a comprehensive National Financial Inclusion Strategy (NFIS). The strategy comes at a particularly opportune moment as new technology and the rapid expansion of branchless banking offer unprecedented opportunities to transform financial inclusion in Pakistan. The NFIS provides a vision that underlies the NFIS, a framework and a road map for priority actions aimed at addressing constraints and significantly increasing access to, and usage of, quality financial services. The strategy will guide efforts to promote financial inclusion over the coming five years (2015-2020). It includes targets and objectives that will be monitored, but it is intended to be a living document that can be adjusted as required.

8. The NFIS has been agreed to at the national level following extensive consultations with stakeholders.[11] It is being championed by SBP, with shared leadership from the Ministry of Finance (MoF) and the Securities and Exchange Commission of Pakistan (SECP). The objectives are fully consistent with the Government of Pakistan's Vision 2025, which calls for enhancing access to credit for SMEs and focusing on financial inclusion and deepening. Successful implementation will require the commitment and active engagement of key stakeholders from both the public and private sectors.

9. The stated vision for financial inclusion in Pakistan is that: *"individuals and firms can access and use a range of quality payments, savings, credit and insurance services which meet their needs with dignity and fairness".* A set of cross cutting conditions – the key enablers – will need to be put in place as they will lay the foundation for implementing this vision. The key enablers cut across all priority sectors and are: (1) public and private sector commitment to the NFIS and coordination; (2) enabling legal and regulatory environment; (3) adequate supervisory and judicial capacity; and (4) financial, payments and information and communications technology (ICT) infrastructure. The key enablers will support targeted actions – the drivers – aimed at increasing access and developing an ecosystem of financial services that will have the quality and features required by the Pakistani population and enterprises. These drivers are: (i) promoting DTAs and reaching scale through bulk payments; (ii) expanding and diversifying access points; (iii) improving capacity of financial service providers; and (iv) increasing levels of financial capability.

10. The current network to distribute financial services in Pakistan falls short, particularly in rural areas, and it does not permit all firms and individuals, especially women, to have easy and convenient access to even basic accounts. Hence, the NFIS prioritizes the need to increase and diversify financial service access points such as bank branches, bank agents, ATMs, POS, mobile money agents and remote access through mobile phones and the internet.

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[11] Annex 3 provides further details on methodology and consultative process.

11. The vision aspires to having universal access to formal accounts, not be limited to simply traditional savings and checking accounts but would also include digital transactional accounts (DTAs) such as branchless banking accounts. Universal access to formal accounts depends on a balanced KYC regime, improvements in the national payment system (NPS), and on shifting large payment streams from cash to digital platforms. These large payment streams include wages in the public and private sectors, government-to-business (G2B) payments, social cash transfers, other government-to-person (G2P) payment streams such as pensions, and also P2G (person to government) payments such as fees and taxes.

12. Aspiring to a large increase in the number of adults with accounts is a necessary but insufficient condition to meet the objectives of the NFIS. Individuals and firms must also have the convenience, tools and confidence to use a range of quality services through these accounts, including simple payments, remittances, savings, credit and insurance products. These services should be provided in both conventional and Islamic-compliant structures. The NFIS calls for the development of a varied set of financial services that meet the needs of consumers and respects their right to dignity and fairness, with a special focus on historically marginalized segments such as low-income households (e.g., small farmers), women, and micro- and small-enterprises. This will require coordinated and parallel efforts with the goals of:

- Diversifying the range of basic payments, remittance and savings products offered to the Pakistani population and enterprises through DTAs and bank accounts;
- Increasing the financing opportunities for urban and rural micro-, small- and medium-enterprises, including agricultural finance for men and women small farmers;
- Increasing penetration of insurance services;
- Bringing pensions to more workers, including those in the informal sector;
- Developing housing finance products, including for low-income segments;
- Fostering Islamic finance to serve those who prefer Islamic products or who are excluded or underserved due to their religious beliefs; and
- Ensuring consumer protection and increasing financial awareness and literacy, as two foundational pillars for responsible inclusion.

1 Introduction

13. Over half of the world's adult population, or 2.5 billion people, lacks access to formal financial services, with the overwhelming majority of the unbanked (90%) living in developing countries. Greater financial inclusion can bring these people into the financial mainstream, with positive effects on economic growth, financial stability and social cohesion. Both theoretical and empirical studies[12] have shown that financial exclusion inhibits human and physical capital accumulation, contributing to persistent income inequality and poverty.

14. Given the positive welfare effects of increased access to finance, building inclusive financial systems has become an important objective for policymakers around the world. In 2010, the G-20[13] produced a set of recommendations known as "The Principles for Innovative Financial Inclusion". The following year, the Alliance for Financial Inclusion (AFI), a global network of concerned policymakers and supervisors, developed the "Maya Declaration", the first set of global and measurable commitments to financial inclusion. The declaration, which has been endorsed by over 80 countries—including Pakistan, commits to:

- Create an enabling environment that increases access and lowers costs of financial services, including through new technology;
- Implement a proportionate regulatory framework that balances financial inclusion, integrity and stability;
- Integrate consumer protection and empowerment as a pillar of financial inclusion; and
- Use data to inform policies and track results.

15. A number of recent developments have contributed to the timeliness of making a push for financial inclusion, including: i) technological innovation such as mobile financial services; ii) a more open regulatory approach to financial inclusion; iii) a greater understanding of some key ingredients of success; and iv) a recognition that market forces alone will not solve the problem of persistent financial exclusion**.** Developing countries have been on the forefront of pursuing innovative solutions to tackle the problem of financial exclusion so global initiatives rely heavily on peer-to-peer learning and knowledge sharing among developing countries.

[12] See, inter-alia, Khandker, 2005, Karlan and Zinman, 2010, Banarjee et al, 2009, and Beck Levine and Levkov, 2010.

[13] The Group of 20 (G-20) is a forum for the governments and central bank governors from 20 major economies, accounting for 85% of gross world product.

2 Current Landscape of Financial Services

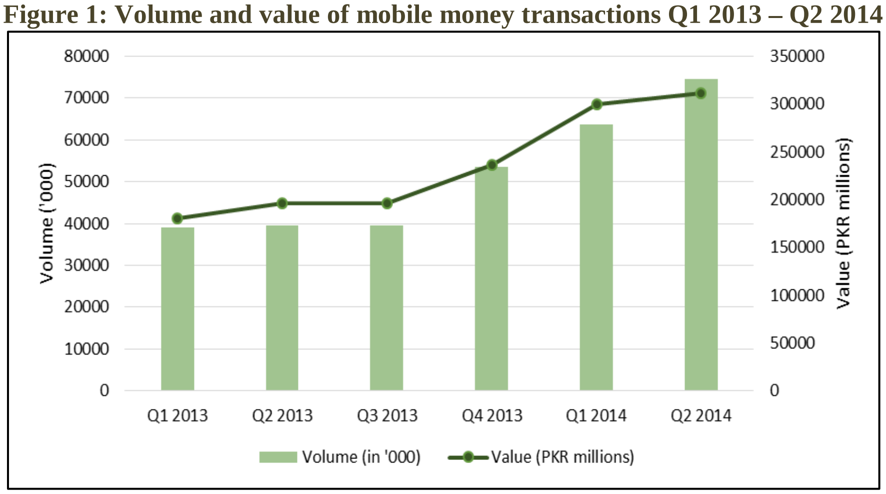
16. The NFIS includes a series of Technical Notes that provide detailed analyses of various segments of the financial sector which are important to achieving the strategy's objectives. The Notes also include detailed action plans for improving financial inclusion in these market segments, the key elements of which are outlined in section 6 and Annex 1 (Action Plan). The Notes form an integral part of the strategy and will serve as a reference for the Technical Committees charged with coordinating implementation of the strategy in these focus areas. This section provides a brief overview of the current state of financial inclusion in these priority areas and summarizes the key constraints to achieving financial inclusion outlined in the Notes.

2.1 Branchless Banking[14], Payments and Digital Transaction Services

17. Pakistan is one of the fastest growing markets for branchless banking in the world. The catalyst for this growth was the introduction of the Branchless Banking Regulation in 2008, which allowed banks and MFBs to leverage mobile phone communications and distribution networks to bring financial services closer to customers. In addition, SBP has made proactive regulatory decisions since 2008 which have facilitated a range of sustainable branchless banking business models. The mobile network is well developed, and while access is not always present for all household members, 9 out of 10 households do have access to a mobile phone and SIM card.[15]

18. Figure 1 below depicts the steady growth in the value and volume of branchless banking transactions in Pakistan in the 18 months prior to Q2 2014.

Figure 1: Volume and value of mobile money transactions Q1 2013 – Q2 2014



***Source**: Quarterly Branchless Banking Newsletter, State Bank of Pakistan, Apr-Jun 2014*

19. While there are 120 million SIM card holders in Pakistan, only 7% of Pakistani adults had used mobile money either through their own or others' accounts. Just 0.4% of adults had

[14] In Pakistan this term means provision of transaction services to a specific class of accounts called as "branchless banking accounts", operated entirely through electronic funds transfers at various alternative delivery channels like agents, ATMs and POS terminals.

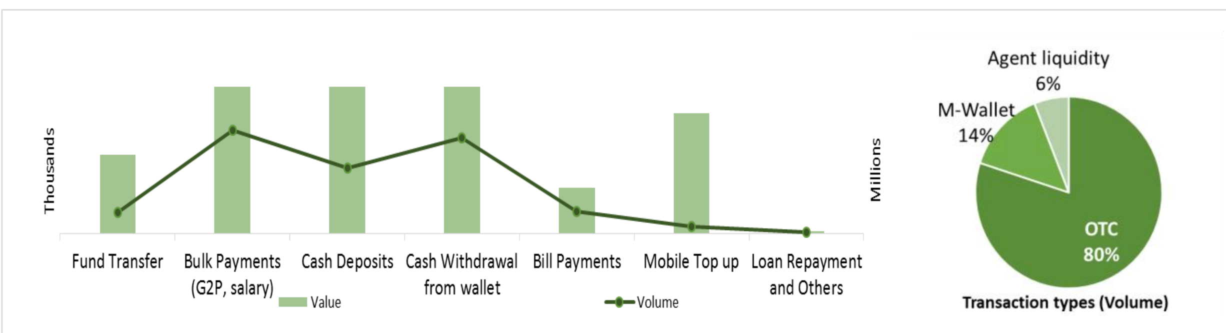
[15] Global Financial Inclusion (Global Findex) Database.

registered mobile money accounts. The top three reasons survey respondents gave for using mobile financial services to deliver or receive remittances were: ease of use (more than 60%), safety (25%) and speed (10%).[16]

20. OTC transactions[17] currently represent 80% of all transactions versus only 14% of transactions are direct wallet-to-wallet (account-to-account). However, wallet-to-wallet transactions are growing in both volume and value thanks to increasing use of e-wallets for mobile top ups and bulk payments. The main driver for growth in value has been bulk payments (e.g. government to person, G2P) and cash deposits or withdrawals. Growth in volume can be largely attributed to mobile top-ups, which accounted for a 40% growth in the number of transactions in Q1 2014.

21. The SBP recently issued rules for Payment Services Providers (PSP) and Payment Systems Operators (PSO). These entities will now be subject to the full supervision and oversight of the SBP and will be prohibited from handling customer or participant funds or conducting any banking activity. This new development has the potential to stimulate the development of the payments market. The lack of a clear and detailed regulatory framework for payment systems and services had prevented the entry of new payment systems and payment services such as: electronic payment gateways for ecommerce transactions; development of systems that would enable a higher level of inter-operability for branchless banking services; Third Party Service Providers (TPSPs) for providing prepaid card and mobile money solutions; white label ATM and POS operators and agent networks; and the introduction of inter-bank direct-debit products.

Figure 2: Volume and value of mobile money transactions and agent liquidity



***Source**: Quarterly Branchless Banking Newsletter; SBP, April-June 2014*

22. There are several priority issues that must be addressed to further enable the infrastructure and ecosystem for DTAs to drive growth in the next five years:

a) The low volume of wallet-to-wallet transactions compared to the high volume of OTC transactions, driven in part by higher fees to agents.

b) The lack of a product ecosystem beyond basic payments that entices customers to transact based on DTAs.

[16] InterMedia Pakistan Financial Inclusion Insights (FII) Tracker Survey 2014

[17] OTC transactions are transfers initiated in person at an agent location through the agent's account. The initiator need not be a branchless banking account holder.

c) There is currently a low level of interconnection of payment services at the mobile and card levels. People are unable to access mobile money services across providers, move money across mobile money accounts and from mobile money accounts to bank accounts and vice versa, and retailers cannot leverage POS terminals for payment transactions from different banks. Currently, only ATM cards are interoperable.

d) More broadly, there are some key gaps in the National Payments System (NPS) which impact the development and usage of digital financial services.

e) The card acceptance network is very limited, and there are no concerted efforts to expand it.

f) Most MFBs do not have access to the National Institutional Facilitation Technologies (NIFT) operated Cheque Clearing House and Pakistan Real Time Interbank Settlement Mechanism (PRISM) systems, so are unable to provide the same level of payment services as banks. Mobile Network Operators (MNO) are offering Unstructured Supplementary Services Data (USSD) service only to their partner bank ("one-to-one" model), thereby hampering development of "many-to-many" operating models which would benefit customers by providing expanded access through inter-operability.

g) There is no deferred settlement system and real-time funds transfer system for interbank low value credit and debit transfers. This has resulted in the predominance of cheques for all forms of corporate, financial service and GoP payments.

h) The lack of integration of the PRISM system within the GoP's financial management system results in inefficiencies to process G2P payments like social benefit and salary payments and in revenue collection.

i) Limited integration of branchless banking services within the broader NPS has hampered the development of electronic retail payments progress towards decreasing the volume of cash payments.

j) The lack of an articulated oversight framework for the NPS and limited resources of the relevant departments at SBP and SECP have hampered full implementation of the necessary oversight activities.

a) Until recently (October, 2014), there had been no detailed regulatory framework for payment systems, which impeded the entry of new payment systems and services. The effectiveness of the new regulation is limited by the lack of delineation of the roles of Payment Service Provider (PSP) and Payment Service Operator (PSO) and sets the same level of capital for all types of PSP and PSO, which might create barriers to entry.

2.2 Housing Finance

23. Housing finance currently represents a negligible share of total bank lending in Pakistan**.** Until 2002, mortgage lending was the exclusive domain of specialized lenders, primarily the

state-owned House Building Finance Company Limited (HBFCL). The entry of commercial banks after 2002 led to rapid growth of the market until the economic downturn in 2008.

24. The 2008 economic downturn and an increase in mark-up rates resulted in a sharp increase in non-performing loans (NPLs), causing lenders to reduce their mortgage lending or withdraw from the housing market entirely. As of March 2014, the outstanding mortgage loan portfolio amounted to just PKR 52 billion (about USD 510 million), or 0.5% GDP and 1.6% of total credit to the private sector. Only 650 loans were extended in 2013, and the total number of loans outstanding is a meager 76,000. MFBs have recently entered the market, with aggregate outstanding loans of just PKR 214 million as of March 2014[18]. The regulatory cap on microcredit (PKR 500,000) constrains the potential for MFBs to offer housing loans in urban areas. In the absence of adequate financing from the financial sector, Pakistanis rely on self-financing, informal sources (e.g. money lenders) and, to a much lesser degree, credit provided by developers to meet their housing finance needs.

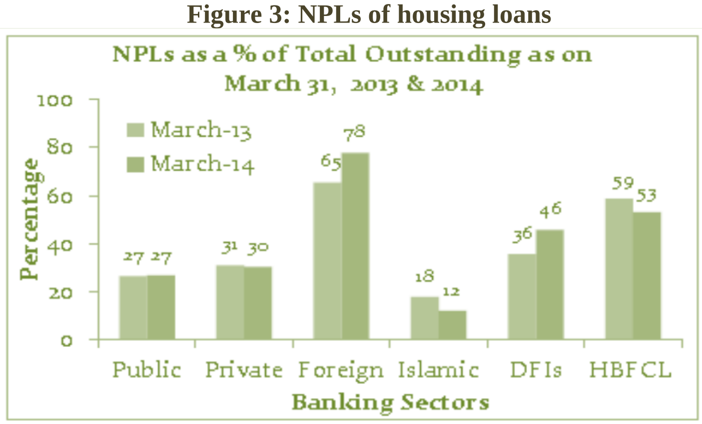
Table 1: Evolution of residential mortgage (loans outstanding in PKR billion)

	Dec 2003	Dec 2008	Dec 2011	Dec 2012	Dec 2013	March 2014
HBFC	18.3	17.0	13.2	12.8	12.3	12.2
Conventional commercial banking	4.4	67.0	30.7	28.4	25.9	23.9
Islamic banking			15.5	13.8	13.1	15.5
Total	22.7	84.0	59.4	55.0	51.3	51.6

Source: SBP

25. Despite a nearly exclusive focus on the salaried middle-class and above, the quality of banks' housing credit portfolios is low, with high NPL ratios in virtually all segments of the market. This further dissuades banks from mortgage lending.

Figure 3: NPLs of housing loans



***Source**: SBP Housing Finance Review January-March 2014*

26. There are a number of factors affecting housing finance which fall outside the scope of the NFIS, including lack of housing supply, affordability of housing, informality, etc. The most significant financial sector issues that need to be addressed to improve access to housing finance are:

[18] They are not included in the data of Table 1.

a) The inefficiency of foreclosure, which undermines the credibility of mortgage security;

b) The low reliability and high cost of land titling and administration systems;

c) The lack of long-term, fixed-rate funding, which results in floating-rate housing finance an increases the risks to both borrowers and lenders;

d) Poor risk management practices and lack of technical capacity of lenders; and

e) The lack of appropriate business models and support schemes for providing housing finance to low-income and informal workers.

2.3 Insurance

27. The insurance sector has been operating in Pakistan since independence but remains with a penetration ratio of just 0.93% (premium/GDP) and density of just USD 7.7 (per capita premium). Historical factors contributing to this situation include the departure of international companies from Pakistan, the large number of non-life players tied to family-based commercial or industrial groups and the nationalization of the life insurance business in 1972.

28. Life insurance and microinsurance have grown strongly in the past few years**.** The life insurance industry has grown consistently and significantly since 2008, with annual growth ranging from 22 to 30%. In addition, a number of microinsurance initiatives have been launched, reaching many households. For example, BISP has covered 4.1 million individuals with term life coverage and 48,000 households (approximately 300,000 lives) with health coverage. MFIs, MFBs and RSPs are providing credit life coverage to 1.77 million policyholders and health cover to 1.56 million policyholders.

29. Insurance figures for the sub-continent countries, whose insurance markets share a common origin, are given below.

Table 2: Insurance penetration (premium as % of GDP)

Country	Non-Life	Life	Total
Pakistan	0.37%	0.56%	0.93%
Bangladesh	0.20%	0.60%	0.80%
India	0.78%	3.17%	3.95%

Source: SECP, IRDA.

Table 3: Insurance density (premium per capita in USD)

Country	Non-Life	Life	Total
Pakistan	3.0	4.7	7.7
Bangladesh	1.7	5.4	7.1
India	10.5	42.7	53.2

Source: SECP, IRDA.

30. The 2008 Access to Finance (A2F) survey found that almost half of the uninsured population has never considered buying insurance. Somewhat surprisingly, the more educated categories were even less inclined. One-third or more of the uninsured perceived the cost of insurance to be unaffordable.

31. The expected growth of DTAs will substantially increase the potential of the insurance industry to expand outreach and increase efficiency. Some insurers have already established partnerships with DTA providers to offer premium payment and product options that better suit consumers. However, the industry will not be able to fully exploit this advantage unless some of the fundamental issues facing it are addressed. These include:

a) A lack of consumer awareness of, and demand for, insurance;

b) Absence of a clear mandate, leadership, technical expertise and resources at public insurance entities, and the weak technical capacity at the Ministry of Commerce that is responsible for industry policy and oversight of public entities;

c) Inadequate minimum capital requirements, which result in a weak industry and a reduced appetite to grow the business;

d) Inconsistent and inequitable taxation of life insurance and *takaful;* and

e) Inadequate staff and capacity of the insurance regulator (SECP).

2.4 Pensions

32. The overwhelming majority of Pakistan's work force—including informal workers, the self-employed and those working in entities employing fewer than five people—have no formal pension coverage. The labor force was estimated at almost 60 million in 2012-13, of which approximately 60% are self-employed or contributing family members. For these 36 million Pakistanis, the Voluntary Pension Scheme (VPS) is the only formal mechanism available for pension provision. Most employers and employees of businesses with fewer than five employees also have only the VPS, since the Employee's Old-Age Benefit (EOB) scheme is not mandated. Thus, VPS is a critical component to old-age income planning for the majority of Pakistanis, but its impact remains marginal due to the small number of participants in the plan. The scheme has tax incentives, but these are largely irrelevant since a very small percentage of potential members could actually benefit from them.

33. Growth in account penetration and DTAs could significantly improve pension contribution collection and benefit payment processes**.** Awareness campaigns can build a greater understanding of the role and importance of savings for old age and can promote greater financial inclusion. However, significantly expanding pension protections will ultimately depend on addressing key issues in pension policy which go beyond the scope of the NFIS[19]. A separate Technical Note has been prepared and submitted to the government on these issues.

[19] These include addressing critical weaknesses in the EOBI, appointing an agency with a clear mandate for regulating and overseeing occupational savings schemes and establishing an overall national pension policy framework.

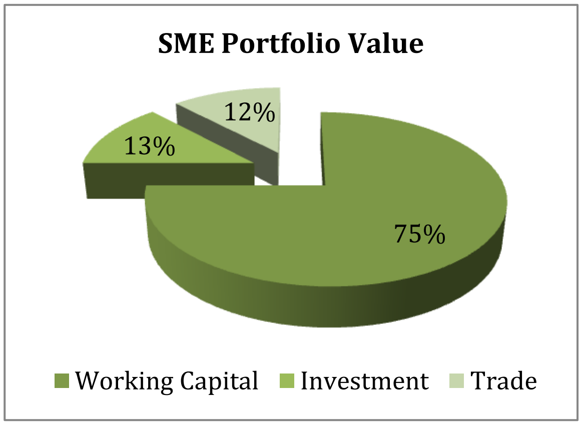
2.5 MSME Finance

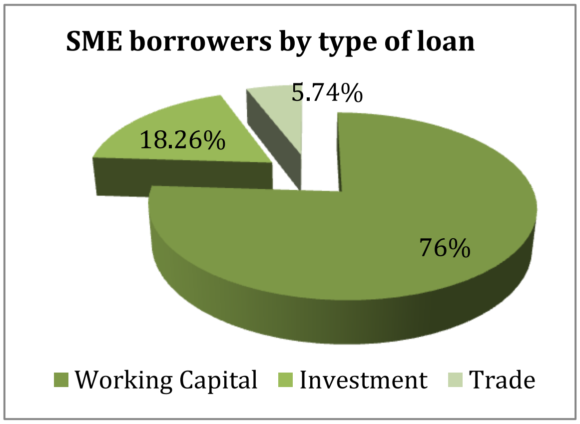
34. MSME financing needs remain largely unmet by the formal financial sector**.** MSMEs are estimated to account for 98% of all enterprises in Pakistan and employ the largest number of people in both rural and urban areas.[20] SMEs use their own resources for approximately 89% of working capital and 75% of investment needs. These figures rise to 90% and 81%, respectively, for microenterprises.[21] Banks are only lending to approximately 188,000 SMEs, or to just 6% of the estimated 3.2 million SMEs in the country.[22] It is worth noting that despite these low levels of access to finance, the percentage of SMEs in Pakistan citing access to finance as their most important obstacle was fewer than 3%, well behind lack of electricity (68%), corruption (10%), and crime (5%).[23]

35. SME lending has been dropping since 2008, after temporarily taking off in the early 2000s. Today, advances to SMEs are only about 1.2% of GDP, with a concerning NPL ratio of 34%. SME Bank, a government-owned entity created to spur the development of SME finance, has almost stopped extending new loans due to poor asset quality (NPL ratio of 82%) and accumulated losses.

36. SME lending is currently based on a limited range of products. Loans for working capital represent the largest share of total portfolio value and number of borrowers (Figure 4). Around five percent of all SMEs get a loan for working capital, while only one percent borrow for investment needs. Most of the loans (72%) are collateralized, usually against fixed assets. Some products that are well-suited to SME finance, such as factoring, are non-existent, due to the lack of an appropriate legal basis and expertise at financial institutions. Lending techniques such as value-chain finance and cash-flow lending are rarely used.

Figure 4: Concentration of SME bank lending in working capital loans





Source*: SBP, as of June 2014*

[20] There are no official statistics on the number of people employed by SMEs, and on the number of SMEs that fall under the microenterprise category. The statistics also do not categorize SMEs according to their sector (e.g. agriculture). Some of the statistics on the MSME sector are conflicting.

[21] Trade Finance in Pakistan: Changing Exports Competitiveness Trajectory, World Bank, 2014.

[22] SME Policy 2007, SME Led Economic Growth–Creating Jobs and Reducing Poverty. SMEDA, Ministry of Industries, Production and Special Initiatives. The statistics on the number of microenterprises and SMEs in Pakistan vary widely according to the source.

[23] World Bank Enterprise Survey, 2007.

37. SBP has been encouraging MFBs to provide larger loans to microenterprises and has recently increased the maximum loan size of MFBs from PKR 150,000 to PKR 500,000. By regulation, MFBs' maximum aggregate microenterprise exposure is limited to 40% of the total loan portfolio. Since microenterprise lending is still in its infancy, these limitations are not binding constraints for now but could become so in the future if MFBs develop the capacity to effectively serve the micro- and small-enterprise market.

38. The limited supply of credit to MSMEs is a major concern to policymakers in Pakistan and around the world given their potential for generating economic growth and employment. A 2011 report by McKinsey estimates that 50-60% of MSMEs globally are unserved or underserved by financial institutions, and this figure rises to 90% in South Asia. SMEs face difficulties in obtaining finance even in developed countries, albeit to a lesser degree. As in Pakistan, the problem has grown in the aftermath of the global financial crisis, prompting many governments to develop new or expand existing programs to support MSMEs. Some stakeholders in Pakistan have proposed the creation of a specialized tier of private SME banks to increase finance to the sector. This proposal, as well as a selection of policy levers used for promoting SMEs and SME finance in other countries, is discussed in the MSME Technical Note.

39. Based on an analysis of the constraints in Pakistan, the NFIS proposes a set of conventional and innovative priority actions that focus on improving the underlying legal and judicial infrastructure for MSME lending, improving MSME capacity, enhancing lenders' expertise in MSME banking, creating effective risk mitigation facilities (e.g., a credit guarantee scheme) and harnessing technology and digital information to foster MSME finance. Digital payments and information platforms create a new source of information that can be used in innovative risk assessment models for both credit and insurance. Information technology can help overcome some of the deficiencies of current screening methods, benefitting informal enterprises or those with no credit history in particular. Psychometrics, "big data" and digital footprints are already being used in innovative financial services in a number of countries. Examples of the use of credit scoring using digital data and psychometrically enhanced credit scoring models include Kenya (M-Shwari), Brazil (Oi Paggo), Peru (Financiera Confianza) and Pakistan (Tameer MFB).

40. Financial exclusion in the MSME sector stems largely from weaknesses in the legal framework, financial infrastructure, macroeconomic conditions and the broader business climate, as well as from limited capacity of both MSMEs and financial service providers. Major constraints to MSME finance include the following:

a) Weaknesses in contract enforcement and in judicial capacity;

b) Lack of the necessary legal frameworks for secured transactions, factoring and credit bureaus;

c) The absence of an electronic movable collateral registry;

d) Limited knowledge, and scarce use, of alternative financing methodologies that could substitute traditional collateralized lending for MSMEs such as value chain finance and cash-flow lending;

e) The limited business capacity of MSMEs;

f) The unreliability of energy supply and the poor security environment, which impact the creditworthiness of MSMEs; and

g) Potential market distortions created by existing subsidy schemes and government involvement in SME finance through a weak specialized bank.

2.6 Agricultural Finance

41. Agriculture is an important sector for Pakistan's economy but 85% of farmers are financially excluded**.** Agriculture contributes around 21% of GDP, 16% of exports, and employs nearly 45% of the labor force (60% of the rural population). Major crops such as wheat, paddy, maize, sugarcane, potato and cotton provide employment to around 13.5 million households. The few upper-income farmers enjoy a rate of access to formal finance that is six times higher (38.7% of farmers) than the poorest quintile (6.5% of farmers). And, although nearly 90% of employed adult women work in agriculture, they accounted for less than 4% of agricultural loans in 2012.[24]

42. Despite the economic slowdown, disbursements of agricultural loans have continued to grow. The total loan portfolio saw an increase of 172% between June 2008 and June 2014. However, the outstanding portfolio remains small, amounting to only 7.6% of total bank loans. SBP estimates the total demand for agricultural credit to be PKR 790 billion (USD 7.7 billion), against the current portfolio of PKR 290 billion (USD 2.8 billion). Banks account for just under half of the total value outstanding, while ZTBL – a specialized government bank and the single largest provider of agricultural loans – accounts for 39.2%. MFBs account for only 7% of the total value of loans outstanding but for approximately one-third of borrowers. Rural finance is also provided by MFIs, but those funded by the Pakistan Poverty Alleviation Fund (PPAF) are usually limited to loans of PKR 75,000 (USD 735). According to PPAF, farmers usually require greater amounts.

43. There is little product diversity, with the large majority (70% of total outstanding value) of lending going to the growing of crops. Livestock accounted for only 17% of agricultural loan value but fully 55% of agricultural value-added in 2014. This distribution mirrors the lack of product diversity, as lenders – and in particular ZTBL, have not yet innovated to offer loans for development of agricultural operations. Lending is also highly concentrated in Punjab, which accounts for two-thirds of the outstanding portfolio and number of borrowers.

44. The informal agricultural credit market – dominated by intermediaries known as Arthis – is vibrant but lacks scalability and transparency and is based on high interest rates. Arthis are deeply embedded in the agricultural supply chain and have developed services and products that, albeit expensive, substitute for bank lending. They provide credit at the time of planting with interest rates ranging from 62 to 80% and non-financial services such as crop sales to farmers they usually know well.

45. There is considerable overlap between the constraints to agricultural finance and the impediments cited above as obstacles to MSME finance. These include: i) weak contract enforcement; ii) limited knowledge and scarce use of alternative financing methodologies that

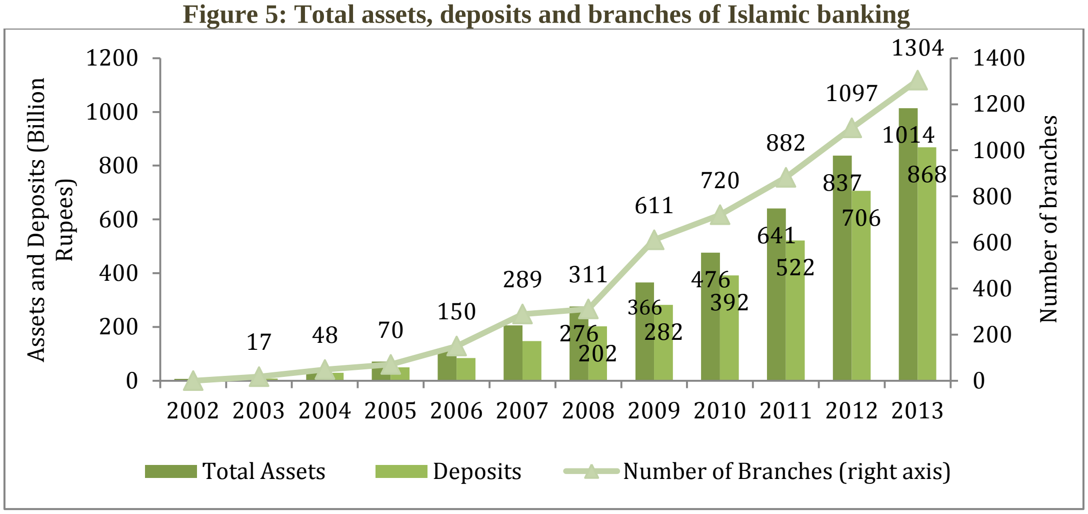
[24] Access to Finance in Pakistan, Key Indicators on Gender-mix. State Bank of Pakistan.

substitute traditional collateralized lending for farmers, such as value chain finance, contract farming and cash-flow lending; (iii) limited financial capacity of small farmers; (iv) the lack of legal frameworks for secured transactions, factoring, and warehouse receipt financing; (v) the absence of an electronic collateral registry; and (vi) potential distortions created by existing subsidy schemes and government provision of finance through a specialized bank. An additional handicap is the underdeveloped physical infrastructure and market standards for warehouse receipt finance.

2.8 Islamic Finance

46. Since Islamic Finance was re-introduced in Pakistan in 2002, Islamic banking assets have grown at an impressive 57% annual compound annual growth rate (CAGR). There are currently 5 full-service Islamic banks and 14 conventional banks with Islamic finance branches, with total assets exceeding PKR 1,000 billion (USD 9.8 billion) (Figure 5). This corresponds to 9.6% of total banking sector assets. Deposits have grown at a similar rate of 60% over the period from 2002-13, and the number of branches has increased from 17 in 2003 to 1,304 in 2013, a CAGR of 54%.

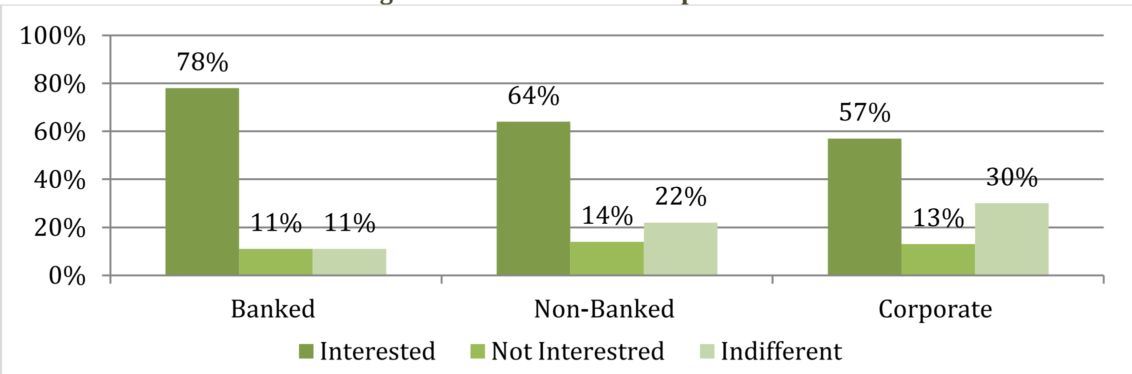
Figure 5: Total assets, deposits and branches of Islamic banking



***Source**: SBP and DFID (2014), Knowledge, Attitudes, and Performance of Islamic Banking in Pakistan.*

47. A 2014 survey conducted by SBP and DfID estimates effective demand for Islamic products among households at 65% and for corporates at 26% (Figure 6). Demand appears to be roughly the same among lower and middle-income groups. Interestingly, significant numbers of those surveyed indicated a willingness to pay more for *Shariah*-compliant products (62% of banked respondents and 43% of unbanked). 7.5% of survey respondents indicated that religion was a primary reason for their voluntary exclusion from the financial sector.

Figure 6: Interest in Islamic products



Source*: SBP and DFID (2014), Knowledge, Attitudes, and Performance of Islamic Banking in Pakistan.*

48. Many of the same deficiencies which hamper development of conventional finance also represent obstacles for the healthy growth of Islamic finance, including weaknesses in collateral management, credit registries and the legal framework. In fact, these issues may have a more profound impact on Islamic finance due to its risk-sharing nature, which is more prone to information asymmetries. Islamic finance providers have therefore shied away from sectors they deem to be higher risk, including MSMEs and housing. Other obstacles to further growth of Islamic finance include the following:

- The absence of a coordinated strategy among stakeholders to enhance financial inclusion through Islamic finance;
- A lack of products and services to cater to the diverse needs of clients;
- A shortage of knowledgeable staff at banks, MFBs and MFIs;
- The lack of an enabling regulatory and supervisory framework for Islamic NBFIs and microfinance, and the absence of appropriate codes of conduct for consumer protection;
- The lack of adequate Islamic funding mechanisms for leasing and *Mudarabah* companies;
- Level-playing field issues, including the double taxation of Islamic products;
- Underutilization of Islamic redistributive instruments, such as *zakat*, *qard-al-hassan*, and *Waaf* due to a lack of transparency and governance in utilization of funds; and
- Low awareness and poor understanding of Islamic finance among both the banked and unbanked segments of society, as shown by a SBP Survey in 2014 (Table 4 and Table 5 below).

Table 4: Understanding of Islamic Banking Model and Products: Banked

	Islamic Banking Model	Islamic Bank Deposits	Islamic Financial Products	Nature of Contracts	Adherence to *Shariah* Principles
Understand	5%	4%	3%	2%	3%
Do not Understand	95%	96%	97%	98%	97%

Source: SBP and DFID (2014), Knowledge, Attitudes, and Performance of Islamic Banking in Pakistan.

Table 5: Understanding of Islamic Banking Model and Products: Non-banked

	Islamic Banking Model	Islamic Bank Deposits	Islamic Financial Products	Nature of Contracts	Adherence to *Shariah* Principles
Understand	14%	12%	9%	11%	8%
Do not Understand	86%	88%	91%	89%	92%

Source: SBP and DFID (2014), Knowledge, Attitudes, and Performance of Islamic Banking in Pakistan.

3 Framework for Action and Headline Targets

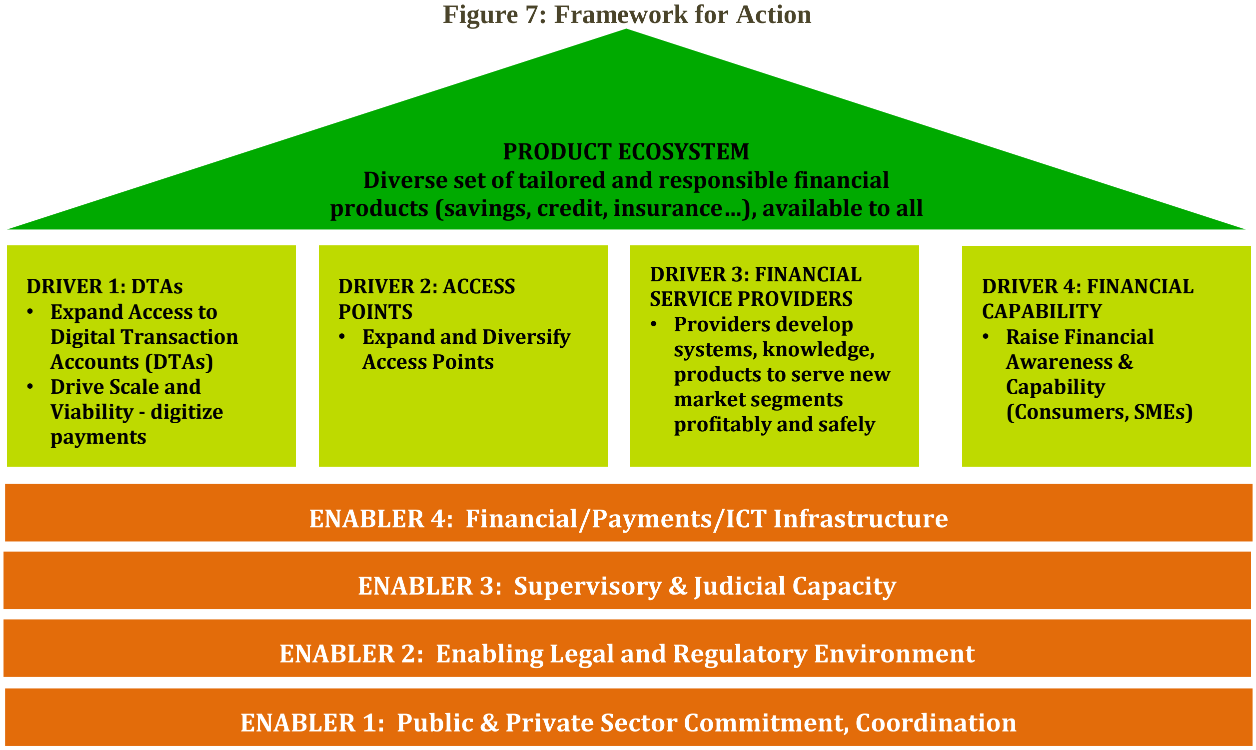
3.1 Framework for Action

49. Massively expanding financial inclusion in Pakistan requires a logical framework for interrelated actions and ambitious but realistic headline targets to drive the parties responsible toward implementing such actions.

50. A set of cross cutting conditions – the key enablers – will need to be put in place as they will lay the foundation for overcoming financial exclusion decisively over the long run. The key enablers will support targeted actions – the drivers – aimed at increasing access and developing an ecosystem of financial services that will have the quality and features required by the Pakistani population and enterprises (see Figure 7).

51. While the key enablers are the foundation for a durable inclusion process, it is necessary to make the most of the opportunities available to rapidly expand geographic reach by providing the unbanked with access to DTAs and bank accounts where they can receive and make simple payments and transfers. Access to accounts and a diverse distribution network will create a base for using the emerging ecosystem of inclusive and innovative digital financial services to affordably and conveniently meet client needs. It is expected that financial institutions will build on digital platforms to get closer to new clients, cut distribution and operational costs and collect transaction data to feed into their risk management and product development processes.

Figure 7: Framework for Action



3.2 Key Enablers

52. The key enablers cut across all priority sectors and are: (1) public and private sector commitment to the NFIS and coordination; (2) enabling legal and regulatory environment; (3) adequate supervisory and judicial capacity; and (4) financial, payments and information and communications technology (ICT) infrastructure. The success of efforts to achieve financial inclusion in Pakistan will depend on these foundational enablers; otherwise it will be hard to move beyond basic payments through DTAs. The next sub-sections describe each of the key enablers and list the most important actions to achieve them.

3.2.1 Public and private sector commitment and coordination

53. The achievement of financial inclusion goals and targets depends first and foremost on the commitment of the relevant stakeholders – the private sector, regulators, the GoP and development partners – to the developmental path envisioned in the NFIS. Commitment from each stakeholder implies their willingness to invest time and resources in the implementation of the Action Plan and to cooperate within a well-functioning and adequately resourced Coordination Structure (Section 4).

54. As part of its broad commitment to the NFIS, the GoP is committed to laying the foundation and creating the infrastructure needed for market-based development solutions. Pakistan has a successful history of interventions aimed at addressing specific pockets of financial exclusion. The NFIS is the first effort to combine GoP and private sector initiatives in a cogent framework to tackle financial exclusion holistically at the national level. It identifies the obstacles that each actor is best placed to address based on the premise that fostering commercial investment is more likely to produce sustainable inclusion than *ad-hoc* interventions that may undermine market initiatives.

55. GoP will avoid programs that create market and price distortions, reduce commercial interest in new market segments or introduce undue competition with commercial providers. It will focus instead on fostering and supporting measures to improve the financial and non-financial infrastructure on which financial sector development relies, with the objective of creating an enabling environment for commercial players. Specifically, GoP will, *inter-alia*:

a) Ensure that critical legal reforms are finalized in a timely manner;

b) Actively foster the opening and use of DTAs by shifting its own payment streams, including social payments, payroll, procurement and revenue collection, to electronic platforms;

c) Ensure that initiatives such as subsidized loans, credit guarantees, savings schemes and direct provision of financial services are only deployed based on a continuous assessment of their effectiveness, and only when necessary to address market failures without introducing distortions, competition with or disincentives to commercially driven providers;

d) Strengthen, reorganize or resolve state-owned development finance institutions and insurers that are not meeting their commercial, financial or development objectives;

e) Ensure fair and equitable tax treatment of financial services so as to not distort markets or discourage increased usage; and

f) Actively support and participate in initiatives to strengthen financial capability and awareness and to improve business skills and capacity of women, MSMEs and small farmers.

3.2.2 Enabling legal and regulatory environment

56. Establishing an enabling legal and regulatory environment is one of the most critical foundations for full financial inclusion. The GoP, with support from the private sector and the financial regulators, will address in a timely manner the pressing legal reforms that will determine and facilitate the development of an ecosystem of quality financial products. These reforms include:

a) Ensure that regulations balance financial integrity – anti-money laundering and combating the financing of terrorism (AML/CFT) – with the goal of universal access to formal accounts;

b) Pass and implement a secured transactions law and credit bureau law aligned with international best practices;

c) Improve the legal framework to ensure effectiveness of both judicial and extra-judicial collateral enforcement, including mortgage security;

d) Reformulate the mandatory and voluntary pension mandates in line with an integrated national pension framework to provide adequate, fair and sustainable pension systems for all categories of formal and informal labor; and

e) Assess the current geographic distribution of financial services access points, identify gaps against demand for services and design regulations accordingly. The current requirement that large banks have a minimum of 20% of their branches in underserved areas is a rather blunt and costly instrument that should be reviewed in light of developments in branchless banking and in accordance with the findings of the proposed mapping. While access points such as agents, ATMs and POS do not have the full-service capabilities of bank branches, the overwhelming majority of customer needs do not require a branch presence. The mapping could provide important information for private sector investment in geographic expansion and, if needed, for the design of policies to encourage investment in less commercially attractive areas.

57. Consumer protection is needed to ensure that consumers receive adequate and easy to understand information, are not subject to unfair or deceptive practices and have recourse to fair redress mechanisms to resolve disputes. This will be particularly critical to managing the risks inherent in a rapid increase in the number of consumers using formal accounts and with the introduction of new products and mechanisms for using these accounts. For many, this will be their first contact with the formal financial system, and it is important to build trust and understanding to encourage responsible and informed use of payments, savings, credit and insurance products. If new consumers are misled, treated unfairly or are unable to quickly resolve problems or disputes, it will undermine efforts towards sustainable financial inclusion in the long-run. Hence, the existence and enforcement of appropriate consumer protection regulations becomes highly relevant in Pakistan. The most pressing areas are to:

a) Ensure that individuals and firms have access to full and transparent information on financial services and products;

b) Ensure that minimum consumer protection standards apply to all microfinance and microinsurance providers;
c) Establish speedy and effective dispute resolution mechanisms for all consumers of financial services;
d) Gather, analyze and disseminate data to inform consumer protection and financial literacy policies and measures; and
e) Ensure that Islamic finance develops in accordance with consumer protection standards.

3.2.3 Adequate supervisory and judicial capacity

58. As markets expand in breadth and depth, the regulatory authorities will also need to continuously modernize regulations and supervisory capacity to reflect new risks, new business models and new types of providers to allow further development of services that cater to a variety of new client segments and ensure protection of financial consumers. Specifically, it will be necessary to ensure adequate capacity at the SBP, SECP and EOBI, as well as national policymakers such as the Ministry of Commerce (MoC) and MoF.

59. It is also important to improve institutional capacity, particularly of Banking Courts, so they can provide timely, effective and predictable contract enforcement that balances debtors' and creditors' rights. Lastly, it is necessary to improve the capacity of institutions to allow for extra-judicial dispute resolution.

3.2.4 Adequate financial, payments and ICT infrastructure

60. The cornerstone of financial sector development is the underlying infrastructure. As basic financial infrastructure is absolutely essential for the expansion of several markets, it will be important to:

a) Build a fully automated, electronic movable collateral registry that is easily and remotely accessible and affordable;
b) Expand the scope of private credit bureaus to include positive credit information and alternative financial information such as bill payment history;
c) Improve the effectiveness, including in terms of accessibility and reliability, of land registries and titling systems; and
d) Strengthen payment platforms by better integrating branchless banking with the NPS, implementing a real-time funds transfer system and deferred net settlement system, integrating remittance flows with other financial services and linking government payment systems to SBP's large value payment system (PRISM).

3.3 Drivers for financial inclusion in Pakistan

61. At the heart of implementation of the NFIS are four mutually reinforcing actions: (i) promote DTAs and reach scale through bulk payments; (ii) expand and diversify access points; (iii) improve capacity of financial service providers; and (iv) increase levels of financial capability. It is important to stress that the four fronts are interdependent. Expanding DTA transactions depends on building a large and diverse acceptance network whose growth is stimulated by a range of services designed by financial institutions with specific knowledge and expertise, which could be responsibly used by capable and informed consumers.

3.3.1 Driver 1: Digital Transactional Accounts (DTAs)

62. There is widespread agreement in the industry and among policymakers that a rapid and substantial expansion of DTA account holders is achievable. The presence of sufficient national payments system infrastructure, widespread use of mobile phones, a robust regulatory framework for branchless banking, the roll-out of a universal biometric national ID, a rapidly expanding agent network and growing competition in the branchless banking arena are all elements that contribute to a solid foundation.

63. The building blocks of DTAs are basic electronic payment services and stored electronic value that function on communications networks in real time. As usage of branchless banking today is mostly based on over-the-counter (OTC) transactions, which increase costs for users and limit the potential for add-on financial products. There is a need to increase account-to-account transactions across networks. This will depend on a substantial increase in the number of people holding DTAs and integration of these DTAs within the mainstream financial sector. Seamless account opening procedures will be key to allow such growth, which requires proportional KYC regulations and near-to-zero costs to verify customer identification information electronically.

64. It will be necessary to: (i) ensure branchless banking models are integrated into the national payment system; (ii) change the incentives for agents, who currently receive higher fees for simpler OTC transactions than for opening customer accounts; (iii) bring about a shift of large-scale payment streams; (iv) develop a large and increasingly interconnected acceptance network infrastructure, and (v) build and share a database of digital transaction information. Increased usage of digital financial services over DTAs will also require building trust and increasing awareness of consumers and keeping transaction fees low to encourage customers to at least partially abandon cash for small value transactions.

65. In addition to the commercial efforts of electronic payments providers and financial institutions in promoting digital financial services, Pakistan can take shortcuts to achieve massive numbers of DTAs and bank accounts. Shifting large-scale, bulk payment streams to digital payment mechanisms will be crucial. The initial efforts will be concentrated in GoP payments (both paying and receiving streams) to replace cash and cheques. This will include: (i) social transfers; (ii) salaries; (iii) tax payments; (iv) payments to individual and enterprise service providers; and (v) transfers between government agencies. In this regard, the Government of Pakistan is encouraged to conclude ongoing discussions to become a member of the Better Than Cash Alliance (BTCA), an alliance of governments, private sector and development organizations committed to accelerating the shift from cash to electronic payments. Membership entails a commitment to digitize government payments; in return, Pakistan would be eligible for technical assistance and/or funding to support the transition if needed.

66. However, government payments alone will not be sufficient to achieve the desired outreach and scale. Recipients of G2P represent fewer than 10% of the adult population. Legal and/or fiscal incentives may be required to push private sector salaries and other private payments to digital platforms.

3.3.2 Driver 2: Expand and Diversify Access Points

67. The single best stimulus to encourage clients to transact using their formal accounts is an interconnected, ubiquitous and diverse network of branches and out-of-branch points allowing a range of transaction types, including deposits, withdrawals, bill payments, merchant purchases, remittances and account-to-account transfers. Most of these transactions could be performed at points that are more cost effective than traditional branches. A diverse distribution network will be comprised of a range of channels, namely, mobile phones, agents, merchants (equipped with mobile or POS) and ATMs. Proximity and interconnectivity are essential features to encourage usage, increase convenience and reduce the costs for clients and providers alike. Therefore, a clear and sustained interconnection policy can enable the expansion and diversification of access points. The current branchless banking agent network and branch network fall short of ubiquitous national distribution with little presence in rural settings, although most of the population is rural. The main obstacle for agent network growth is operational, not regulatory, as providers must invest heavily in selecting, recruiting, training and managing agents, establishing alliances with existing retail networks such as the post office, ensuring cash availability at agent points (liquidity) and making arrangements for interconnectivity while not hurting competition.[25] The entry of such third-party service providers could help to address these operational issues.

3.3.3 Driver 3: Financial Services Providers

68. A pre-condition for effective and healthy financial inclusion is a minimum and sufficient level of capacity of providers. Departing from current traditional business models in order to massively expand financial inclusion requires commitment from providers' boards of directors and senior management. They will need to develop new techniques to serve new market segments - particularly lower-income clients, profitably and safely. This will involve attracting and retaining qualified personnel, engaging in capacity building to improve lending techniques and building strategic alliances to make the most of the potential synergies with other financial and non-financial firms.

3.3.4 Driver 4: Financial Capability

69. To ensure that financial services meet customers' needs with fairness and dignity, as noted in the vision, it is important that financial literacy measures be an integral part of the NFIS. Efforts to promote financial literacy and awareness of products and services will be key to achieving inclusion targets. Several measures are already underway by both the private and the public sector, including SBP's National Financial Literacy Initiative. These are welcome and should continue. Well-designed, comprehensive initiatives to increase users' knowledge about a range of innovative financial services, including MSME finance, agricultural credit, pensions, housing finance, insurance, Islamic finance and digital payments are also needed to spur confidence. Initiatives such as developing school-based financial education, leveraging "edutainment" as a means to disseminate financial information and developing programs targeted at specific groups, such as women or youth, should be considered.

70. Information and telecommunications technology will be invaluable in reaching population segments with mobility limitations, such as women. Education and literacy programs delivered

[25] Close coordination with the Competition Commission of Pakistan will be critical for interconnectivity arrangements.

through digital channels open up potential for low-cost, targeted, and tailored information, available in a more convenient and timely manner. Studies indicate that mobile phone texts linked to the timing of salary receipt or other events can raise customer awareness and result in higher savings and increased frequency of account usage.

71. Moreover, MSMEs, women and small farmers may need support to enhance their eligibility for credit. This could include training to improve their business skills, strengthen linkages to value chains and industry associations and increase their level of formality to the extent possible, from registration to accounting. The purpose of building their financial capability is to increase their survival rate and performance as viable businesses, helping them to secure easier access to various formal financing instruments. This, in turn, contributes to employment and Pakistan's overall economic and social development.

72. Finally, efforts to enhance financial capability must be grounded on robust analytical evidence, such as national financial capability surveys or assessments, and should include results frameworks to facilitate monitoring and impact evaluation.

3.4 Development and support for an ecosystem of diverse products

73. DTAs are an initial entry point for the currently excluded to start a relationship with the formal financial sector and an additional convenience feature that enables providers to consolidate relationships with existing clients. A far-reaching and diverse network of interconnected access points, coupled with awareness and trust in DTAs by users and other service providers, will encourage increased development of simple add-on digital financial services, such as microinsurance and savings. The buildup of a financial history of receiving benefits, salaries, remittances and of paying bills, insurance premiums and of making purchases and transfers will feed into providers' product research and development and into customer assessment and due diligence.

74. However, providing digital or even conventional access to varied range of quality services will depend on addressing other issues that hinder progress in underdeveloped markets such as MSME, agriculture and housing finance, pensions, insurance, Islamic finance, and the inclusion of women. Most of these issues are related to the key enablers described above and are detailed in the Action Plan under each of these priority areas. For the sake of simplicity and ease of understanding the legal and regulatory actions, as well as the measures to improve capacity of providers and customers, are listed under each priority area instead of under the key enablers and drivers in the Action Plan.

3.5 Headline financial inclusion targets

75. Committing to ambitious financial inclusion targets is important to drive sustained efforts in implementing the Action Plan. The overall goal is universal access to formal accounts, although Pakistan faces many challenges to achieve that. Based on the fast expansion of the network of financial service access points, and the push for universal access to accounts, the headline target for access to formal accounts, driven by the measures set out in the NFIS, is to increase from 10% of adults with a transactions or other type of formal account to 50% by 2020.

76. The proportion of women with a formal account will need to increase substantially to achieve the global target. The NFIS envisions that 25% of adult females will have a formal account by 2020, up from 2.9% in 2014.[26]

77. In order to achieve ubiquitous access, it will also be important to increase the percentage of adults living within 5 kilometers of an access point by 2020.[27]

78. To encourage the development of an innovative ecosystem of inclusive services, it is useful to set a target for the percentage of savers having used formal financial services to save during the previous 12 months. This indicator is expected to increase from 1% to 10% by 2020. The NFIS will also encourage investment in new credit products tailored to SMEs. When coupled with the improvement of the broader business environment, this will increase the proportion of SME lending to total bank credit to the private sector from 7% to 15% by 2020.

79. It is important to note that some markets are so incipient today that they will naturally, cater to the upper-income groups before providers are driven further down-market on a competitive basis.

[26] Global Financial Inclusion (Global Findex) Database.

[27] In order to establish a baseline and target, it is recommended that a baseline geo-spatial survey be conducted as soon as possible and be updated every 2 years, at least. If this is not achievable, the indicator could be the number of access points per 100,000 population.

4 Coordination Structure

80. The initiatives needed to achieve broad financial inclusion will be carried out by multiple stakeholders in the public and private sectors. Hence, the formation of a national coordinating structure is critical to achieving the objectives of the NFIS. The Coordination Structure is composed of three governing bodies: 1) the NFIS Council; 2) the Steering Committee; and 3) the NFIS Secretariat. Their work will be supported by Technical Committees.

4.1 NFIS Council

81. **Objectives:** The National Financial Inclusion Council will be the primary platform for achieving Pakistan's financial inclusion objectives and vision, under the structure illustrated below.

82. **Composition:** The Council will be chaired by the Minister of Finance, whereas Governor SBP and Federal Finance Secretary will be members of the Council. The Council will also draw representation from other relevant government bodies, including SECP, PTA, Federal Board of Revenue and Secretaries of Finance of the provincial governments.

83. **Activities and Scope of Work:** The NFIS Council will function as the guiding body for governance and coordination of Pakistan's National Financial Inclusion Strategy. The Council will:

a) Notify the National Financial Inclusion Steering Committee, monitor its performance, and provide guidance on an ongoing basis;
b) Adopt and launch Pakistan's National Financial Inclusion Strategy;
c) Guide the implementation of major legislative and policy reforms required to realize Pakistan's National Financial Inclusion objectives;
d) Lead the effort to coordinate with federal and provincial leadership on nationwide policy reforms, particularly with respect to aligning policies on government payments, taxes, competition, etc.;
e) Ensure that budgetary allocations provide sufficient resources for implementation of reforms under the National Financial Inclusion Strategy;
f) Monitor and evaluate the implementation of the National Financial Inclusion Strategy, including tracking the progress of reform actions and monitoring indicators and results achieved;
g) Meet bi-annually to take stock of the progress on the NFIS and make necessary course corrections;
h) Report to the Cabinet/Office of the Prime Minister on progress and results related to Pakistan's National Financial Inclusion Objectives; and
i) Perform other functions required to achieve its purpose.

4.2 NFIS Steering Committee

84. **Objectives**: The Steering Committee will have the overall responsibility of implementing the National Financial Inclusion Strategy, under the guidance of the National Financial Inclusion Council with support from various technical committees established as envisaged in the governance structure to drive financial inclusion.

85. **Composition**: The Steering Committee is chaired by the Governor of SBP and with the participation of senior technical level representatives from public and private institutions, such as MoF, SBP, SECP, PTA, Board of Revenues, professional associations (PBA, PMN, IAP) and possibly demand side representation (SME associations or other).

86. **Activities and Scope of Work**: The NFIS Steering Committee will:

a. Lead effective intra-government, inter-institutional and public-private coordination of activities geared toward meeting the national financial inclusion objectives;

b. Collaborate and coordinate with other existing or future thematic consultative groups such as the national payments council etc.;

c. Notify and establish mechanisms and guidelines for clearly mandated and relevant Technical Committees to aid in the implementation of the NFIS;

d. Supervise the activities and effectiveness of the Technical Committees (on items such as structure, operational procedures of the working group, etc.) and make changes when necessary;

e. Ensure that a functional NFIS Secretariat is in place and has sufficient capacity to provide support on updates to the NFIS action plan, conduct data aggregation, report on results indicators, conduct M&E, research, support implementing agencies and conduct various administrative functions for the Steering Committee

f. Establish a system for proper cascading, implementation and reporting of financial inclusion reform actions by the respective implementing institutions and Technical Committees;

g. With assistance from the Technical Committees, prepare and approve a detailed action plan based on the NFIS action plan, identifying and assigning specific tasks for the short-, medium- and long-term;

h. Identify, communicate, and work towards acquiring sufficient resources from various funding sources (government budgets, donors, international institutions, private sector etc.) for the implementation of financial inclusion reform actions;

i. Create the necessary public awareness on the National Financial Inclusion Strategy and its implementation progress;

j. Review, measure, monitor and evaluate implementation the progress reports of member institutions against the set NFIS M&E targets and milestones, providing timely feedback;

k. Review existing policies, practices and systems and identify opportunities and or critical obstacles to enhance financial inclusion and implement proper remedial actions;

l. Meet on quarterly basis, or more frequently where deemed necessary, to review and discuss development and implementation of the National Financial Inclusion Strategy processes and provide guidance accordingly;

m. Report to National Financial Inclusion Council on implementation, progress and results of the National Financial Inclusion Strategy through regular periodic reports; and

n. Perform other duties as directed by the National Financial Inclusion Council.

4.3 NFIS Secretariat

87. **Objectives:** The NFIS Secretariat, housed at SBP, is responsible for providing technical, administrative and research support to the NFIS Council, Steering Committee and Technical Committees to ensure smooth implementation of the NFIS.

88. **Composition:** The Secretariat will consist of staff with the requisite technical, research and administrative expertise from relevant departments of SBP, and/or other implementing agencies (SECP/MoF). In order to ensure proper implementation of the NFIS, it is recommended that the Secretariat have a minimum of 2-3 full-time staff.

89. **Activities** and **Scope of Work:** The NFIS Secretariat will:

a) Ensure the availability of required data and information for establishing baselines and tracking progress under the Monitoring and Evaluation Framework;

b) Conduct or contract research required to inform implementation of the NFIS;

c) Collect information, data, and implementation updates from the Technical Committees;

d) Provide quarterly progress reports on NFIS implementation to the Steering Committee;

e) Conduct impact evaluations of initiatives; and

f) Provide technical and administrative support to Technical Committees, the Steering Committee, the Council and the lead implementing agencies.

4.4 Technical Committees

90. **Objectives:** Technical Committees will be formed in each focus area: Payments and DTAs, SME Finance, Agriculture Finance, Housing Finance, Islamic Finance, Insurance and Pensions. In addition, there may be cross-cutting thematic Technical Committees that will focus on topics such as gender, financial literacy and consumer protection. Their primary objective is

to propose detailed implementation plans, resolve technical issues and propose solutions to the Steering Committee in order to achieve specific NFIS objectives.

91. **Composition:** The Committees will comprise representatives from the public and private sector implementing entities that have the requisite technical expertise in each defined area.

92. **Activities and Scope of Work:** The Technical Committees will:

a. Develop detailed NFIS implementation plans in their specific area of focus, including timelines and assignment of responsibilities for proposal to the Steering Committee;

b. Consult with other industry players or stakeholders to get buy-in on proposed actions, solutions and plans;

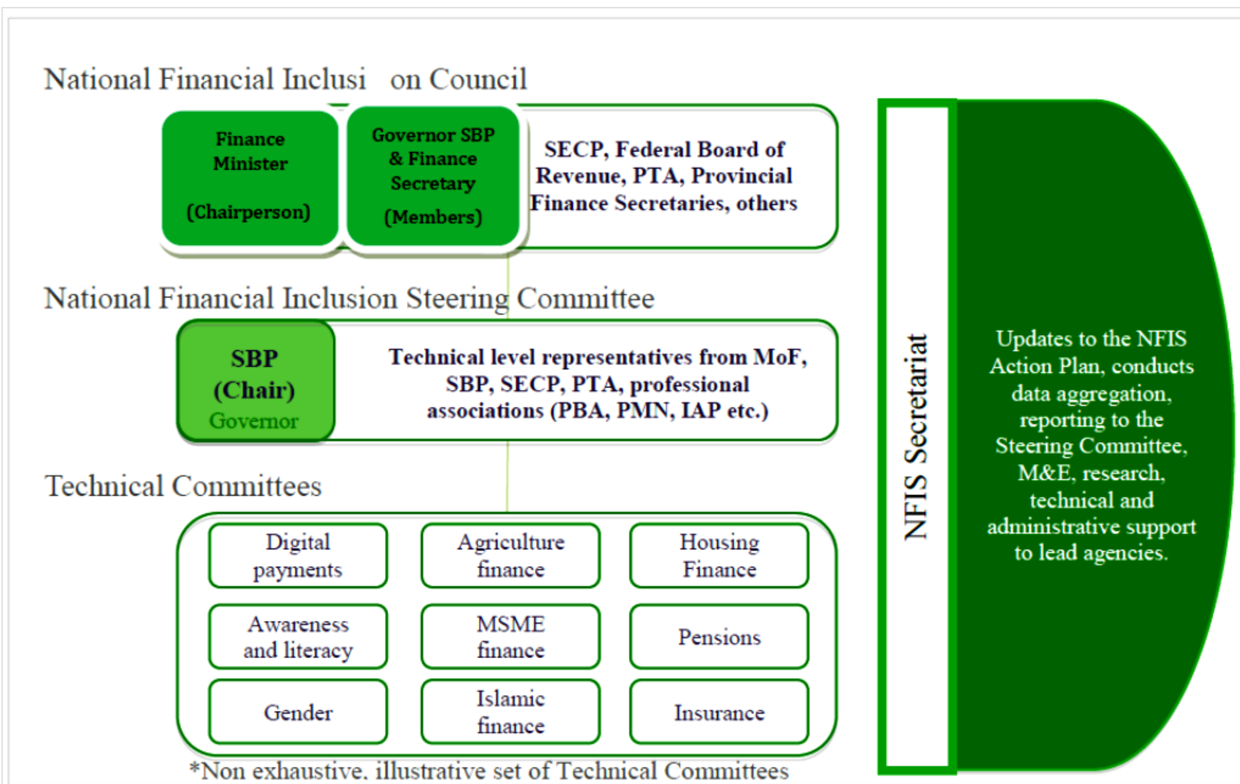
c. Collaborate and coordinate with other existing or future thematic consultative groups such as the national payments council etc.;

d. Provide information on progress in implementation and related targets to the Secretariat on a quarterly basis, or as needed;

e. Propose solutions to theme-specific challenges to the Steering Committee; and

f. Propose changes and course corrections to agreed Action Plans or targets, as required.

Figure 8: Proposed Governance Structure for the NFIS



5 Key Recommendations and Priority Actions

93. The draft NFIS Action Plan (See Annex 1) provides high-level suggested measures to address the enablers and drivers of the NFIS, covering the period 2015-2020[28]. The proposed actions are to be implemented by a range of public and private sector players. These include the relevant areas within the GoP, financial regulators, NADRA, provincial governments and the formal financial sector. These stakeholders would be engaged in a range of activities, which reduces the burden on any given implementing party. Nonetheless, GoP and financial regulators are assigned substantial responsibilities particularly in the first three years of implementation of the NFIS. Therefore, technical assistance and support from international development agencies will be key to ensuring the Action Plan is be achieved within the proposed timeframe.

94. The activities have been prioritized based on extensive stakeholder consultations and will be vetted, further detailed and refined by the Technical Committees, which will also review their timelines to ensure effective implementation. This section summarizes the highest priority actions and indicates areas that require further analysis.

95. To promote access to enrollment of DTAs by the largest number of individuals and enterprises as possible by 2020, the NFIS emphasizes the need to further lower the cost of CNIC verification by end of 2015.[29] This could be pursued through negotiations between NADRA, SBP and financial service providers. It also calls on financial services providers to reach wallet-level interoperability agreements by end of 2016. The NFIS targets rely on the GoP to shift all government payments, including payments to farmers and pensions, to digital platforms by end of 2017 and on large private sector payers (including in the agricultural business) to shift the majority of corporate payments (salaries, G2B, B2B and B2G) to digital platforms by the end of 2020. This would first require a mapping of the largest payment streams that are currently made in cash or cheques.

96. Key improvements to the financial infrastructure will need to be prioritized over the next five years, particularly in the area of payments systems and the framework for secured transactions, in order to support the healthy expansion of credit markets, including credit to MSMEs and the agricultural sector[30]. These include:

i. Passing a secured transactions law in accordance with international best practices. Given the status of the current draft law, this could be achieved by the end of 2015;
ii. Building an electronic collateral registry. It has been proposed that this be implemented by NADRA, by the end of 2016; and

[28] Additional measures can be found in the Technical Notes.

[29] While the reported reduction in the current charge in November 2014 is undoubtedly a big improvement and reduces the barrier providers to open more accounts, it is still relatively high.

[30] As the existing credit bureaus were not identified by stakeholders as a major barrier to financial inclusion, no actions were included in the Action Plan. Specific actions to expand the scope of credit bureaus, which would require the passing of the Credit Bureau Act, can be found in the related Technical Notes.

iii. Developing a regulatory framework for payment services and payment systems that builds on the provisions in the PSEFT and the recently issued rules for PSPs and PSOs. This would be implemented by SBP by the end of 2016; and
iv. Developing infrastructure to support low-value interbank credit and debit transfers, bulk payments and instant transfers. This would be implemented by SBP by the end of 2017.

97. Substantial efforts will need to be made in order to increase the levels of financial literacy and awareness in Pakistan. The NFIS seeks to include the large majority of Pakistanis, including women and other segments of the population who have been excluded even from informal financial services. These groups will need help in understanding how to use and benefit from digital accounts and other products. The NFIS proposes phased nationwide awareness and education programs that cover the role and importance of financial services such as digital payments, insurance, different types of credit, warehouse finance and credit guarantee schemes (including programs specifically targeting MSMEs, women, and small farmers) and Islamic finance. The initial education and awareness efforts aimed at spurring large-scale financial inclusion would happen between 2015 and 2018, when an assessment would be done to determine whether further action is required.

98. Consumer protection is critical to maintaining public confidence in the financial sector and to protecting customers who are less experienced in dealing with formal financial service providers. The highest priority actions are for the SBP and SECP to require standard methodologies to calculate and disclose total costs and returns of financial services by the end of 2015 and to establish minimum contents of terms and conditions through simple Key Fact Statements, in coordination with industry associations, by the end of 2016.

99. In addition to the proposals to strengthen the secured transactions framework, which was cited by industry players as a critical obstacle for MSME (particularly SME) lending, the NFIS identifies four other high priority measures for the MSMEs and agricultural finance:

i. Assess the effectiveness of current government interventions in the MSME and agricultural credit markets, evaluate the need for reforms and design targeted interventions with an appropriate monitoring and evaluation frameworks, by 2016. This would be undertaken by GoP, in coordination with SBP, PMN, banks, MFBs, SMEDA and agricultural industry representatives;

ii. Throughout the implementation period of the NFIS, it will be necessary to build the capacity and develop the expertise of service providers in MSME and agricultural finance, particularly in the use of alternative business models such as value chain finance, contract farming, warehouse receipt finance, program lending, women-focused services, cash-based lending and provision of nonfinancial supporting services for business development. This is primarily the responsibility of financial services providers and will be complemented by learning events held by industry associations, training institutions and development agencies;

iii. Strengthen value chain linkages and access to clusters and industry associations for MSMEs and farmers and improve or create linkages between rural farm and non-farm enterprises. This also is primarily the responsibility of the industries and actions would span the five-year implementation period; and

iv. Secure the commitment of senior management from key financial institutions to a strategic view for MSME and agricultural (particularly small farmer) lending. This has been noted by stakeholders as a priority action to guarantee the requisite investments and research, given that banks have immediate profit opportunities in several other market segments. Such commitments would need to be secured in the first year of implementation of the NFIS.

100. To spur access to insurance, a key priority measure for the first three years of implementation of the NFIS is to ensure, by reviewing and (if needed) reforming the law, a fair and equitable taxation regime, which would involve negotiations between SECP, MoC and MoF.

101. Islamic finance is at its infancy in Pakistan, despite a potentially large market. To unleash such potential and contribute to the NFIS' headline targets, two highest priority measures have been identified: i) to set up a national task force to design and implement a long-term strategy to enable Islamic finance by promoting risk-sharing (a task to be undertaken by the Steering Committee on Islamic Finance) and ii) to develop human resources knowledgeable in Islamic finance, through learning events to disseminate global experience, and the establishment of the Center of Excellence for Islamic Finance, by 2017.

102. Lastly, a key priority for the development of housing finance and its contribution to the NFIS to be undertaken by SBP (in consultation with PBA) by the end of 2016 will be to mitigate market risks incurred by borrowers by developing and encouraging loan products and origination practices that reduce the impact of markup rates hikes. Critical longer-term measures to develop a healthy housing market include the need to improve the efficiency of foreclosure (including improvements in the out-of-court options for foreclosure) and the reliability of land titling and administration systems, particularly in areas that are/could be designated for development of affordable housing. Finally, investment and prudential regulations could be adjusted to foster the attractiveness of the capital market for primary lenders. Other measures are outlined in the Technical Note.

103. All the above priority actions were identified based on the existing body of knowledge and extensive consultations with a range of stakeholders. There remain, however, information gaps and diagnostic work that could not be done within the tight timeframe of the NFIS drafting process and that will inform future updates to the NFIS and its Action Plan, to more adequately address market failures and take advantage of new opportunities through policy measures and market-based initiatives.

104. One critical area that requires further analysis is how best to address the gender gap in access to finance. Policy measures would need to be informed by further demand-side surveys and focus groups to better understand the barriers that women face, their needs for financial services, and how best to tailor initiatives to meet their requirements. In addition, it is proposed that there be a technical committee under the NFIS specifically charged with developing an action plan for addressing gender barriers, including eliminating any legal or procedural biases and promoting awareness, education, and marketing campaigns targeted at women. A specific target for financial inclusion of women will be established and closely monitored to ensure that the current imbalance is effectively redressed over time.

105. Another key area meriting further analysis is to know which specific financial tools are priorities for individuals and MSMEs, how such tools would impact their lives and operations, and which measures would be most effective to bridge the financial inclusion gap. This requires demand side surveys, to point out the challenges faced by specific MSME sub-sectors (e.g., women-owned MSMEs, non-farm MSMEs, etc.) and specific segments of the population (e.g., urban females, rural (agri and non agri) females). There are several efforts underway to develop more granular knowledge from the demand side:

(i) SBP's demand side analysis of 10,000 plus households, to update the findings of the 2008 A2F Survey (to be completed in 2015);
(ii) KfW's survey of SMEs across Pakistan, with a focus on financial inclusion (results expected in early 2015);
(iii) BMGF's work with Intermedia, on an International Demand Side Survey, to be completed in 2015;
(iv) 2015 Findex Survey (available in the second quarter of 2015); and
(v) 2014 Enterprise Survey that would include data findings on the A2F.

106. Building on the results of the above surveys, additional work could be done through focus group discussions and roundtables with groups of specific market segments, such as women, including women entrepreneurs, and industry associations, such as farmers associations.

107. Another area that would provide valuable data to inform updates to the NFIS and its Action Plan is to identify, in detail, the geographic areas of Pakistan with low financial access through a geo-spatial mapping of access points. This detailed knowledge, coupled with geospatial data on other social and economic development indicators, such as roads, electricity, telecommunications and economic activity, would provide a basis for targeted private investments in geographic expansion and the design of policies – in consultation with the private sector – to spur geographic reach of the financial sector, including in less commercially attractive or costly areas, which could, for instance, benefit from subsidies if needed. This could also help the GoP establish the fees it pays for G2P transfers.

108. As the NFIS relies strongly on the shift of large payment streams to digital platforms as a means to spur financial inclusion and generate financial information to be used by a range of financial service providers, it is important to map and measure at least the major government and private sector payment streams that are currently done in cash or by cheque. This would provide more granular information that is needed to identify the priority sectors when working to shift to electronic payment instruments, as proposed in the Action Plan.

109. Finally, the Technical Note on insurance has noted the emergence of a range of microinsurance products in Pakistan, including through digital platforms. However, there are some accounts of inadequate products that do not meet the need of clients, or that may be purchased by clients who are not even aware they are acquiring an insurance product. It would be useful to investigate this market further in order to assess the fairness and suitability of existing microinsurance arrangements.

6 Monitoring & Evaluation Framework

110. The NFIS must include a monitoring and evaluation (M&E) mechanism to track the progress of Action Plan implementation and measure the direct and indirect impact of the actions through key financial inclusion indicators. The M&E system will allow for timely and precise feedback to all stakeholders so that the implementation efforts – as well as the Action Plan – can be adjusted as needed to address bottlenecks.

111. The M&E framework is based on the headline targets set for the priority financial inclusion goals, which will be measured against baseline values of indicators reflecting the current state of financial inclusion in Pakistan. It will also identify and monitor interim benchmarks, which are steps needed to implement specific measures outlined in the Action Plan.

112. The NFIS Secretariat will be responsible for putting the M&E mechanism in place, which entails:

- **Allocating and monitoring implementation of each action.** Specific responsibilities will be allocated to each implementing party with timelines and interim benchmarks, in consultation with relevant stakeholders. The effectiveness of monitoring will depend on the level of collaboration and coordination among implementing parties, particularly with respect to gathering data and information on actions taken;
- **Collecting data to monitor headline and specific financial inclusion indicators**. Periodically measuring objective financial inclusion targets depends on gathering quality and timely data. The first step is to collect data on headline indicators (those subject to targets) and sub-indicators (those not subject to targets, but that will provide important information for monitoring purposes);
- **Periodically reporting progress** on implementation of the Action Plan and financial inclusion indicators to the NFIS Steering Committee;
- **Conducting periodic evaluations** of key initiatives under the Action Plan, such as government support schemes (e.g. credit guarantee schemes).

113. The NFIS Council will ensure that the NFIS Steering Committee and Secretariat have the necessary human and financial resources and full, timely access to the data needed to be provided in a timely manner by private and public sector actors, in order to conduct in-depth analyses and produce periodic reports to the Steering Committee and the wider public. The frequency and format of reporting will be decided by the NFIS Steering Committee and incorporated into the M&E process.

114. The tables below show the headline indicators and respective NFIS targets for 2020, as well as the sub-indicators that will be tracked within the M&E framework, including sub-indicators of access, usage and quality. These cover the three dimensions of Pakistan's vision of financial inclusion. The current proposed data sources could be replaced by country-owned data, if relevant indicators are included in household surveys or other data collection systems.

Headline Financial Inclusion Indicators and Targets				
Priority Area	**Indicator**	**Baseline (Year)**	**2020 Target**	**Data source(s)**
Indicators of Access				
Distance to access points	% of adults living within 5 kilometers of an access point	[%}	[%]	MIX, BMGF geo-spatial survey
Indicators of Usage				
Access to accounts	% of adults with a transaction account	10.3% (2014)	50%	Findex (2011)
	% of women with a transaction account	2.9% (2014)	25%	Findex (2014)
Usage of accounts	% adults who saved at a formal FI in the past year	1.4 (2011)	[10%]	Findex (2011)
	% of SME loans as % of total bank loans to private sector	7%	[15%]	SBP

Financial Inclusion Sub-indicators for Tracking Purposes Only			
Priority Area	**Sub-indicator**	**Baseline (Year)**	**Data source(s)**
Sub-Indicators of Access			
Access Points	ATMs per 1 million inhabitants	25 (2010)	GPSS
	POS per 1 million inhabitants	300 (2010)	GPSS
	Number of financial access points per 100,000 adults	100	SBP
Sub-Indicators of Usage			
Access to accounts	% of adults with accounts at formal financial institution (% of male) / (% of female)	10.3% (2011) 2.9% (2011)	Findex
	% adults with a payment card	3 (2011)	Findex
	% adults using mobile financial services	3 (2011)	Findex
	Number of mobile money deployments	7 (2010)	GPSS
	Cashless retail payments per capita	2 (2010)	GPSS
	% MSMEs with account at formal institution	NA	Findex, A2F Survey
	% SMEs with loan from regulated entity	4.2% (2011)	Findex, A2F Survey
	NPL as % of SME bank loan portfolio	34% (2014)	SBP
	% of firms with loan from regulated entity	8.6% (2007)	WB Enterprise Survey
Agricultural Finance	% agricultural bank loans to GDP	1.18% (2014)	SBP
	NPL as % of agricultural bank loan portfolio	13% (2014)	SBP
	% agricultural loans to total bank credit to the private sector	7.6% (2014)	SBP
Insurance	Number of adults with insurance policy	NA	SECP
	Insurance penetration (premium/GDP)	0.93% (2014)	SECP
	Insurance density (premium per capita)	USD 7.7 (2014)	SECP
Pensions	Number of adults covered by pension	NA	SECP
	% labor force with pension accounts	3.96% (2014)	EOBI
Housing Finance	Number of housing loans	76,000 (2014)	SBP
	Number of loans to households earning less than KPR 40,000 per month	NA	SBP
Sub-Indicators of Quality			
G2P payments	% of adults using accounts for G2P payments - % female	2 (2011) 0.8% (2011)	Findex/GPSS
Wages	% of adults using accounts to receive wages - % female	5.3% (2011) 1.1% (2011)	Findex
	% of wage workers receiving wages via digital channels	NA	Findex (2015)
Remittances	% domestic remittance recipients receiving payments via digital channels	NA	Findex (2015)/GPSS
Consumer Protection	Financial Consumer Protection and Capability Index (composite)	NA	WB CPFL survey
Use of digital wallets	% of adults (15+) who use at least one digital financial service beyond basic wallet, P2P and bill payments - % of female	1 (2014) 0.3 (2014)	Intermedia (Financial Inclusion Insights Survey) (n=6,000)

Annex 1: Action Plan

115. The draft NFIS Action Plan below provides suggested high-level measures to address the enablers and drivers identified in the strategy. Additional measures can be found in the Technical Notes. The actions, timelines and prioritization will need to be validated by the technical committees charged with relevant areas, who will also provide further granularity on specific measures.

Priority Level: Highest High

Objective	Activity / Action	Lead Roles	Implementation timeline					
			2015	2016	2017	2018	2019	2020
Promote DTAs	Lower further the cost of CNIC verification for OTC transactions	NADRA, SBP, MFBs, Commercial banks						
	Become a member of the Better than Cash Alliance, and work with them to shift government payments to digital	EAD, MoF						
Achieve scale through bulk payments	Shift G2P payments into DTAs, including transfers to farmers	GoP, development partners						
	Shift the majority of corporate salary payments, G2B and B2G to digital platforms, including in the agricultural business	GoP, Commercial banks, MFBs, FMGCs, agriculture						
Expand and diversify access points	Reach wallet-level interoperability agreements between providers	Commercial banks and MFBs						
	Design a plan to expand card merchant acceptance points	SBP, Commercial banks						
	Connect Pakistan Post to 1Link, encourage and support its integration the National Payment System	Pakistan Post, SBP						
	Design a plan to expand the ATM network	Commercial banks and MFBs						
DEVELOPING FINANCIAL INFRASTRUCTURE								
Create a strong framework and infrastructure for secured transactions	Pass a secured transaction law in accordance with international best practices	GoP, Parliament, SBP						
	Build an electronic collateral registry that could be accessed by any MSME	NADRA						
	Establish reliable titling systems, particularly where affordable housing could be developed, and enhance capacity of registration agencies	MoF, Provincial Boards of Revenue, Federal Land Commission						

Objective	Activity / Action	Lead Roles	Implementation timeline					
			2015	2016	2017	2018	2019	2020
	Adopt legal amendments required to improve efficiency of mortgage rights and make extra-judicial enforcement compliant with the decision of the Supreme Court of Pakistan	SBP, MoJ, MoF						
	Strengthen the capacity of Banking Courts to grant timely relief to secured creditors	Banking Courts, development partners						
Improve the legal and regulatory framework for the NPS	Develop regulatory framework for payment services and payment systems building on the provisions in the PSEFT and the recently issued rules for PSPs and PSOs	GoP and SBP						
Strengthen the retail payment systems	Develop infrastructure to support low value inter-bank credit and debit transfers, bulk payments and instant transfers.	SBP						
Enhance commercial funding for MFBs/ MFIs	creation of Pakistan Microfinance Investment Company (PMIC)	GoP, PPAF, Development Partners						
INCREASING LITERACY AND AWARENESS								
Increase awareness and knowledge of public at large	Carry out phased, nationwide awareness and education programs covering role and importance of financial services provided by the formal financial sector, such as digital payments, old-age income planning, Voluntary Pension Schemes, insurance, different types of credit and credit guarantee schemes, warehouse finance, Islamic finance	GoP, financial institutions, development partners, industry associations						
PROTECTING CONSUMERS								
Ensure that individuals and firms have access to full and transparent information on financial services and products	Require standard methodologies to calculate and disclose total costs and returns	SBP, SECP						
	Establish minimum contents of terms and conditions, with simple Key Fact Statements	SBP, SECP, professional associations						
Ensure minimum consumer protection standards for clients of all microfinance providers	Assess and implement suitable and pragmatic institutional arrangements to address gaps in non-bank microfinance consumer protection and extend minimum standards to MFIs	SBP, SECP, PMN and PPAF						

Objective	Activity / Action	Lead Roles	Implementation timeline					
			2015	2016	2017	2018	2019	2020
Ensuring Islamic finance develops in accordance with consumer protection standards	Define guidelines dealing with code of conduct, consumer protection, and *Shariah*-compliance for institutions conducting Islamic financing services as recommended by IFSB	SBP, SECP						
MSME FINANCE								
Create a policy environment that encourages market-based development	Ensure government commitment to shift government role from intervention to market-based holistic approach	GoP, SBP						
	Assess effectiveness of current interventions and evaluate need for targeted interventions with appropriate monitoring and evaluation framework	GoP, SBP, PMN, banks, MFBs, SMEDA, development partners						
	Design and launch improved partial guarantee scheme to foster MSME lending	GoP, SBP, PMN, banks, MFBs, development partners						
Increase capacity of banks and MFBs to develop products and channels for MSMEs, by exploring new business models that ride on digital payments platforms and strategic alliances	Build capacity and develop expertise in MSME finance, particularly in the use of alternative models such as value chain finance, cross-selling, program lending, women-focused services, cash-based lending, and provision of nonfinancial supporting (technical assistance) services for business development	Banks, MFBs, and other financial service providers, SBP, PMN, PPAF, training institutions, development agencies						
	Secure senior management commitment to a strategic view for MSME lending	Banks, MFBs, MFIs and other financial service providers						
Improve business skills and capacity of MSMEs	Design new or expand existing capacity building efforts, with focus on priority areas (i.e., better organized sectors that are more likely to immediately benefit from financial access)	SMEDA, other relevant agencies, development partners						
	Strengthen value chain linkages and borrowers' access to clusters and associations	SMEDA, other relevant agencies, development agencies, banks, PMN, MFIs and MFBs						
AGRICULTURE FINANCE								
Increase capacity of banks and MFBs to develop better products and channels for farmers, by exploring new	Build capacity and develop expertise in agriculture lending, particularly in the use of alternative models, such as value chain finance, warehouse receipt finance, cross-selling, program lending, contract	Banks, MFBs, MFIs and other financial service providers, SBP, PMN, PPAF, training institutions,						

Objective	Activity / Action	Lead Roles	Implementation timeline					
			2015	2016	2017	2018	2019	2020
business models that ride on digital payments platforms and strategic alliances	farming, women-focused services, cash-based lending, and provision of nonfinancial supporting (technical assistance) services for business development. This would also include the development of products that ride on digital platforms.	development agencies						
	Secure senior management commitment to a strategic view for agriculture finance, including small farmers	Banks, MFBs, MFIs and other financial service providers						
Create infrastructure for warehouse receipt finance (WRF)	Set up regulatory and monitoring body for WRF	SBP, GoP, development agencies						
	Build a solid legal framework for WRF	SBP, GoP, development agencies, agricultural industry representatives						
Create a policy environment that encourages market-based development	Ensure government commitment to shift government role from intervention to market-based holistic approach	GoP, SBP						
	Assess effectiveness of current interventions and evaluate need for targeted interventions with appropriate monitoring and evaluation framework, and greater level of granularity in the segmentation of this market	GoP, SBP, PMN, banks, MFBs, SMEDA, development partners						
	Design and launch improved partial guarantee schemes to foster agricultural lending	GoP, SBP, PMN, banks, MFBs, development partners						
Improve business skills and capacity of small farmers	Design new or expand existing capacity building efforts, with focus on priority areas (i.e., better organized sectors that are more likely to immediately benefit from financial access)	Other relevant agencies, development partners						
	Strengthen value chain linkages and borrowers' access to clusters and associations, as well as linkages between rural farm and non-farm enterprises	Other relevant agencies, development agencies, banks, PMN, MFIs and MFBs						
		INSURANCE						
Strengthen capacity of public sector insurers	Redefine and reenergize the public insurance companies and corporatize and formalize PLI	MoC / MoF / SECP / Ministry of Communication						

Objective	Activity / Action	Lead Roles	Implementation timeline					
			2015	2016	2017	2018	2019	2020
Strengthen insurance sector regulation and supervision	Ensure a fair and equitable taxation regime	SECP / MoC / MoF						
	Strengthen minimum capital for insurers in a phased manner and encourage entry of new players	SECP						
ISLAMIC FINANCE								
Promote Islamic finance by developing infrastructure for risk-sharing in the financial system	Set up national task force to design and implement long-term strategy to enable Islamic finance by promoting risk-sharing (asset-based, equity-financing, etc.).	Steering Committee on Islamic Finance						
Develop regulation to promote products and services for MSME, *Takaful*, agri-based, and micro-housing	Review taxation issues concerning Islamic sales, salaam, and Ijarah (leasing) contracts.	CBR, GoP						
	Develop Sukuk structures to securitize portfolio of Islamic SMEs, leasing, and *Mudarabah* companies.	SECP						
	Define guidelines for institutions replicating Akhuwat model	SECP						
Revitalize and institutionalize re-distributive institutions to complement commercial tools to enhance inclusion	Define regulations for financial institutions and NGOs offering *qard-al-hasan* based mode of micro-finance.	SECP, Ministry of Awaqaf						
	Undertake review of *waqf* laws and regulations to encourage revival and development of *waqf* offering *Shariah*-compliant savings or lending services.	SECP, Ministry of Awaqaf						
Develop human resources knowledgeable in Islamic finance	Conduct workshops for key stakeholders and policy makers on global developments in Islamic MSME and *Takaful*. Establish proposed Center of Excellence for Islamic finance, linked to international centers such as IRTI or WB Global center	SBP, SECP, Islamic Banks, MFIs						
HOUSING FINANCE								
Reduce the cost of capital market-based funding	Develop better suited investment guidelines for PMRC bonds	SECP, SBP						
Mitigate market risks incurred by borrowers	Develop and encourage loan products and origination practices that reduce the impact of markup rates hikes	SBP, PBA						
Mitigate the credit risk involved in	Improve specific provisions of the prudential framework	SBP						

Objective	Activity / Action	Lead Roles	Implementation timeline					
			2015	2016	2017	2018	2019	2020
lending to lower-income groups	Improve the draft Housing Guarantee Scheme and establish the scheme	Ministry of Housing, SBP, MoF						
Develop new business models based on demand aggregation and extended outreach	Design model templates, build strategic partnerships, launch pilot projects, assess and disseminate the results of pilots	SBP, PBA, banks						
Improve efficiency of mortgage rights	Amendment to the foreclosure law and include new approaches for out-of-court foreclosure that balances creditor's and debtor's rights and comply with the Supreme Court decision that overturned the 2001 framework	SBP with Ministry of Justice						
Establish reliable titling systems where affordable housing can be develop	Adopt legal and regulatory amendments allowing the compulsory property registration in designated areas	Ministry of Finance, Provincial Boards of Revenue, Federal Land Commission						
PENSIONS								
Develop a national pension policy framework	Create a working group to develop the Pensions policy	GoP						
Increase percentage of labor force actively participating in EOB scheme	Strengthen EOBI, by increasing its policymaking and administrative capacity resolving its legal status, and its financial sustainability	GoP, Provincial authorities, EOBI						
	Expand role of mandated EOB scheme and consider introducing voluntary participation							
	Develop additional scheme for informal sector workers							
Increase participation in VPS	Consider developing subsidized VPS schemes for low-income earners not covered by other mandates	GoP, Provincial authorities						
Increase the number of employers providing pensions to fulfill labor law mandate through formal registered schemes	Rationalize the Labor Law to require formal schemes for all employee benefit mandates, and expand mandate of Labor Law to all employers	GoP, Provincial authorities						
	Designate regulator and supervisor for employee benefit schemes	GoP, Provincial authorities						
	Reprioritize tax incentives to benefit VPS and other pension funds compared to other forms of savings	GoP, Provincial authorities						
	Undertake a national survey of formal employee benefit schemes	GoP, Provincial authorities, FBR						

Annex 2: Financial inclusion among individuals: Banked vs. Unbanked

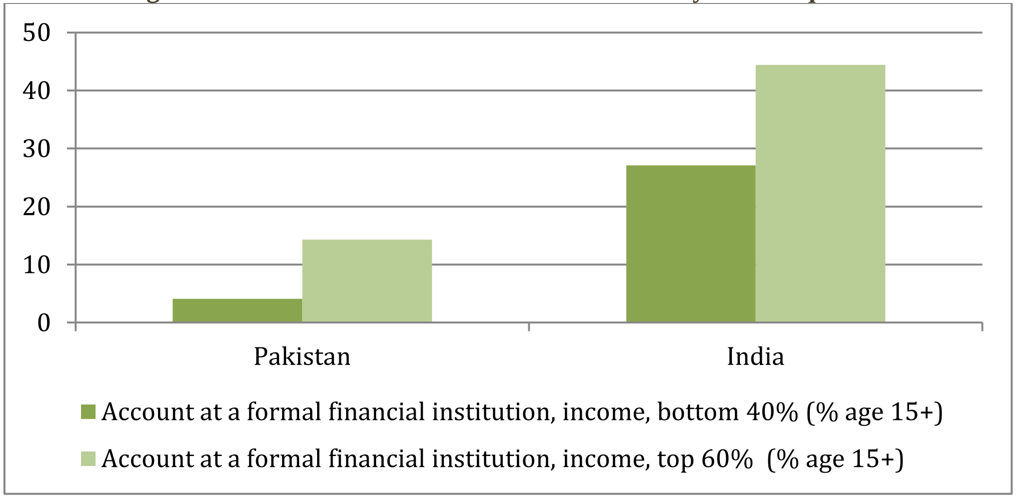
1. Pakistan lags behind India and the South Asia and East Asia and Pacific regional averages in individuals' usage of accounts with formal financial institutions. Income is also associated with the use of financial services. The gap between the access rates of the lowest and highest income quintiles in Pakistan is double that in India (Figure 8).

Table 6: Proportion of adults (age 15+) with an account in a formal financial institution

Demographics	Pakistan (%)	India (%)	South Asia (%)	East Asia and Pacific (%)
All adults	10.3	35.2	33.0	54.9
Male adults	17.3	43.7	26.7	57.6
Female adults	3.0	26.9	25.0	52.3
Adults living in rural area	7.2	33.1	30.8	49.5
Adults living in urban area	15.4	40.9	39.7	70.8

Source: Word Bank: Findex 2011

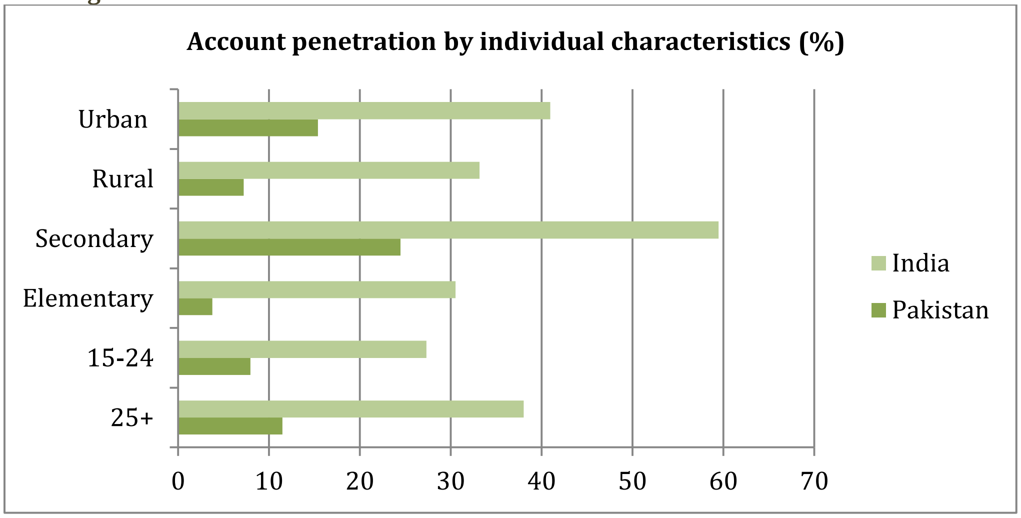
Figure 9: Account at formal financial institution by income quintiles



Source: Findex 2011

2. Usage of a bank account also increases with the level of education. The percentage of adults with a bank account in urban areas (15.4%) is twice that of rural area residents (7.2%). The gaps between urban and rural residents are much wider than in India (Figure 9).

Figure 10: Characteristics of Individuals with Accounts in a Formal Institution

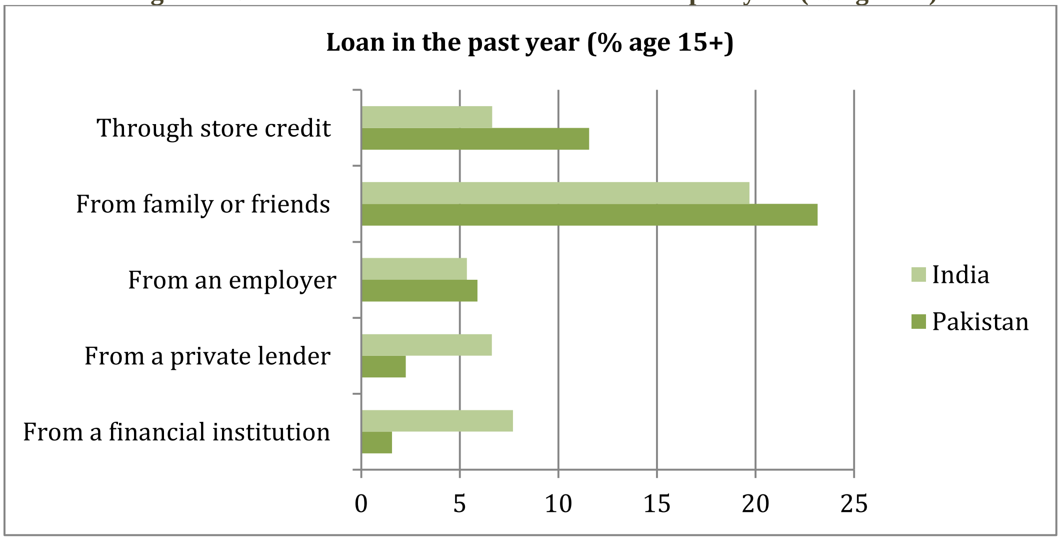


***Source**: Findex 2011*

3. The Findex 2011 survey revealed that 7.4% of the adult population in Pakistan had saved in the previous 12 months, though only 1.4% had saved in formal financial institutions. The earlier Access to Finance Survey (2008) indicated that up to 56% of adults save if informal sources such as cash at home, livestock, informal group savings (committees), land and jewelry are taken into account.

4. One-third of the adult population borrows, but less than 2% uses a formal financial institution to do so. Access to credit increases with age and education. Borrowing is mostly informal. Figure 10 shows the importance of borrowing from friends (23%) and shopkeepers (13%). The percentage of informal borrowing is lower in India. On the other hand, Pakistan lags behind India in borrowing from a private lender (3% versus 7%) or from a financial institution (2% versus 8%). These findings reinforce the importance of the informal sector in Pakistan.

Figure 11: Individuals who received a loan in the past year (% age 15+)



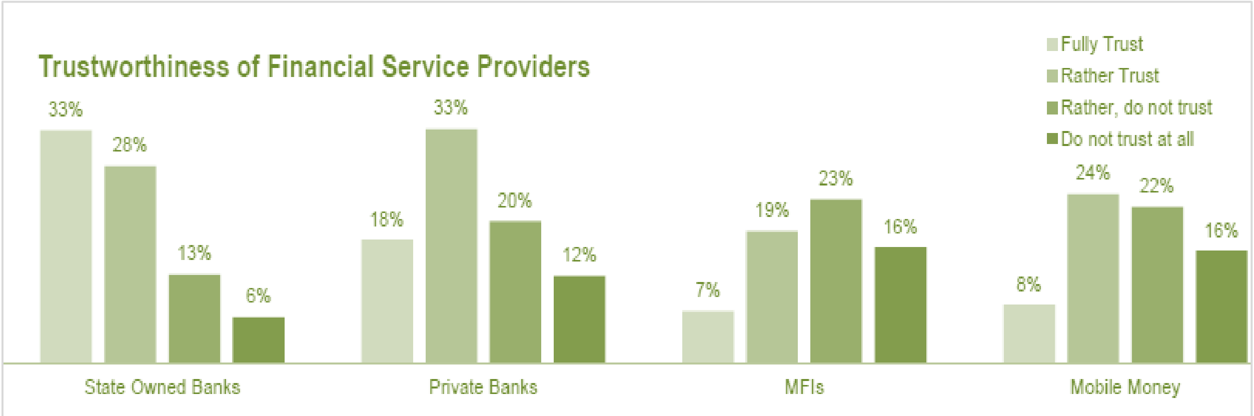
***Source**: Findex 2011*

5. The main products used by the banked population are savings and checking accounts. Of the banked population, 51% have savings accounts and 36% have checking accounts). Only 5% of the banked population has personal loans.

6. The 2008 Access to Finance Survey found that 41.6% of the unbanked population expressed a strong desire to have an individual account. This desire increases with income and is stronger for men and in urban areas. The main obstacles to accessing bank services cited in the survey were documentation requirements (identity card, permanent address and credit references) and a lack of information on verification of income. Distance from the bank was also cited as an issue. It is worth noting that this survey was taken prior to the rapid rise in branchless banking which has reduced documentation requirements for low-risk accounts. We will see whether respondents to the 2015 Access to Finance Survey cite documentation and distance as lesser constraints. On the borrowing side, the requirement for immovable collateral was noted as an important constraint.

7. Another potential impediment to financial inclusion is a lack of trust in private financial service providers by a significant share of the population, as shown in Figure 11. In this regard, the expected passage of the long-pending deposit insurance legislation might partially address this lack of trust and would provide much-needed protection to new and existing small depositors.

Figure 12: Trust in Financial Institutions

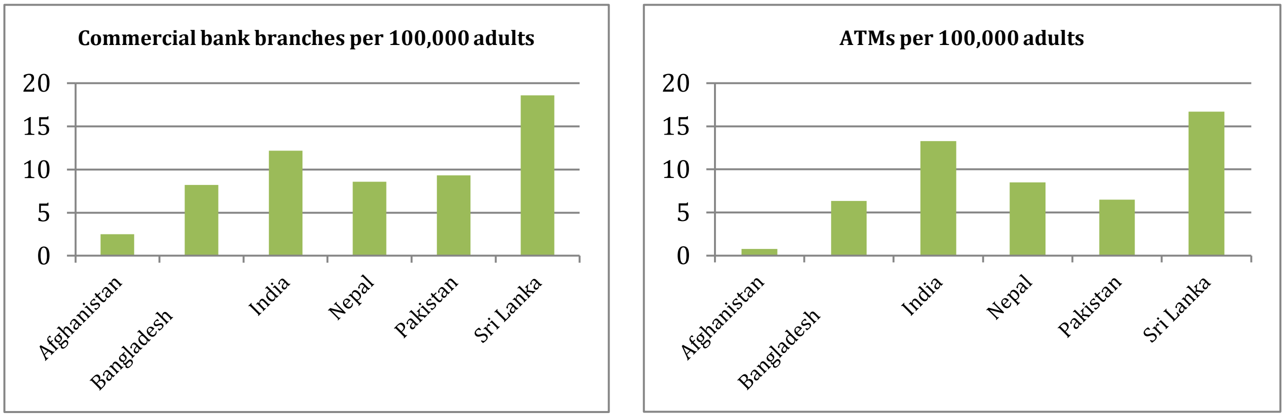


***Source**: InterMedia Pakistan FII Tracker Survey (2014)*

Note: Percentages do not add up to 100% as some respondents were not familiar enough with the financial service providers to respond

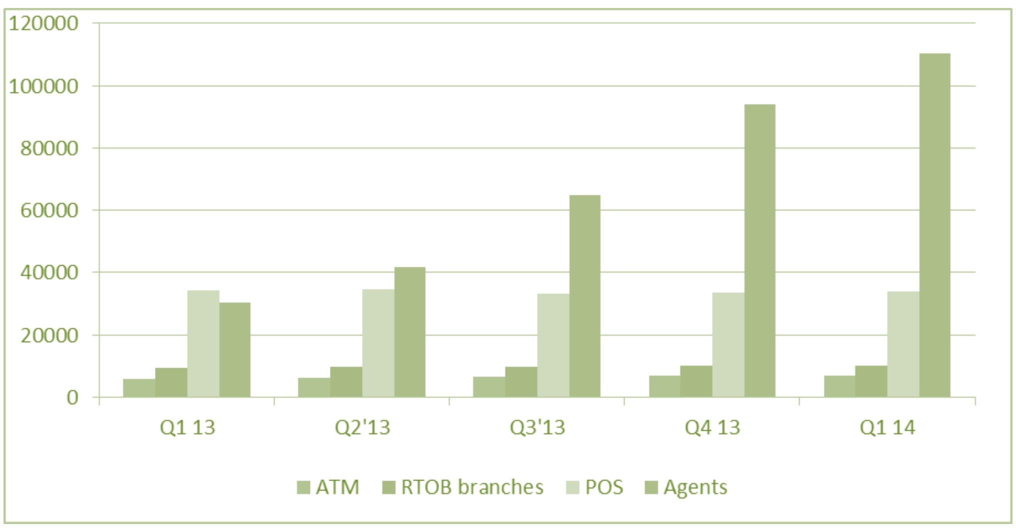
8. On the supply side, proximity to financial services has traditionally been a key determinant of access. Pakistan has roughly the same number of bank branches and ATMs per 100,000 inhabitants as most countries in South Asia. The recent development of branchless banking has increased access points considerably. While there were just 6.6 bank branches per 100,000 adults in 2014, there were 152 registered agent outlets (up from just 15 in 2011). Nonetheless, the agent network still falls short of achieving full national distribution. There has been little growth in rural settings where the absence of formal financial services is more acute. A geo-spatial mapping of access points would be helpful to determine how many individuals may remain excluded due to lack of physical access.

Figure 13: Commercial bank branches and ATMs per 100,000 adults



***Source**: IMF FAS 2013*

Figure 14: Access points by transaction channels



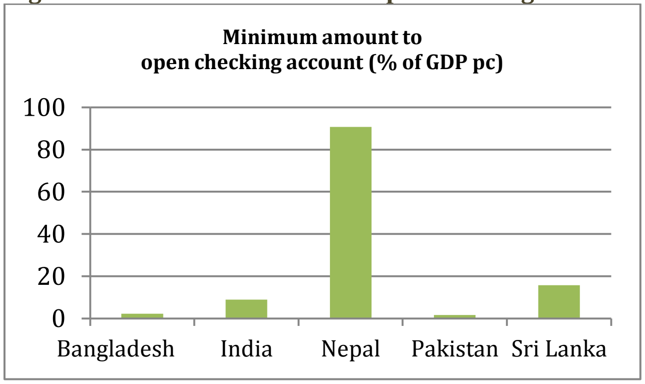
***Source**: SBP*

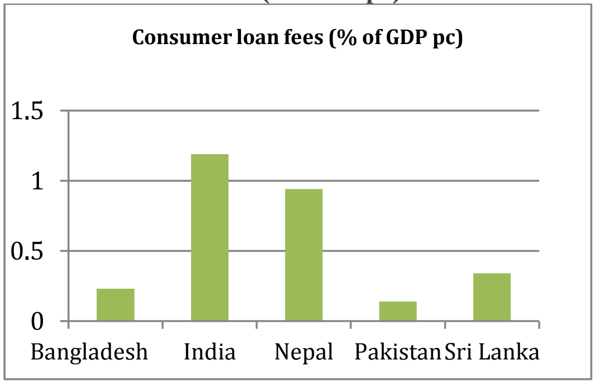
***Note**: RTOB are Real-Time Online (bank) Branches*

9. Other issues from the supply side which affect access to financial services are minimum balance requirements, fees and documentation requirements for account opening. In this regard, Pakistan fares better than most regional comparators (Figure 14). SBP mandated fee-free basic banking accounts in 2006, though uptake has been relatively modest because SBP subsequently eliminated account maintenance charges on all accounts, thus minimizing the differentiation. SBP has also been proactive in reducing documentation requirements for KYC and Customer Due Diligence (CDD) by using a risk-based approach, which distinguishes four levels of accounts with differing documentary requirements. The lowest level L0 accounts can be opened with just a Citizens National Identity Card (CNIC) and verification of the details with the National Database and Registration Authority (NADRA), which issues the CNIC. The near-

complete roll-out of a national biometric identification document (ID) should greatly facilitate financial inclusion efforts by reducing the paperwork associated with account opening.

Figure 15: Minimum amount to open checking account and consumer loan fees (% GDP pc)





Source*: Banking Services for Everyone? Barriers to Bank Access and Use around the World, Thorsten Beck, Asli Demirguc¸-Kunt, and Maria Soledad Martinez Peria*

Microfinance

10. The microfinance industry in Pakistan is a major source of credit to lower-income individuals. It is comprised of MFBs, MFIs, rural support programs (RSPs) and others. MFBs, the only part of the industry regulated and supervised by the SBP, account for 39% of active borrowers and 56% of total loan portfolio of the microfinance industry.[31] The sector is concentrated in the urban areas of Punjab and Sindh. MFIs, which account for the majority of borrowers in the microfinance sector, practice predominantly group lending. MFBs are undergoing a strategic shift towards individual lending, savings and larger loans - including microenterprise loans. Though recent growth in microcredit has been due primarily to growth in portfolio value rather than number of borrowers.

11. Despite the significant growth of microfinance since 2000, the current supply of 3.1 million borrowers is estimated to be less than 12% of the potential market.[32] The microfinance loan portfolio increased from PKR 19.6 billion (USD 192 million)[33] in June 2008 to PKR 61.2 billion (USD 600 million) in June 2014. Microinsurance is also growing rapidly, geared toward credit life insurance and health insurance.

12. Branchless banking by MFBs is expanding rapidly and has the potential to reduce the divide between rural and urban outreach**.** MFBs, in particular Tameer MFB, have been aggressively expanding their outreach to mostly urban (but starting to expand to rural) clients with the use of mobile money. MFBs added 1.3 million depositors in the second quarter of 2014 alone, which was attributed mainly to the surge in the accounts used to disburse the Benazir Income Support Program (BISP) through EasyPaisa mobile money accounts. Other MFBs are linking up with third parties to increase their footprint. Khushhali MFB and First MFB, for example, have partnered with the Pakistan Postal Savings Bank to expand their physical presence in rural areas and to facilitate loan disbursement and repayments.

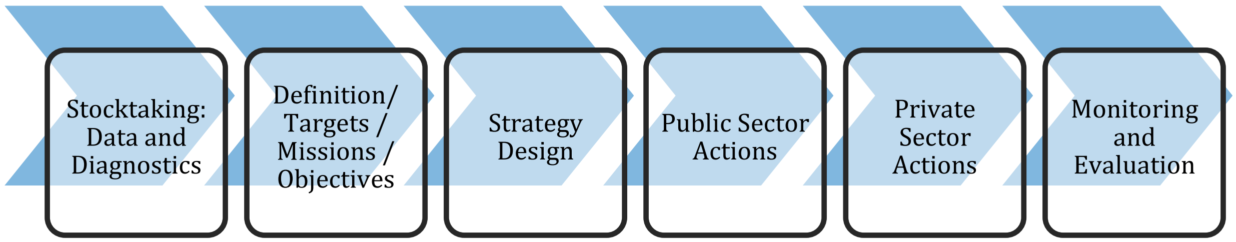
[31] Microwatch, Issue 32, September 2014.

[32] Mcirowatch, Issue 32, September 2014.

[33] 1 USD=102 PKR.

Annex 3: Methodology and Consultative Process

The methodology and process of designing and implementing the NFIS is spread over six phases as illustrated below: i) stock-taking (data and diagnostics); ii) targets and objectives; iii) strategy design; iv) public sector actions; v) private sector actions; and vi) progress monitoring and evaluation.



A scoping mission was conducted as the first step in April 2014, with the purpose of gathering secondary data and engaging key stakeholders, including regulators, financial institutions, and public and private sector representatives. The result was a Stock-Taking Diagnostic, which helped identify issues on which to focus during the preparation of the NFIS.

Subsequent analytical work focused on relevant international examples of financial inclusion strategies, and on extension of consultations to a broader set of stakeholders to refine the understanding of key enablers and drivers of financial inclusion and to increase awareness about the NFIS process. The overall NFIS framework, particularly the definition of financial inclusion, the tentative indicators, the suggested NFIS governance structure, as well as the key enablers and drivers of financial inclusion, were submitted to broad consultations through workshops in September 2014 (60 participants) and November 2014 (100 participants), in which MoF, MoC, regulators, financial institutions, and other stakeholders from the private and public sector had the opportunity to discuss the NFIS process, and the key premises that underpin financial inclusion targets. This comprehensive process guided the NFIS Framework for Action, and provided inputs for the Action Plan for implementation.

Quality at entry was assured through the deployment of leading experts from the World Bank's Finance and Markets Global Practice, IFC, CGAP, and other international organizations. Valuable and ongoing feedback from the Government, including SBP and SECP, provided guidance across all stages of strategy design. Finally, sequenced consultations contributed towards strengthening the design and content of the NFIS, and developing the Action Plan.

The NFIS Governance Structure, with support from the NFIS Secretariat is expected to provide the necessary impetus for implementing reform actions, conducting monitoring and evaluation, and considering progress towards national financial inclusion targets.