REMARKS BY DR. ISHRAT HUSAIN, GOVERNOR STATE BANK OF PAKISTAN AT THE ASIA PACIFIC MICROCREDIT SUMMIT HELD AT NEW DELHI ON FEBRUARY 3, 2001.

1. State Bank of Pakistan(SBP) is playing a proactive role in setting up, nurturing and promoting Microfinance institutions (MFIs). It has used its learning from DFIs to avoid Government ownership, provision of capital, management control, subsidised interest rate, lines of credit and government guarantees. This means that the focus will be on design of MFIs as sustainable community-based service delivery system and the supporting financial infrastructure. There have been some limited developmental activities for which funds have been channelled through commercial banks. The main thrust, of course, will remain on the promotional activities for spread of MFIs.

2. State Bank of Pakistan is pursuing an experimental learning-by-doing approach to prudential regulations and supervisions of MFIs. Instead of following a prescriptive approach with a blueprint specifying all the prudential norms and regulations well ahead of the institutions being set up we are allowing the various kinds of MFIs to flourish without any prior set of restrictions. We will wait until a critical mass of such institutions has taken off, evaluate the experiences of these different approaches and **then set out the** rules of the game at an appropriate time. But one thing is clear – the conventional norms applied to commercial banks and other financial institutions will not be extended mutatis mutandis to MFIs. We have to evolve the rules in the light of the unique characteristics and operating requirements of this sector. This means a light supervision and less onerous licencing conditions, allowing more freedom and space to MFIs to innovate.

3. As the SBP's own capacity is limited in this field, a consultative mechanism has been formally put in place to involve all stakeholders in the process of setting up, learning, evaluation and formulation of the standards and rules. This ensures a responsive and gradually tailored approach to the evolution of the regulatory process. An important element of this mechanism is that the design and the financial infrastructure created to

support MFIs will be used as a basis to develop the overall legal and regulatory framework in a mode of partnership, self evaluation and continuous learning. For example, if the MFIs become large deposit taking institutions and their liabilities become a source of concern for the Central Bank their credit extension activities can suffer a setback if the same rules are applied to them as to other deposit taking institutions in the formal sector.

4. Subsidised interest rate is not the answer, as a number of observers believe, to achieve financial sustainability of Microfinance institutions. Empirical evidence from a variety of developing countries suggests that it is the lack of access by the poor to formal credit that is the serious constraint faced by them. Microcredit borrowers have borrowed at market related interest rates with an exemplary recovery record. Thus those who argue that the poor cannot afford to pay higher interest are sadly mistaken. In fact, the supervision provided by the Microfinancial institutions is akin to a kind of informal technical assistance provided to the poor and the cost is willingly borne by these borrowers.

5. The Microfinance sector is the largest financial sector in Pakistan in terms of potential clientele base comprising more than 6.3 million poor households. The Microfinance services market, however, is underdeveloped having less than 5 per cent outreach, narrow institutional base, limited retail capacity and little, if any, financial integration. Three sources of Microfinance services i.e. (i) informal, reciprocal arrangements, (ii) semiformal such as NGOs and (iii) formal sector comprising Commercial Banks and DFIs, exist in the country. Informal sources, which account for more than 80% of the micro-credit supply in the country, mainly supply short-term credit at terms that reflect the weak bargaining power of the poor, particularly for land-based credit arrangements. Also insurance to mitigate risk for the poor does not exist. The semiformal sector comprising mainly of NGOs and Rural Support Programs have shown

appreciation of the nature of Microfinance demand emanating from the poor through effective targeting, participatory approaches, capacity building and gender sensitivity. Yet, their Microfinance operations are unlikely to attain financial self-sufficiency if they are scaled up too rapidly. Commercial banks, in general, are neither structured nor geared to extend their Microfinance exposure beyond experimental forays whereas DFIs do not target the poor. The informal sources are the only window available to the poor. However, informal sources provide services at the terms that tend to perpetuate rather than ameliorate poverty.

6. What are we doing in Pakistan to extend the formal sector institutions to microcredit services. We have initiated a Microfinance Sector Development Program (MSDP) as part of our poverty alleviation strategy.

The main features of this program are:

(i) Creating a conducive policy environment.

(ii) Developing appropriate financial infrastructure

(iii) Promoting and strengthening Microfinance institutions (MFIs)

(iv) Developing linkages with NGOs and community organisations

(v) Investing in building social capital

(vi) Mitigating risks of poor households and

This public policy underpinning program aims at the concept of sustainable Microfinance, recognises the need to enhance social capital and considers risk mitigation as a necessary safety net measure for the poor. The policy also recognizes the need for and encourages private sectors, especially NGOs, in poverty reduction. The policy encourages private sector entry into banking with the poor to ensure innovation and flexibility. The State Bank of Pakistan has taken a proactive role by creating the required financial infrastructure in consultation with existing providers of Microfinance, based on international experience and discussions with ADB.

7. What are the key elements of the financial infrastructure for Microcredit services in Pakistan? As a first step a Microfinance Bank (MFB) has already been established under joint ownership of 3 public sector, 11 private sector and 2 international banks. The organisation and operations of MFB have been designed for a sustainable community-based service delivery system. Other attributes built-in the framework of MFB are structural integration and partnership with the National Rural Support Program (NRSP), the largest NGO in Pakistan with extensive experience in social mobilisation as well as Microfinance. The MFB will deliver services through NGOs using their core competency in social mobilisation. The design and the financial infrastructure created to support MFB will be used as a basis to develop a framework-legal, supervisory and regulatory – to mainstream the attributes of the basic Microfinance policy through definition and categorization of MFIs and their licensing procedures, development of supervision and regulation standards and systems, disclosure and reporting requirements and appropriate adjustment for entry threshold prescribed under the banking laws.

8. In addition to MFB it is proposed that three categories of Micro Finance Institutions (MFIs) should be licensed by State Bank of Pakistan (a) the MFIs having country wide operations, (b) the MFIs operating in a specific Province and (c) the MFIs operating in a specified District. The MFIs will be companies incorporated in Pakistan as public or private limited companies under Companies Ordinance 1984. The MFIs will have minimum paid-up capital ranging from Rs. 50.00 million to Rs. 1000 million depending on the nature of their licence. The framework will provide the scope for NGOs to become regulated Micro Finance Institutions (MFIs)to broaden and deepen the Microfinance sector. The MFIs will be regulated and supervised by State Bank of Pakistan through on-site inspections and off-site surveillance but not as elaborate as for banking institutions or NBFIs. The State Bank will make policies and formulate rules in a flexible way so that they contribute to the sustainable growth of MFIs and development

of Microfinance sector. The Bank will ensure good corporate governance and introduction of prudent business policies and practices in MFIs over time in light of the experience gained from various approaches. Further, a mechanism will be developed for rating of NGOs which could not be licensed as MFIs, but engaged in extension of micro-credit facilities to the poor people. The rating mechanism so developed will lend credibility to the operations of NGOs and will enhance their access to financial market and formal resources of finance. A Micro Finance Support Division has been established in State Bank of Pakistan to ensure orderly development of the sector.

9. As an integral part of Microfinance policy, support for intensive and sustained social preparation, particularly to enhance outreach to poor women, building capacity of communities and providing access to basic infrastructure has been recognised. Two funds namely Microfinance Social Development Fund and Community Infrastructure Fund has been created to ensure sustained and assured investment in building social capital and community infrastructure development. Support will be provided for Community Organisations, skill development and enhanced access of the poor, specially the women to community infrastructure to enable them fully utilize Microfinance services. Dedicated initially to MFB, support from these funds will be made available to regulated MFIs as they emerge under the new framework. As NGOs will provide social intermediation services on behalf of MFB and will be paid for it, these funds further Government’s objective to strengthen the NGO sector for other positive externalities, particularly those related to gender. Pursuing this approach from the outset will ensure group cohesion, quality of loan portfolio, and sustainability.

10. As a pro-poor innovation, a Risk Mitigation Fund (RMF) has been established, to reduce the risk aversion of the poor for the fear of indebtedness in failed enterprises and enable the poor households to take advantage of potentially viable new technologies, production choices, and income opportunities. The Risk Mitigation Fund will assist the

poor in case of loss of income generating assets due to unforseen circumstances beyond their control. Also to provide safety to the small depositors and to build the confidence of the poor in the activities of Micro Finance Bank and regulated MFIs, a Deposit Protection Fund (DPF) has been established to provide security to the savings of the poor. The depositors of MFB or regulated MFIs will be paid from this fund in case of their liquidation.

11. MFB and Government of Pakistan have made initial contributions to these funds. Rules to operate these funds have been framed to ensure transparency and good governance. As a matter of additional precaution the State Bank of Pakistan Act, 1956 has been amended to enable SBP to hold and invest these funds directly to provide further insulation from any extraneous interference.