APRACA FinPower
Programme on Rural Finance

Knowledge Sharing Between
State Bank of Pakistan and Central Bank of Sri Lanka

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Dear Madam Cooray, ladies and gentlemen, it's my pleasure to welcome you to the knowledge sharing session on Central Bank of Sri Lanka's policy initiatives in rural finance. Our distinguished guest is a prominent economist with extensive exposure to the insight of central banking and rural finance. She has been associated with many rural finance projects in Sri Lanka and has represented her central bank at various national & international forums.

Before hearing from Madam Cooray, I would like to articulate SBP's regulatory and policy initiatives in creating an enabling environment for improving access to finance to the rural community in the areas of agri., SME and micro credit to facilitate the government's goals for economic growth and poverty alleviation through rural development in Pakistan.

Pakistan is a country of around 160 million people, out of which, around 67 percent live in rural areas. Agriculture accounts for about 40% of the rural household incomes whereas only 37% of rural households own arable land. The majority of the rural population works as tenants or haris. The rest are family or self employed as small entrepreneurs. The uncertainties in agriculture production and prices makes their income vulnerable and as such, around 80% of the poor of Pakistan are in rural areas. Therefore, agricultural growth remains an important avenue out of poverty in rural Pakistan, but given that 60 percent of the country's rural poor are landless and primarily reliant on non-agricultural activities as their main source of income and employment, it is increasingly recognized that a well developed and well-functioning rural non-farm sector is essential for generating employment, ensuring income diversification and reducing poverty (World Bank, 2004).

Access to credit is considered to be a major constraint in the development of the rural economy. Therefore, financial inclusiveness is critical as 42% of Pakistan's population is under 15 years of age and about 24% of the population lives below poverty line. Both these segments can benefit from economic empowerment. Apart from banks' loan pricing policy and lack of easy availability of credit, financial institutions are reluctant to venture into new areas as they do not have the capacity to assess the demand and deliver their financial services. The lack of availability of financial services, lack of alternate delivery channels and financial innovation, inadequate database and information on borrowers, and weak enforcement of contract etc. are some of the main stumbling blocks that prevent inclusiveness of the financial sector.

The State Bank is committed to financial inclusion of the rural population. In this regard, it has formulated a separate Development Finance Group to synergize all rural finance activities viz. agri., SME and Microfinance. In addition to this group, other arms of SBP are contributing in aligning its policies to the initiatives and developments for encouraging the banks to adopt development finance as a viable business line.

Agri. Finance

Agriculture lending has received a significant boost as the banks have met their targets over the past 5 to 6 years and the agri. disbursement has increased to Rs 212 billion in FY 2007-08 from Rs 39 billion in FY 1999-2000. Despite this robust growth, outstanding agriculture advances account for about 6% of total advances of banks and the current flow of credit meets only 40% of the agriculture credit requirements of the farming community. Out of 6.6 million farmers, 2 million have access to formal credit and the rest have to rely on informal sources at exorbitant rates that at times ranges from 40% to 50% per annum.

Studies abroad & in Pakistan have shown that subsidized and mandatory regimes in agri. financing have not proven successful at large. Therefore, SBP has done away with the mandatory regime and is making efforts to create an enabling environment for banks to adopt agri. financing as a commercially viable business.

Under the new paradigm, SBP has taken several initiatives in the last 7 years which, inter alia, include the induction of 14 domestic private banks in agricultural credit scheme, besides the five big banks and two specialized banks viz. ZTBL & PPCBL, standardization of loan documents and issuance of guidelines for livestock, fisheries, poultry & horticulture financing. Further, to resolve the issue of the farmers for fresh documentation for input loans on each crop loans, a Revolving Credit Scheme for three year credit limits with one time documentation was introduced. To implement SBP's initiatives at the regional level, separate Development Finance Support Department and its units have been established at SBP-BSC. Focus groups on agri. financing comprising of all local stakeholders have also been formulated at 16 offices of SBP BSC to help banks and local farming community resolve agri. credit related issues at grass-root level.

Separate Prudential Regulations for agriculture financing have also been developed. To facilitate lending to landless farmers/ tenants, a Small Farmers' Scheme on group lending methodology has been developed. Under the scheme, small farmers can get agri. loans up to Rs 200,000 on a mutual guarantee of the members of the group. Besides, per acre indicative credit limits for crop production loans have been enhanced by an average of 70% from Rabi crop 2008-09 to meet the agri. credit requirements due to sharp rise in prices of inputs.

To elevate the awareness of the farming community, SBP started training & awareness programs at the district level, wherein representatives of local banks were invited to provide to the farming community details of agri. financing facilities available and to discuss the issues being faced by them. Around 50 such programs have been conducted successfully thus far. For capacity building of Agri. Field Officers (ACOs) of banks, a one-week crash training program was introduced. Thus far 14 such programs at the regional level have been conducted and around 450 ACOs and officers of SBP-BSC have been trained.

SBP has joined Asia Pacific Rural Agricultural Credit Association (APRACA), a regional forum, for sharing knowledge of international best practices of the region in agri. /rural finance. Using the network of APRACA, training programs for officers of SBP and agri. heads of banks were arranged at the Bank for Agriculture and Agricultural Cooperatives (BAAC) to learn from its experiences in the field of agri. / rural finance.

To mitigate the risk of banks and the farming community against losses caused by natural calamities, SBP has developed a Crop Loan Insurance Framework with the help of a Task Force comprising of representatives of banks, leading insurance companies, the farming community and other stakeholders. Based on SBP's framework, a mandatory crop loan insurance scheme has been introduced from Rabi crop 2008-09 for major crops, viz. wheat, cotton, rice, sugarcane and maize The government is bearing the premium cost of subsistence farmers up to a maximum of 2% per crop. The scheme will safeguard the interest of banks and farmers in case of natural calamities and will also save a huge amount of funds spent by the government in the shape of frequent write-offs / waivers of agri. loans of ZTBL's borrowers in such situations.

An Agricultural Credit Advisory Committee chaired by the Governor, SBP, representation of banks, farming community, federal & provincial agriculture & planning departments, agri. research institutes and other stakeholders meet bi-annually to review the performance of the financial sector in agri. financing and discuss ways and means to resolve bottlenecks in access to finance to the farming community.

A strategy for agriculture credit focuses on doubling the number of borrowers from 2 million to 4 million and meeting 75-80% of the agriculture credit requirements, is being developed with the help of experts.

SBP is striving to establish a farmer-friendly market based financial sector in the country to meet the increasing credit requirements of the agriculture sector. However, there are issues at the government level like geographical disparity in low developed provinces of Sindh, Baluchistan and NWFP due to low absorption capacity, lack of enabling environment, passbook related issues, high NPLs, frequent demands for write-offs/ waivers, low recoveries, lack of effective extension services, law and order situation, lack of proper storage & marketing facilities, non-viability of small farmers due to low yield, non-availability of one window operation facility for banks in crop seasons, etc. that need to be addressed to increase the flow of credit to the rural community for meeting the national goals of agricultural growth and poverty alleviation in the country. Banks also need to focus on addressing the issues of low outreach, lack of rural branch network, reduction in loan processing time, awareness of farmers about loan facilities, simplification of loan documentation, etc. to increase the flow of credit to agriculture on a fast track basis.

Microfinance

The history of microfinance (MF) in Pakistan has followed the conventional route. In the 60s, the focus was on agricultural credit, mostly for inputs, and the idea was that the poor primarily needed access to subsidized credit. In the 70s, there was a move to nationalize banks in the country and most of the credit provided to the small farmers was by government owned banks. During the 80s, the Agha Khan Rural Support Programme (AKRSP) began its operations in the northern region of the country through Community Based Organizations (CBOs). The success of the AKRSP led to the gestation of several other RSPs in Pakistan, which included the Sarhad Rural Support Programme (SRSP), the National Rural Support Programme (NRSP) and the Punjab Rural Support Programme (PRSP). In the 80s and somewhat into the 90s, the RSP methodology, involving a holistic approach to rural development, dominated the microfinance scene in Pakistan. At the same time, in urban credit the Orangi Pilot Project (OPP) had developed an individual lending approach targeting existing entrepreneurs in urban slums.

The 90s can be seen as the decade of awakening of the sector as a whole. The RSP methodology though workable in several settings, required a more specialized banking overlay. This led to the setting up of several experimental programs such as Kashf Foundation (converted to microfinance bank) modeled essentially on the Grameen Bank, started operations and was followed by other similar initiatives including the NGO/MFIs Taraqee Foundation and Damen.

The millennium has seen some interesting developments: in addition to greater interest of the government in the sector by taking various initiatives, there have been innovations in the private sector. Major initiatives include the setting up of an apex organization - Pakistan Poverty Alleviation Fund (PPAF), introduction of a comprehensive Microfinance Sector Development Program (MSDP), facilitation in establishment of Khushhali Bank, enactment of a law (MFIs ordinance 2001) and establishment of Pakistan Microfinance Network (PMN).

Currently, the Microfinance sector players can be classified into three broad categories based on the criteria of their regulatory status. Microfinance Banks and Commercial Banks involved in Microfinance falling under the regulatory ambit of the Central Bank (State Bank of Pakistan), leasing companies involved in micro-leasing business regulated by the Securities Exchange Commission of Pakistan (SECP) and Rural Support Programs, NGO/MFIs, Cooperatives, etc. that are generally self-regulated under PMN framework of Disclosure on financial and operational performance. The larger NGO-MFIs (NRSP & Kashf Foundation) have registered themselves with SECP under Section 42 (Not for profit companies).

A conducive and enabling policy environment is an important prerequisite for the development of a sound and vibrant microfinance sector. It largely stems from the government and policy makers' belief in the utility of microfinance, the level of their commitment to facilitate development and growth in the sector, and the level of trust and cooperation between policy makers and practitioners to work together for serving the poor. Those countries and economies whose governments adopted sector friendly policies and encouraged private sector investment in the sector, have seen microfinance growing at a faster pace benefiting a large number of the poor.

Currently, MFBs and MFIs have an outreach of 1.8 million borrowers. The State Bank of Pakistan has developed a national strategy to target 3 million microfinance clients by 2010 and 10 million by 2015. SBP has identified three concurrent steps the industry needs to undergo in order to fulfill its set goals viz; Sustainable and cost covering operating/business model; Mobilization of private domestic capital; and Building human resource capacity/systems.

In order to develop these critical components of the microfinance industry, SBP has undertaken several steps, that includes but not limited to, launching the Financial Inclusion Program (FIP), aimed at eliminating market failure and improving access to financial services. FIP is a £50 million program funded by the UK Department for International Development (DFID). It includes a Microfinance Credit Guarantee Facility aimed at providing incentive to banks / DFIs to channelize funds to MFBs/MFIs for on-lending to low income segment of the population. The facility will provide a credit guarantee for up to 40 percent of funding provided by banks/DFIs and aims to develop the market and graduate poor borrowers to mainstream financial service providers. The Institutional Strengthening Fund is designed to build capacity of the microfinance sector and is expected to enhance the potential for growth and create depth in outreach by improving human resource quality, service delivery and increase service availability to prudential microfinance clients. The improving Access to Finance Service Fund is designed to enhance capacity of the microfinance sector and promotes financial literacy in the country. Besides the above, SBP has issued Branchless Banking guidelines, which is the regulatory framework to promote banking in remote/rural areas. Microfinance institutions are encouraged to transform into regulated entities as international players including BRAC & ASA have incorporated in Pakistan. SBP has also encouraged the partnership between the post office network and MF providers.

Many of these initiatives are recent and have yet to demonstrate effect vis-à-vis improved outlook for microfinance. However, the effectiveness of some of these initiatives may be improved in light of inferences drawn from the microfinance industry trends. Broadly, the current outlook for microfinance remains promising, but we must examine the emerging trends with caution. For SBP, it is especially important to consider regional disparity in availability of microfinance services in Pakistan. The industry is still young and continues to be dependent on donor assistance to grow, which is an unsustainable approach to long-term development and will hinder the achievement of the National Strategy of reaching 10 million clients by 2015. It is critical that MFBs move toward deposit mobilization to increase funds for on-lending. Cost-efficiency is especially important in the current environment amidst the global financial crisis where the higher cost of borrowing will eventually impact the cost of lending for MFIs and MFBs as they move towards commercial funding. Resource deficiency exists for microfinance not only in the form of funding, but also human resource capacity must be strengthened to provide quality microfinance services. Concerns over gender and regional participation needs to be critically examined and addressed in order to make microfinance's ability to fight poverty more meaningful. Relative to gender issues, we must be cognizant of the fact that when 50% of the population is in a non-productive capacity, how can we as a nation achieve progress.

SME Finance

Like many developing countries, in Pakistan, there are 3.2 million economic establishments, 44% in rural areas and 56% in the urban areas. Out of these, a total of 99.06% employed 1-10 persons, clearly indicating that these establishments fall under the definition of SMEs. Similarly, individuals own about 97% of such establishments, where 53% of the establishments belong to the wholesale & retail trade and restaurant & hotel sectors, 20% are part of the manufacturing sector, and 22% fall in community, social and personnel services sector. In Pakistan the corporate sector takes away the major chunk of credit extended by the banking system, while SME finance follows with the second largest share of total credits.

In Pakistan, the SME sector is confronted with a number of demand side constraints, including a lack of bookkeeping at SMEs, missing succession planning, rare strategic objectives or business planning, low level of financial literacy, unskilled human resources, lack of collateral, etc. On top of these, there is an issue of availability of formal credit to SMEs which hinders the progression of smooth growth of this sector. The banks also consider financing to SMEs and Rural Entrepreneurs (RE) as risky ventures; hence they are shy of lending to rural sector enterprises. The issues at the bank level include non aggressive lending strategies by banks, absence of specific products offered for SMEs, and a perceived high risk area by the banks, etc.

To motivate banks for lending to SMEs and Rural Enterprises, SBP has taken several initiatives. SBP has completed an ADB funded project for Strengthening Secured Transaction Framework. The project is aimed at enhancing SMEs, agri-farmers' and Rural Entrepreneurs' access to formal source of finance by establishing a system of charge creation on moveable & immovable assets of small borrowers in urban and rural areas. Based on the study, the necessary amendment in the Legal Framework has been suggested to the government. SBP has also developed SME definition, SME Prudential Regulations, introduction of SME Independent Credit Ratings through existing credit rating agencies, launching of a SME Finance Cluster Training Program at different SME hubs throughout the country, introduction of Financial Awareness Campaign at main SME clusters, establishment of "SMEs Help Desk", initiation of awareness building measures like "Booklet on SME Financing Products by Banks", formation of a SME Core Group to provide a forum for the resolution of SME finance issues; a concept paper on introduction of SME Credit Scoring Mechanism in Pakistan and launching of SME Finance Quarterly Review.

Further, to encourage banks for lending to SMEs and Rural Enterprises by sharing their credit risk, SBP is working on establishing a Credit Guarantee Scheme for Small & Rural Enterprises (RE) under the DFID funded Financial Inclusion Program.

Conclusion

I would like to encourage all commercial banks, microfinance banks and microfinance institutions to optimize the benefits of SBPs initiatives for creating an enabling environment for financial inclusion of the rural population. They should undertake their best efforts to meet the maximum credit needs of the rural community. Innovations in product development and adoption of best practices are the need of the hour that would assist in developing the rural economy, eradicating poverty and increasing food security. Today's program will provide the audience an opportunity to learn the experience of Sri Lanka in developing such innovations in rural finance. I look forward to strengthening the relationship between SBP and Central Bank of Sri Lanka in knowledge sharing with financial policy makers and practitioners in rural finance.

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