STATE BANK OF PAKISTAN
AGRICULTURAL CREDIT & MICROFINANCE DEPARTMENT

Financial Innovation Challenge Fund

Challenge Round 2 Guidelines for Promoting Innovative Rural and Agricultural Finance in Pakistan

06 March 2014

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1- Financial Innovation Challenge Fund

1.1 Introduction

State Bank of Pakistan is implementing the Financial Inclusion Program (FIP), sponsored by the UK Aid, with the aim to improve access to financial services in Pakistan. FIP has adopted a multi-pronged approach towards tackling financial exclusion by combining market forces and public sector principles. A noteworthy tool of this approach is to catalyze on innovations to widen the reach of financial services in Pakistan.

FIP has earmarked GBP 10 million in grants under the Financial Innovation Challenge Fund (FICF) to help the financial sector reach the excluded with use of innovations. Specifically, FICF aims to foster innovations to test new markets, lower cost of delivery, enable systems and procedures to be more efficient and provide new ways of meeting the unmet demand for financial services. The fund holds specialized challenge rounds focusing on innovations that market wishes to undertake to alter the scope and reach of financial services.

1.2 Objectives

The following are the objective of FICF:

a) Spur innovation and innovative practices that increase access to financial services by the unbanked or the financially excluded. The fund provides support for pilots and up-scaling of financial services vis-à-vis seed capital.
b) Leverage FICF funds to attract private investment. Additional capital will help create a bridge between pilot and roll-out of an innovation.
c) Create linkages between successful projects and other FIP funds to ensure that pilots can be brought to scale through donor and private sector partnership and coordination.

1.3 Scope

The broad scope of the fund is to facilitate the spread of financial services through innovation. Innovation may come in the following forms:

a) A product or service completely new and novel proposed by the applicant; or
b) A product or service that has been tested and proved successful somewhere in the world but is new to Pakistan; or
c) An innovation that has been tested in Pakistan by organizations and has proved successful and the applicant organization wishes to test it with a new partner or in a different location.

Innovations may hinge on either technological advances such as mobile phones or non-technological advances such as introducing value chain financing or warehouse receipts system for farmers to serve as collateral for loans. However, in order to encourage market based innovations, the Fund is expecting that the market will take the lead in developing scalable and sustainable ideas. Innovations may be broad-based and occur in products, delivery systems or marketing. Specific themes covered under FICF are announced in the form of periodic challenge rounds.

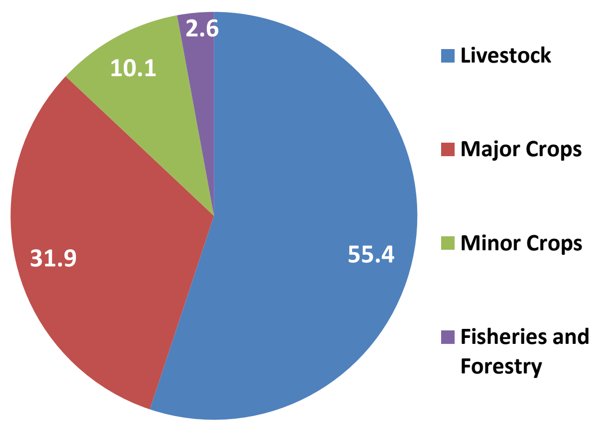
The 1st Challenge Round was held on promoting "Financially Inclusive Government to Person (G2P) Payments" through branchless banking models. Under the first round, FICF is supporting a number of pilots for adoption of innovate approaches to deliver financially inclusive G2P Payments, covering the entire spectrum of G2P payments including, salaries, pensions and welfare payments.

Now, the 2nd Challenge Round is unveiled on promoting innovative rural and agricultural financial services. Through this round the Fund aims to support pilots for promotion of broad based financial services using innovative products and channels for people who are not currently participating in the formal financial markets.

2- The Opportunity - Innovative Rural and Agriculture Finance in Pakistan

Round 2 of FICF will focus on innovations in Rural and Agricultural finance. Rural and Agricultural Finance for the purpose of this challenge round includes the provision of holistic financial services specifically credit dedicated to financing agricultural related activities such as input supply, production, distribution, wholesale, processing & marketing, savings, insurance, payment and business advisory services to the rural farm and non-farm enterprises, households and individuals. In addition, rural finance includes provision of rural microfinance which provides financial services for low income clients including micro-enterprise loans and savings & deposit services.

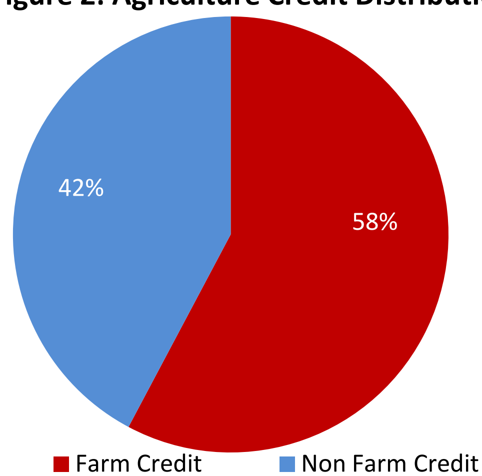
Figure 1: Agriculture Sector Composition



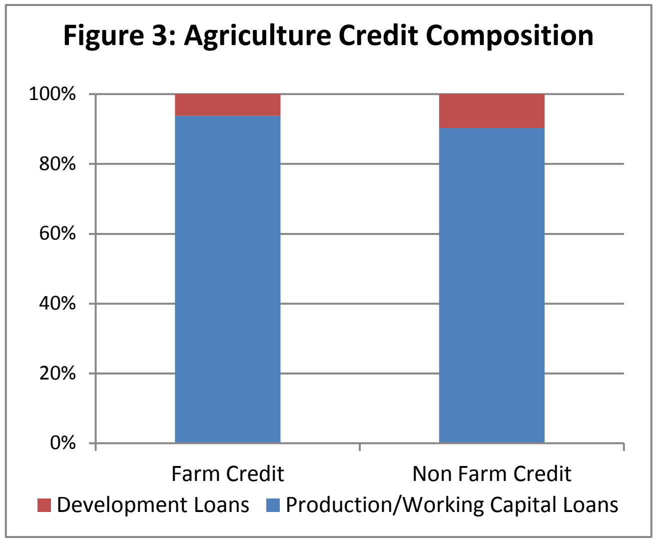
Major Crops : cotton, sugarcane, rice, wheat, gram, maize, and others.
Minor Crops: tobacco, oil seeds, potato, onion, pulses, chilies, and others

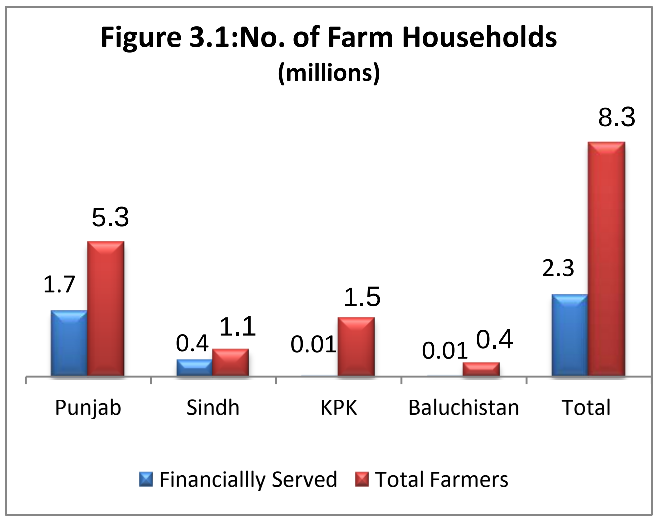
The agriculture sector is one of the major sectors of Pakistan's economy and contributes 21 percent to the GDP. It employs around 45 percent of our total labour force and 68 percent of our rural population is dependent on agriculture sector for their livelihoods. Agriculture plays a strategic and vital role in ensuring food security, generating economic growth, reducing poverty & inequality. Agriculture also raises productive capacity of the economy through its backward and forward linkages with the industries and increases potential for growth through its impact on the services sector. For instance, it contributes a major portion of our foreign exchange earnings through exports of raw products such as rice and cotton processed & semi-processed products such as cotton yarn, cloth, carpets and leather products. Therefore, agriculture is essential for sustainable improvements in internal and external balances.

Figure 2: Agriculture Credit Distribution



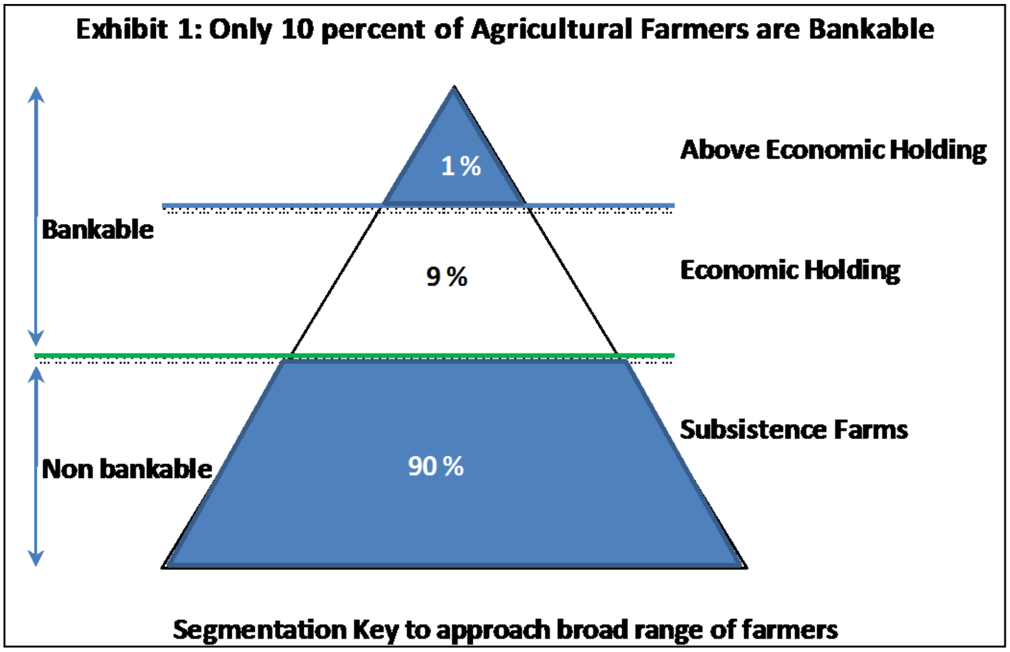
Currently, the credit to agriculture sector and related activities accounts for less than 6% of the loan portfolio of commercial banks which stood at Rs. 240 billion as on 31 December 2013, amounting around 1 percent of the GDP. Similarly, the current agriculture credit outreach at around 2.4 million farmers as against total 8.3 million farm households in the country is also very low. The picture becomes more skewed in case of small farmers where agri. credit outreach is limited to only 23% of 5.3 million small farm households. This is due to the fact the outreach of banks is currently limited in rural areas and also due to outdated modes of financing through collaterals such as passbook etc. which excludes the non-farm activities and landless masses. This also means that the non-crop sector which contributes more than 50 percent of agricultural GDP remains neglected in terms of its financing needs. Similarly, the share of working capital loans is relatively high thereby leaving very little for developmental loans for farm and non-farm capital investment essential for increasing productivity. The non performing loans (NPLs) in agriculture financing stand high at 12.5 percent, however, remains much lower than SME sector NPLs.



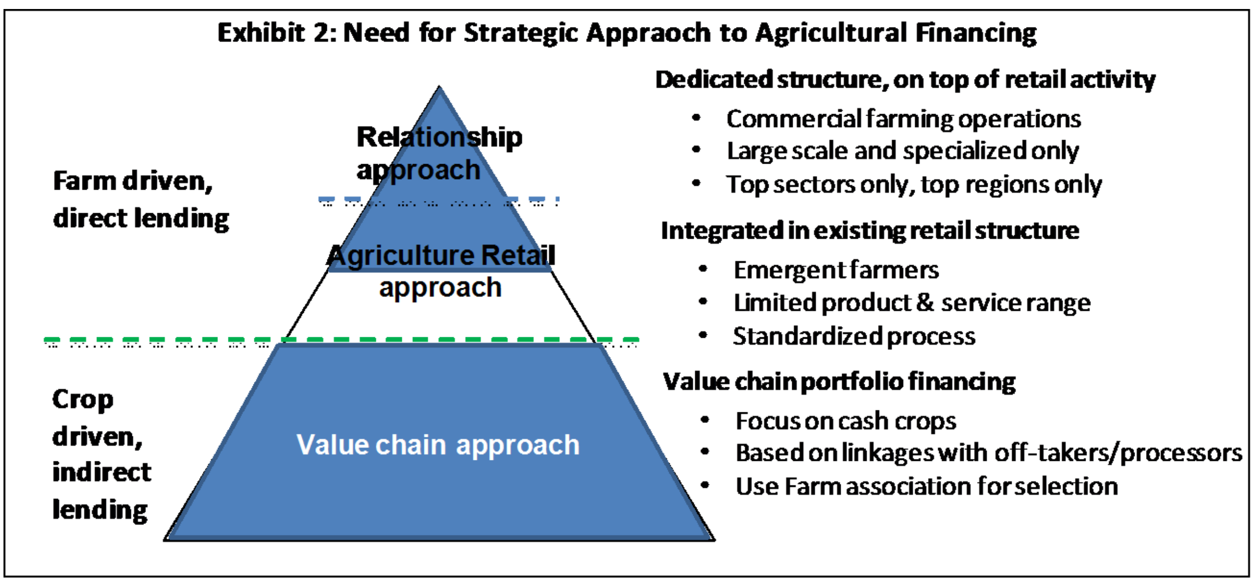


In Pakistan, rural and agriculture finance market is characterised by low landholding and income levels making it unfeasible for financial institutions to finance agriculture and create economies of scale through conventional financing practices. In addition, banks lack understanding of agricultural sector and market infrastructure, lack of enabling legal environment (collateral value is questionable, land title is often an issue), in transparent value chains, powerful traders, fragmented farmers (price takers) and poor financial literacy and poor understanding of banking requirements.

Expansion of rural and agricultural financial services through innovations can create a win-win scenario that will promote growth while also help reduce poverty. The rural areas of Pakistan hold a significant untapped potential of creating a vibrant market segment. With development of demand-responsive products and cost effective delivery channels, the financial institutions can create a profitable niche by exploiting the un-served rural segment to drive growth in assets and enhance portfolio diversification through geographic, customer and product & service diversification. In Pakistan, like other developing countries, not all farmers are upfront



bankable due to a number of supply and demand side barriers such as low income levels, lack of collateral and lack of financial education etc. Therefore, there is a clear need for innovative interventions to meet the unmet demand for financial services. Banks need to adopt a strategic approach based on market segmentation along farm sizes as depicted in exhibit 1 and 2. The FICF challenge round aims to promote innovative approaches to primarily meet the financing requirements of non-bankable segments which currently forms around 90 percent of farm households in Pakistan.



Globally, innovations in value chain financing have largely been driven by increasing integration and formalization of relationships among the different value chain players locally. However, we have also witnessed globalization of agricultural food chains beyond national borders leading to vertical integration and linkup with international clients through such as fair trade movement etc. In some instances, value chain financing has been nurtured and developed by donors for betterment of small farmers, and also due to willingness of banks to look at new ways of supporting small farmers due to their majority in numbers and market potential.

Although value chain financing innovations are still in their infancy and require continued streamlining and enhancements for further refinement, their development in a number of countries has led to new products and services that are responsive to the needs of rural and agricultural clients, while mitigating risks for the lending institutions. Some specific value chain financing innovations are as follows:

> *First,* the value chain innovation involves financial institutions to examine value chain relationships and make financing decisions based on third-party agreements rather than conventional collateral which help in expanding agricultural finance to poorer farmers and small agricultural enterprises. Banks become more confident in the face of the secure markets offered by the lead firms that drive the value chain and provide an outlet for produce. Furthermore, such relationship also enables third-party lending where banks provide loans to aggregators and processors allowing such business to lend to trusted suppliers. This reduces the due diligence and operational costs of lending on the part of the bank, while also mitigating their own risk.
>
> *Second,* innovations such as Ware House Receipts (WHRs) systems are another significant innovation in value chain finance which can enable collateralization of agricultural outputs, and the formalization of their value. With the growth of managed warehouses – both low-tech field warehouses and sophisticated supply chain management establishments – banks can gain confidence in the preservation of goods, and their sustained or increased value over time.
>
> *Third,* the WHRs are also good for farmers and others in the chain to enable them to maintain ownership beyond the high season, and sell products when markets are not glutted and prices are more favourable. This leads to higher returns and enhanced ability to repay loans and be profitable, with instruments like warehouse receipts and forward contracting being innovated as a result of this trend.
>
> *Fourth,* value chain finance innovations have opened opportunities for banking value chain businesses, particularly subsistence farmers, beyond credit such as for development of agriculture businesses, farms, savings and life cycle financing needs. The potential to offer a range of financial services is bolstered by the risk diversification opportunities offered by the spread of risk across large numbers of producers and multiple chains. The value chain finance innovations provides controlled environment which may be used to test weather, crop and health insurance to help increase their use for risk reduction, including smallholder farmers, enabling them to 'push the envelope' on productivity and cash-cropping.

Fifth, value chain financing allows developing price risk reduction strategies and instruments through structured mechanisms such as national spot and future exchanges. One significant innovation in this regard may be to the develop an Internet and cell phone enable platform and applications to be able to not only share information on current and futures prices among small producers, but also allow them to make use of that information for making forward contract sales. This in turn would allow the farmers to borrow funds against the sales contracts and also to hedge risk of price reductions at the time of harvest or delivery of the products.

Sixth, financing of supporting services to agricultural value chains – from input and equipment suppliers to extension services and telecommunications – has also evolved. Innovation in financing of supporting services also extends to the funding of suppliers who can provide non-cash disbursals of needed inputs to farmers, repayable in-kind or cash at the time of sale. In some cases, the input supplier and the buyer are one and the same, leading to tighter integration of the chain and more secure repayment.

Banks need to adopt the value chain approach as bulks of the farmers are in subsistence category. Two specific approaches can be adopted and tested in selected subsectors (a) out-growers schemes for major crops especially Sugarcane, Rice, Cotton, Tobacco & Dairy and Livestock and (b) Warehouse Receipt Financing which is likely to be applicable in Pakistan in some agriculture subsectors. The salient features and benefits of the above two approaches are as follows:

2.1 Out-growers Schemes

- Out-grower schemes involve financing agriculture producers and traders based on forward linkages in the value chain with a reputable off-taker and processor.
- The loans are self-liquidating as the value chain ensures continuing flow of goods and cash thereby credit risk is effectively converted into performance risk.
- Out grower loans are based on the experience and performance of the out growers therefore, such schemes help financial institutions to develop strong focus on agricultural activates and markets.
- Farmer group structure (Village Groups) may be essential to coordinate scheme and to ensure social pressure
- Collateral may be still required to avoid side selling and cash diversion
- Extension services by the off-taker and processor complements bank monitoring

2.1.1 Benefits of Out-grower Loan Schemes

- To provide credit to out growers of different crops for purchase of inputs, crop maintenance and to meet other costs related to the development of the crop.
- To substitute input financing by buyers to farmers. The buyer's credit is often provided on unfavorable terms of trade.
- The crop and the structure are leading and not the individual farm's credit capacity.
- Role of Farm Organization is key, they can even be the borrower if well organized

- Sugar sector has been found 'most eligible' in case of Pakistan. Other sectors i.e. Rice, Cotton, Tobacco & Dairy Farming are also suitable.
- A successful scheme demands strong cooperation among banks, farmers, processors and farmer organizations.

2.2 Warehouse Receipt Financing

A document issued by a licensed warehouse operator certifying the quality and quantity of a specified commodity placed by a named depositor into a secure storage environment. It specifies:

- Location of warehouse
- Commodity type
- Quality and quantity
- Name of depositor
- Date of delivery
- Storage charges

2.2.1 Benefits of the WHR System

- Lower handling cost as it decreases the number of physical movement of grain during the change of its property rights
- Brings integrity to the storage system
- Gives farmers a choice (store or sell)
- Brings balance to the market
- Supports bank financing to the sector (stock finance, pre-export finance)
- "Easy" way to pledge stocks to a bank as collateral
- Fixed assets can be used to attract medium/Long Term funding
- Pakistan has a vast agri. commodity market (wheat, maize, rice, sugar, cotton)
- It has a progressive Pakistan Mercantile Exchange Limited (PMEX)
- PMEX is in a position to provide a transparent and efficient trading platform for agriculture commodities
- A WHR system is not a silver bullet but supports the development of efficient agriculture commodity markets.

3- Round Two: Innovative Agricultural Financing Challenge Guidelines

3.1 Introduction: Scope and Challenge

There is a clear need and scope for innovative products and services to develop resilience, risk mitigants and exploit the long-term potential of rural and agriculture financing in Pakistan. The financial institutions in partnerships with various eco system providers could develop and pilot structured products by packaging business development services, credit, savings and insurance products which would allow entrepreneurs to run profitable businesses while remaining insured for most risks and save in case of emergency thereby reducing the probability of default for financial institutions. Therefore 2nd challenge round invites both financial and non-financial institutions from the agricultural and rural value chains/ecosystem to propose innovative projects for promoting agricultural and rural finance in Pakistan. Further, International marketing chains, interested in sourcing from Pakistan, may also participate if they have joined hands with local partners. The projects should propose to test innovations to overcome both supply and demand side challenges hampering the progress of financial inclusion in rural areas such as;

- Majority of rural and agriculture clients are small farm owners and poor households which are unbanked primarily due to low income levels and lack of collateral etc.
- The rural agricultural households are located in remote parts of the country, are often so widely dispersed that financial institutions find it challenging to provide cost-effective and affordable services.
- The large swaths of the agricultural population are subject to the same weather and climate risks, making it hard for providers of financial services to hedge risks or operate in the absence of profitable insurance pools.
- The service providers being mainly urban-based simply do not have enough knowledge about the business of agriculture to devise appropriate and affordable financial products for rural masses for profitable relationship.
- There has been an unequal distribution of credit among the agricultural subsector which is important for risk diversification.
- The repayment of loans in agriculture sector is also not stable due to fluctuations in agricultural commodity prices forcing financial institutions to minimize their rural portfolio. Therefore, there is need for improving loan recovery mechanism through innovations Value Chains financing mechanisms such as Out-Grower and Ware House Receipts financing schemes.
- Most of the small agricultural producers lack basic awareness and knowledge of financial services and how to a form relationship with financial institution. They rely mostly on informal providers for their financial services which may have the advantages of quick turnaround time and lack of cumbersome paper work. Therefore, there is strong need for building financial literacy and capability of agricultural and rural clients.

The eventual aim of the innovative rural and agricultural financing round under the FICF is to identify and leverage on the strengths of existing and newer rural and agricultural eco system players such as input suppliers, aggregators, processors, marketers etc., and use their strengths for opening up opportunities for the financing of rural and agricultural activities through formal financial institutions. In addition, the newer ways of financing rural and agricultural activities will have several benefits. Hence, different players from rural and agricultural eco-system will benefit from establishing such innovative financing schemes. The end goal of the challenge round is to help small rural businesses and farmers to build assets and create wealth for improved livelihoods.

3.2 Challenge Round Objectives

The quality of proposals will be judged based on the key areas of innovation which need support to be tested and replicated are listed below:

- Develop and test financing models (out grower schemes including contract farming, warehouse receipts, collateral management, leasing, equity finance, supply and structured commodity finance) for promoting value chain financing in Pakistan.
- Form new partnerships with focus on developing technology-based financial solutions for rural and agricultural finance through innovative channels such as low cost delivery of financial services through branchless banking.
- Introduce Information and Communication Technology (ICT) solutions to enhance productivity and pricing transparency of agricultural commodities.
- Develop risk management tools (crop and weather risk insurance, futures and options).
- Develop and enhance service provision to the clients for value added services (integration of service facilitator companies into value chains).
- Organize farmers through formation of farmers' associations and self-help groups to facilitate small farmers to gain better voice and negotiate prices on better terms with larger buyers and wholesale chains which also often seek out large-scale suppliers due to a number of factors.
- Develop financial literacy and capability of rural and agricultural clients.

3.3 Operational Mechanism

a) Challenge Round: Applicants to submit complete proposal by 10 April 2014. Upon a thorough desk review and detailed consultation with applicants, FICF secretariat will develop a finalized business plan that will be presented to the FICF Advisory Committee for approval. FICF funds will be disbursed in accordance with the work plan thereafter, and regular desk monitoring will be conducted by the Fund Secretariat through periodic reports. Onsite monitoring/inspection may be conducted by SBP inspectors and independent consultants, if needed.

b) Duration and Size: Grant sizes will be determined according to the financing requirements of the proposal in question; however, the duration of the projects should ideally be not more than six months. Applicants will be required to contribute at least 30% matching funds for the grants that they apply for.

c) Criteria:, Broadly, the FICF will adopt the following criteria in addition to specific objectives set under each round:

   i. Uniqueness of the innovation in product, service, system or procedure in question;
   ii. Scope of innovation particularly, impact of innovation on broadening client base and/or diversity of financial services offered
   iii. Financial viability of the innovation after grant funding is complete.
   iv. Level of financial resources that the applicant organization is willing to commit.
   v. Quality of team that will be leading the innovation.
   vi. Market positioning and ability of the applicant organization to introduce proposed innovation
   vii. Plans of the organization to institutionalize the innovation within their organization
   viii. Plans of the organization to seek private sector funding to take the innovation from pilot to full scale.

d) Management: FICF is housed in SBP. However, keeping in view its peculiar requirements, it is managed by FICF Advisory Committee. The Committee draws representation from SBP, DFID and experts from the private sector. The Committee is assisted by the Fund Secretariat in fulfilling its duties such as designing, screening, approval, and oversight of the challenge rounds.

e) Monitoring: Monitoring will carried through FICF quarterly progress reports submitted by grantees. The quarterly reviews will present three key aspects of projects, including progress on grant utilization, work plan and outcomes.

f) Knowledge exchange: FICF grantees are expected to contribute regularly and share project experiences in the form of regular reporting, contribution to newsletters, presentations and conferences.

4- Submission of the Proposal

Proposal Deadline	Friday, April 25, 2014
Deliverable	Proposal to be sent electronically at ficf@sbp.org.pk Hard copies must be sent to: Director Agricultural Credit and Microfinance Department State Bank of Pakistan, I.I. Chundrigar Road, Karachi Karachi-74000 Tel: +92 21 99221285 Fax: +92 21 99221215
Matching Grant	At least 30% of project cost must be covered by grantee organization
Eligible institutions	Banks, Microfinance Providers, service providers such as suppliers, aggregators, processors, marketers etc., telecommunication companies and academic institutions etc. Further, International marketing chains, interested in sourcing from Pakistan, may also participate if they have joined hands with local partners. <u>Service providers must collaborate with financial service providers to be eligible to apply.</u>

4.1 Proposal Format

The Proposal shall present complete project including executive summary, the idea along with the business plan. The proposal must address the following questions:

a. Describe the proposed rural and agricultural finance innovation including market research/segmentation, SWOT & cost-benefit analysis and how it will challenge the existing approaches and modalities to promote rural and agricultural finance.
b. The proposal must provide detailed track record and market positioning of the applicant organization to introduce the proposed rural and agricultural finance innovation.
c. The proposal must identify and suggest mitigants for key challenges and risks that the organization foresee in initiating and implementing the project.
d. The proposal should provide profiles of the team leader and other key human resources and his/her qualifications and skills to lead and implement the project.
e. The proposal must include signed partnership agreements with the proposed partners/organizations/stakeholders/investors etc. to demonstrate the level of readiness.
f. The proposal must provide detailed costing of the proposed project activities and indicate the amount of organizational contribution which should not be less

than 30 percent of the proposed project cost. Also, the following costs are ineligible for grant expense i.e. regular staff salaries, equipment not related to project etc.

g. Overall the proposal should be self contained presenting the business proposal and call to action along with the business plan for the proposed assistance and the project deliverables must indicate clear attributable results as challenge round encourages tying grant releases to results than mere funding of inputs and processes.

4.2 Assessment Criteria

The strength of the proposal will be assessed on the basis of the following criteria:

i. Uniqueness of the rural and agricultural finance innovation in question to the organization. Create a new market and value network, key features, benefits, and sustainability of the product (Impact of innovation on future profitability of the organization).

ii. Potential for Transformation of rural and agricultural finance landscape. Potential for disruption and transformation of existing rural and agricultural finance and rural and agriculture value chain networks.

iii. Partner institutions and their readiness in implementing the innovations. (Existing value chain participants etc partners and other solutions providers)

iv. Potential for Financial Inclusion for providing financial services to millions of un and underserved rural and agricultural clients, particularly, impact of innovation on broadening client base and/or variety of financial services offered.

v. Extent of market research on the project including profiling of rural and agricultural finance recipients along with Adequacy of Work Plan (Clear and concise action plan with step by step activities and timings required).

vi. Institutional readiness to adopt the innovation and take advantage of the opportunity such as Competitiveness/Market Positioning

vii. Financial Requirements along with Level of financial resources that the applicant organization is willing to commit (Clear and concise presentation of amount, timing, type and use of funds required for proposal including Plans of the organization to seek private sector funding to take the innovation from pilot stage to full scale.

viii. Quality of team that will be leading the innovation (Qualifications particularly Track record of implementing innovative rural financial solutions).

ix. Identification and Mitigation of Critical Risks. (Realistic identification of the major risks that could threaten the project and presents viable contingency plans)

x. Impact on small farmers, (The extent to which the proposal will finance small famers and low income households and quantification of welfare impact such as improvement in assets and wealth of the potential beneficiary).

4.3 Enquires relating to Submission of Application

All enquiries relating to the application process may be made at ficf@sbp.org.pk

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