Special Section 4

Development of Microfinance Sector in Pakistan

Microfinance (MF) is the provision of financial services, usually in the form of small sized financial transactions to people who are unable to access such services from commercial banks. After the inception of Grameen in Bangladesh in 1984, the first formal microfinance bank of the world, MF has widely been recognized as an important tool for poverty reduction. Successful experience of Grameen Bank, in serving the financial needs of the poor segment of the society on sustainable basis, made the bank a role model for private and public sector institutions in other countries to follow. During 1990s, the importance of microfinance has been recognized at international forums; more importantly International Financial Institutions (IFIs) started providing funds for development of MF sector. Presently, development of MF sector has become one of the main pillars in poverty reduction strategies of many developing countries.

In Pakistan, MF has started gaining importance, as a tool of social mobilization and poverty reduction, since late 1990s. Indeed the enhanced international emphasis, in particular the increased funding from IFIs for MF, encouraged both public and private sector to develop microfinance sector in the country.

The objective of this special section is to revisit the developments of microfinance in Pakistan since 2000, particularly the experience of Microfinance Banks (MFBs) in the country. A brief review on evolution of microfinance in Pakistan is presented in the next section, followed by scope and current market structure in third section. The fourth section covers the growth, loans classification and sustainability of Microfinance Banks (MFBs) in Pakistan. The last section concludes the study.

Evolution of Microfinance Sector in Pakistan

As mentioned above, following the rising focus at international level, microfinance started getting importance in Pakistan[1] towards the end of 1990s. The significant increase in the international funding enabled Non Government Organizations (NGOs) to expand their operations and was also a major driving force for establishment of specialized microfinance institutions in the formal sector i.e. MFBs.

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[1] Microfinance sector was present since long but informally and at very small level, for example Rural Support Program (RSP) by NGOs and the government were providing small loans to farmers since 1980s (see SBP First Quarterly Report for FY05 for the further details).

Realizing the need and importance of MF, as a tool of poverty reduction and social mobilization, the government has accelerated its efforts to establish strong foundations of MF in formal sector and extended a considerable support to the informal sector (NGOs) as well. In order to promote the MF in formal sector, the most significant step taken by the government was the launching of Microfinance Sector Development Programme (MSDP) in 2000. The main objective of this program was to broaden and increase the pace for the development of the sector to provide the financial services to poor on sustainable basis. Moreover, the government has recognized microfinance as an important tool of poverty reduction in its Poverty Reduction Strategy Paper (PRSP). Khushali Bank (KB), the first specialized microfinance bank, was established in 2000 under a special ordinance. Then MFI Ordinance 2001 was put in place to provide separate regulatory framework exclusively for MF.

While these measures by the government provided the enabling infrastructure for the MF development, the regulatory and promotional services were undertaken by the State Bank of Pakistan (SBP) (see **Box S4** for details). SBP is the executing agency for MSDP and has also been responsible for monitoring of formal microfinance institutions (MFIs). Focus of SBP policies remained on providing conducive environment to the private sector and increasing the coordination between public and private sector for the speedy growth of the MF sector. As a result, within the four years of MFI ordinance 2001, four specialized MFBs (excluding KB) have started their operations. First Microfinance Bank Limited (FMFBL) and Tameer Microfinance Bank Limited are operating at national level, while Rozgar Microfinance Bank Limited (RMFBL) and Network Microfinance Banks Limited (NMFBL) are serving at district level.[2]

In order to support the informal sector, the government has established the Pakistan Poverty Alleviation Fund (PPAF), apex institution, in 1999 to ensure availability of funds on continuous basis. PPAF can finance any legally established entity in the government or private sector.[3] PPAF is also working for the capacity building of its partner organizations (see **First QR 2004-05** for further details). Moreover informal group, at its own, has established Pakistan Microfinance Network (PMN) in 2001 for capacity building of institutions in this

[2] FMFBL and Tameer has started their operations in 2002 and 2005, respectively. While both the district level MFBs became operational since 2004.
[3] The criteria for selection depends upon the strength of the organization by analyzing its past trends and the proposal submitted to PPAF

group. PMN is also providing a platform for coordination between formal and informal sectors for the development of MF in Pakistan.[4]

Box S4: Role of SBP in MF Sector Development

Considering MF as a growing sector, as an effective tool for poverty reduction and financial deepening, SBP has accepted the dual responsibility of supervision and development of MF in the country. In order to effectively perform these functions, SBP has undertaken several steps for its own capacity building, including: (a) a separate division has been established within SBP; (b) extensive trainings is being imparted to a pool of officers at SBP, to get them equipped with the techniques and information required to fulfill their jobs efficiently in this specialized area; (c) International consultant groups have also been hired to provide assistance in the development of on-site and off-site surveillance manuals for MFBs.

As a supervisor, SBP is monitoring and regulating MFBs and has taken various policy measures to provide the operational infrastructure such as: (a) licensing criteria for establishing Microfinance banks has been set; (b) prudential Regulations for MFBs have been issued; (c) guidelines for the Mobile Banking and transformation of NGO/ RSPs / Cooperative into MFBs have been provided; (d) Fit and Proper Criteria for Board of Directors has been defined, etc. SBP has adopted a consultative mechanism for designing policies.

In order to create conducive environment for the MF sector growth and development, SBP is frequently interacting with stakeholders. In this regard, in December 2004 a two day international conference on "*Microfinance in Pakistan-innovating and Mainstreaming*" has been arranged by SBP in collaboration with PPAF, PMN and KB.

Scope and Coverage of Microfinance in Pakistan

There is no unanimous international standard to estimate the potential market of microfinance; every country estimates the market size according to its own objectives and focus of the sector. In Pakistan, the potential market for MF is generally being considered around 6 to 7 million household, which is approximately one third of total household in the country. A little is known about the methodology to come up on this market size, though practitioners in this area explain that the potential market is roughly the population below the poverty line.

However the potential market can actually be much larger in size, as it is important to target the household just above the poverty line, especially the household in Transitory Vulnerable and Transitory Non-poor categories.[5] This is because experiences from other countries suggest that a significant portion of

[4] A study by Tameer Bank Limited on "Microfinance Market Assessment in Pakistan, 2004", explained the role of PMN.

[5] In the standard definition transitory non-poor are defined as households that were not above the poverty line for most of the defined period but not always, while transitory vulnerable are transitory non-poor that have high probability of getting poor

transitory groups fall back into poverty due to seasonality in their income and lack of appropriate income smoothing mechanism available to them. Moreover the MF Ordinance 2001 considers people below taxable income eligible for microfinance,[6] which reinstates that the potential market size of MF could be larger than what is generally being considered in Pakistan.[7]

Table S4.1: Microfinance Outreach -- Number of Borrowers
numbers in thousand, shares in percent

	2003		2004		2005	
	Numbers	**Shares**	**Numbers**	**Shares**	**Numbers**	**Share**
NGOs & RSPs	228.8	70.6	262.3	58.7	na	-
MFBs	95.2	29.4	184.7	41.3	270.9	-
Total	324.0	100.0	447.0	100.0	-	-

na: not available

Nevertheless, even admitting the 7 million as potential market the coverage of MF is very low at present. The most recent available data (2004) indicates that the total coverage of MF sector (including NGOs, RSP, and MFBs) was hardly 7 percent of this market size.[8] As shown in **Table S4.1**, NGOs and RSPs were contributing the major share i.e., 58.7 percent of the overall coverage of the market.[9] It is important to note the rapid growth in share of MFBs in market coverage, which has gone up from below 30 percent in 2003 to above 40 percent in 2004.

Experience of MFBs in Pakistan

As mentioned earlier, presently, five specialized microfinance banks are operating in the country; three are operating at the national level and the two at the district level. The assets of MFBs are highly concentrated in one bank, i.e. KB; specifically, at the end of 2005, share of KB in overall assets of MFBs was around 79 percent. As Tameer Bank has recently started its operation, analysis in rest of the section is based on the remaining four banks.

Since the inception of the KB, in 2000, the MFBs saw substantial growth. The total number of branches of these banks increased from 4 in 2000 to 91 at the end

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[6] Presently Rs. 100,000 is the taxable income

[7] The rough estimation based on the Labor Force Survey of 2000-01, the household below the taxable income were between 14 to 15 million around 70 percent of the total households.

[8] But one element should be kept in mind that want is equally important as access is implying that not necessarily every household would be in need of credit. So the problem of coverage is not only from the supply side but from the demand side as well.

[9] No of borrowers has been taken as the coverage indicator.

of 2005 and total assets of MFBs have increased from 1.7 billion at end-December 2000 to 7.9 billion in December 2005 (see **Table S4.2**), showing a compound annual growth rate of 35.5 percent. As expected, MFBs also saw significant changes in their assets composition; the share of advances in total assets has jumped from below one percent in 2000 to almost 29 percent in 2005.[10] During the same period advances of MFBs increased from hardly Rs 0.1 billion to Rs 2.3 billion, showing a compound annual growth rate of 184 percent.

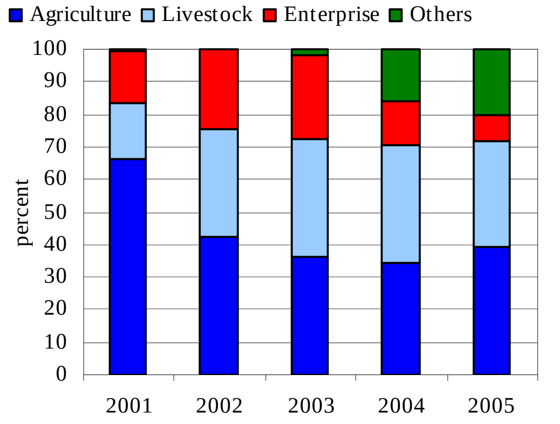
Table S4.2: MFBs Growth

	Unit	2000	2001	2002	2003	2004	2005
Assets	million Rupees	1734.7	1885.7	3066.0	4334.6	5686.7	7908.9
Advances	million Rupees	12.3	108.1	493.1	736.3	1538.8	2271.7
Deposits	million Rupees	0.0	0.0	64.4	392.0	469.0	707.8
Branches	Numbers	4	30	39	56	75	91
Borrowers	numbers in '000'	n.a	12.8	56.3	95.2	184.7	275.21
Advances	numbers in '000'	n.a	21.1	87.9	192.6	380.1	647.3
Savers	numbers in '000'	0	0	0	10.2	18.6	32.5

Note: Data of Tameer Microfinance Bank Limited is not included here.

The sectoral composition of loans suggests that the most of MF loans are extended to Agriculture and Livestock sectors (see **Figure S4.1**). At the end of 2005, together these two sectors were sharing above 70 percent of total advances extended by MFBs. This distribution is justified as majority of the population, especially the poor, is associated with these two sectors.

Figure S4.1: Distribution of Micro Finance Loans



[10] In the initial period a larger proportion of MFBs was coming from investment, as their client base is increasing the share of advance is increasing, rapidly.

Table S4.3: Gender -wise Distribution of Loans

percent share

	2001	2002	2003	2004	2005
Male	70	70	71	72	76
Female	30	30	29	28	24
Total	100	100	100	100	100

An important objective of MF, as defined in MSDP, is to increase the access of females to financial services. Providing MF facilities to female group is expected to improve women empowerment in the country.[11] At the end of 2001, loans extended by MF were distributed in proportion of 30 to 70 percent among female and male groups, respectively. However in their efforts to increase coverage to remote areas in rural sector, where people have strong social and cultural views on women participation in economic activity, MFBs failed to maintain this proportion and share of females in total loans declined to 24 percent by end December 2005 (see **Table S4.3**). It is important to mention here that informal sector (NGOs and RSPs) has got better coverage of female[12] as compared toMFBs. In fact some of the NGOs are predominantly providing MF services to females group.[13] MFBs can learn from experiences of these NGOs to overcome the social and cultural gender biases against female participation.

In order to fund their assets growth, MFBs are primarily dependent on borrowings. However, while the largest MFB, KB has not even begun deposit mobilization yet, is relying on external sources to finance its assets[14], during the CY02-CY05 period, deposits of other MFBs increased by more than 10 times to reach Rs 679.2 million at the end of CY05. On average, the loan to deposit ratio for MFBs (excluding KB) was at 58.2 percent in December 2005. The experience of the MFBs (ex-KB) suggests that there exists a demand for saving products even from the poor.[15]

Although it is too early to reach at any strong conclusions, asset quality of MFBs is reasonably good. At the end of 2005, Gross Non Performing Loans (NPLs) to gross advances ratio was 4.3 percent. Moreover a substantial part of NPLs have been provisioned. In December 2005, net NPLs (net of provision) to net advance ratio was even below one percent level.

[11] Improving women empowerment is one of the main objectives in the government Medium Term Development Framework (MTDF) for 2005-2010.
[12] On average female constitute 56 percent share (2004). 200620648
[13] For example, KASHF & DAMEN is extending MF facilities only to female.
[14] High reliance on external funding raises question about the long term sustainability of the institution
[15] Although, irrespective of income level, any body can deposit his saving with MFBs, anecdotal evidence suggests that, in practice, only the people with low income (also eligible for credit) are also depositing with these banks.

Conclusion

In Pakistan, microfinance is relatively less developed sector and a large scope is available to increase the financial services to poor people in the country. Realizing the importance of MF in social mobilization and poverty reduction, the Government has geared up its efforts to provide support to both formal and informal sector. Currently informal sector, i.e. NGOs and RSPs, is contributing major share towards the coverage of the market, however, MFBs saw a rapid growth during the last four years and have captured a significant share in overall coverage of MF sector in the country.

Although the MFBs have recently started their business, Pakistan's experience also confirmed the increasingly establishing fact at international level that poor can repay their loans on time and also has ability to save a part their income. However it is important for MFBs to increase focus on deposit mobilization to sustain their operations in future as presently mainly dependent on external funding.

While high performing loans is a healthy sign, it is more important to analyze the impact MF have on the wellbeing of clientele. Unfortunately, an independent study in this area is missing in Pakistan case, though MF institutions have done some studies.[16] In order to perform the social impact analysis, there is a dire need of independent survey.

[16] These studies concluded positive effect of MF on their customers' welfare.