Expanding Microfinance Outreach in Pakistan

State Bank of Pakistan

This presentation has benefited from consultation with PMN, CGAP and other international agencies

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Pakistan – Microfinance Strategy

A. Structure and Achievements of Microfinance Sector

B. Microfinance Selected Sector Issues

C. Microfinance Strategy– Its Goals and Objectives

D. Commercialization of microfinance industry key to financial and social sustainability of microfinance industry and to trigger a degree of upscaling
   i. Requires sustainability
   ii. Raising domestic private capital
   iii. Human resource development

E. More substantive upscaling would require
   i. New Players
   ii. Credit Union Models
   iii. Technology
   iv. Introduction of Credit Bureau for Microfinance borrowers
   v. Effective and synergistic use of Pakistan Post resources
   vi. Other policy and regulatory measures

A. Structure and Achievements of Microfinance Sector

1. **KB Ordinance 2000 to set up a dedicated financing institution**

2. **MFIs Ordinance 2001 encourages holistic financial services provision – thus far licensed** 5 MFBs set up- 3 national and two district based

3. **PPAF as a lead whole sale apex institution**

4. **Rural and agricultural based microfinance promoted through** NRSP and RSPs are key leaders

Achievements

- **Public: Private partnership working well**
- **About 1 million borrowers about 60 % rural**
- **High recovery rate**
- **Low operational cost ($42) –translates into 20% when liked with the average loan size of about Rs 12,000 (June 2006)**
- **All deposit takers under SBP oversight supported by effective prudential regulations**
- **Transparent reporting-- Performance Indicators Report (PIR) published by the PMN is globally acknowledged**

Microfinance Sector- Present Outreach and Potential

Actual Borrowers one million as on December 06 up from 0.7 m in June 06

Potential Borrowers 25 – 30 million

Type of Institutions	No. of Active Borrowers (Dec 2006)	Loan Portfolio Rs. Millions (June 06)
MFBs	371,073	2,736
Rural Support Programs	336,393	2,616
MFIs	202,401	1,142
NGOs	68,795	422
Commercial Institutions	12,861	279
TOTAL	991,523	7,195

Source-PMN

B. Microfinance
Selected Sector Issues

1. Degree of anomalies in legal, regulatory and taxation framework which prevents level playing field among operators – Pakistan not unique in this respect

- KB widespread district coverage with 290,000 borrowers
  - KB operates under its own ordinance which gives it an artificial edge
  - It has privileged access to donor funding
  - No deposit mobilization
  - Low client retention ratio raises questions of effectivity of resource deployment
  - Issues surrounding its operational efficiency

- PPAF's --operates under companies ordinance-- and has emerged as wholesaler supplier of donor financed credit lines cum capacity building subsidized funding to mainly MFIs/RSP
  - Its financial capacities circumscribed by availability of grant component
  - Its niche is to fund MFIs/RSP but it has not succeeded in graduating MFIs/RSP out of its subsidized lending todate

- NRSP – largest rural retailer of microfinance reaching 250,000 clients and promoted 69,000 COs– has had an impact on poverty reduction but questions arise on its sustainability given its dependence on PPAF funding exclusively and offering single product business

- MFIs/NGOs operate as societies, companies etc
  - All non deposit taking institutions and are reliant either on charities or donor funds
  - All MFIs/NGOs enjoy income tax exemption, while all deposit taking institution subject to normal income tax -this is delaying scaling and transformation

2. Complex Geographical Outreach

Urban – mostly homogeneous –opportunities exist for micro-enterprise lending on selective basis

Rural- heterogeneous -- primarily agricultural and livestock, limited non-farm opportunities

Barani and un-irrigated areas bring their own challenges to MFIs operations

Pakistan has fewer micro enterprises, so bulk clientele individuals

→These characteristics require multiple approaches rather than unified approach

→Financial sustainability is feasible in better terrain, but is difficult to anticipate in rural Sind and Baluchistan

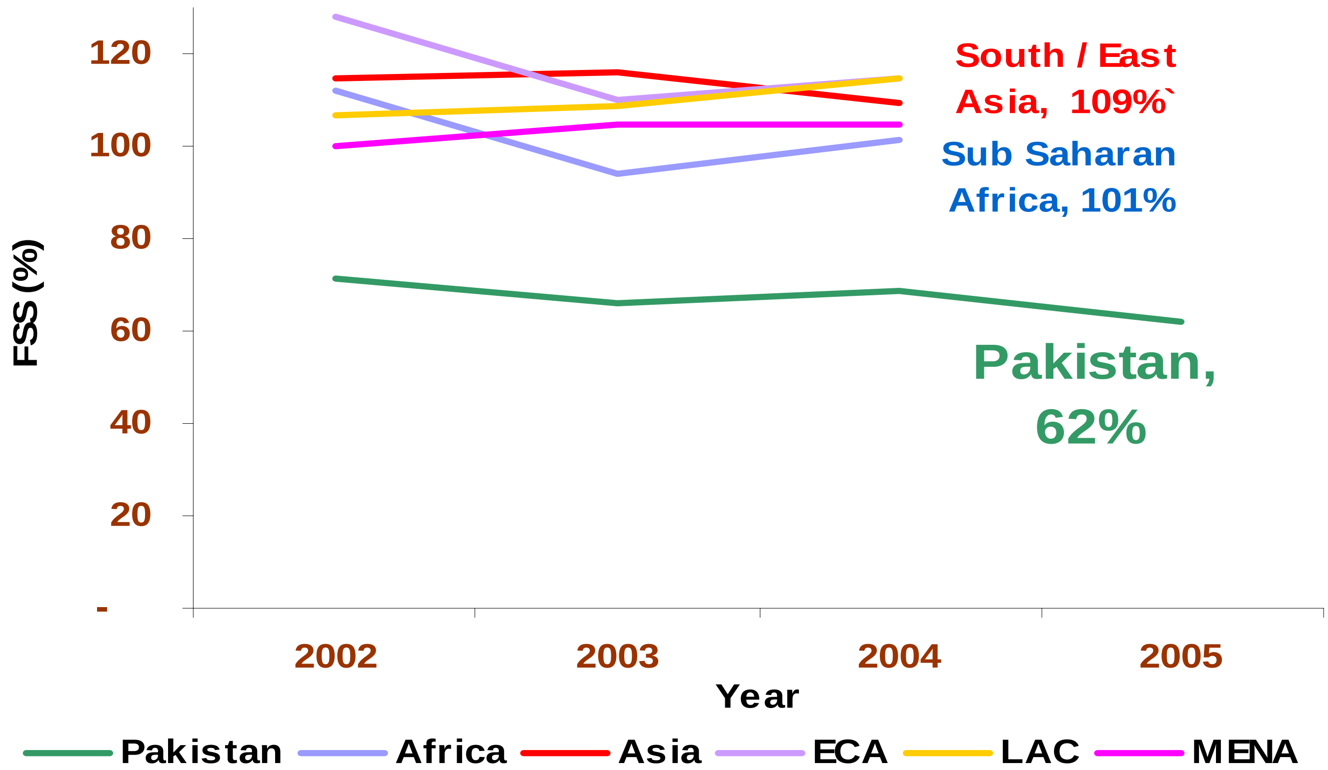
Canal irrigated (Central Punjab)

Irrigated (rest of Punjab & NWFP)

Baarani (Punjab) & Irrigated Sindh

Baarani Sindh and Balochistan

3. Financial sustainability of microfinance businesses in question



Source-PMN

Microfinance – Other Selected Sector Issues

4. Part of the industry uses organizational resources for non-core activities such as taking responsibility for implementing development projects

5. Limited alternate delivery channels and inadequate use of technology

6. Historical experience not very rich-lack of domestic knowledge base
   - AKRSP confined to selected regions of north
   - Orangi Pilot Project localized in south

7. Almost single product driven sector
   - Exclusive focus on micro credit
   - Micro insurance business recently started
   - MFIs can not offer saving products -- only some MFBs have plans to start or recently started -- Others are not allowed to take deposits or members savings

8. Staff productivity- Good on an overall average basis – individual institutions have problems where overall HR strength is more

C. Microfinance Strategy: Goals and Objectives

1. Commercialization of microfinance is critical to enhancing the outreach and scale of microfinance industry and to blending effectively both financial and social sustainability in the operations. This requires

– Treating microfinance as a viable business that requires market to determine its pricing aligning it to cost of delivery and risk perceptions – this in turn underscores need for an eventual phasing out an across the board reliance on subsidized lending which creates distortions and serves as deterrent to growth and graduation of MFIs and also renders commercially viable institutions unprofitable

– Multiple players to infuse competition which will be principle element of offering clients competitive interest rates and service delivery

2. Notwithstanding above, the geographical complexities make it difficult to deliver commercially viable programs to start with in the poorer and resource deficit regions/districts so: Recommend confining the subsidized lending to these poorer and resource deficit regions/districts

Microfinance Strategy…

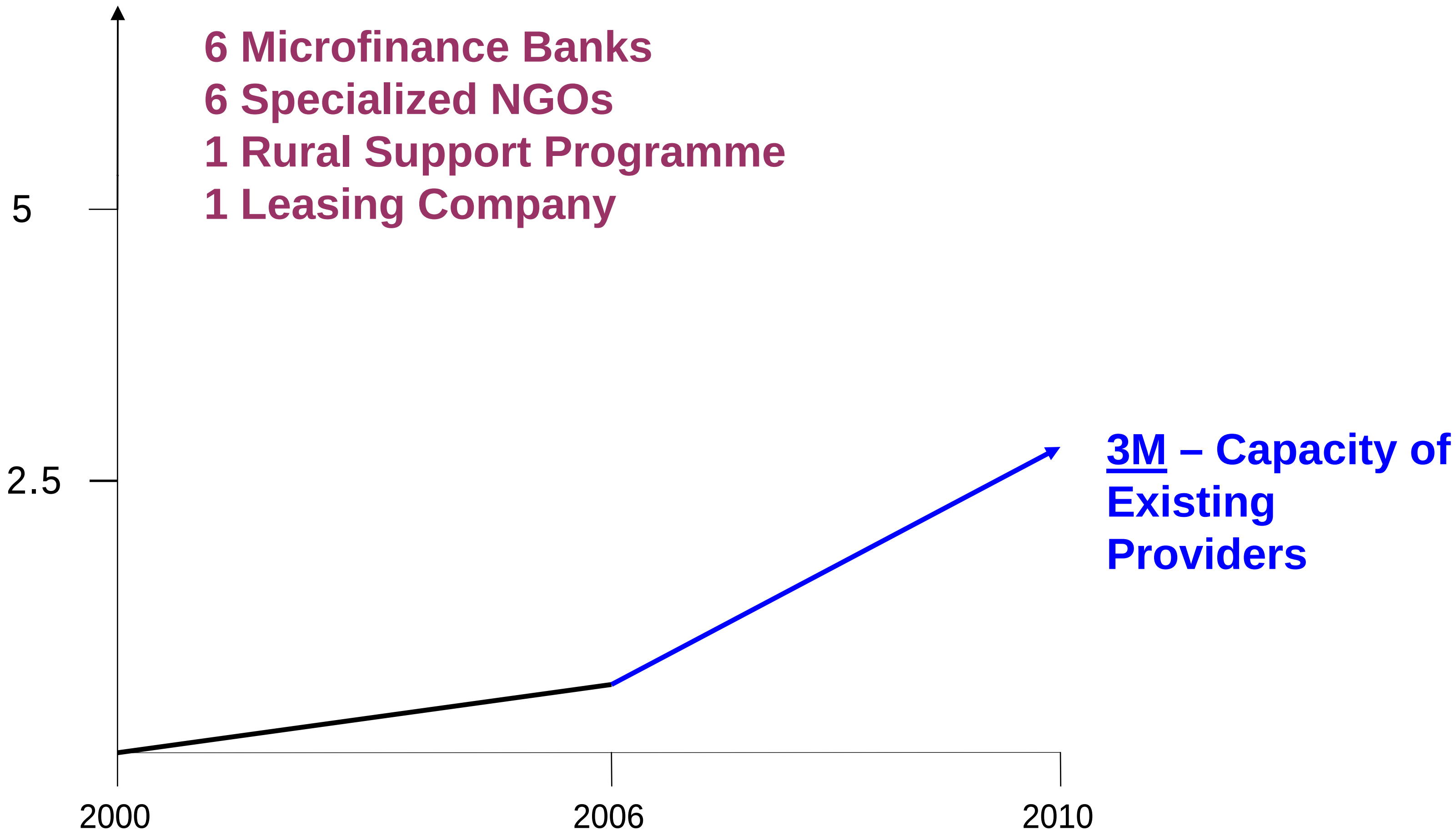
Upscaling of outreach can be achieved by

- Commercialization of microfinance industry
- Infusing competition by allowing multiple and international players
- Encouraging all-encompassing financial services delivery
- Launching Innovative Solutions to product delivery

Commercialization of Microfinance Industry

Key to financial and social sustainability and to trigger a degree of up-scaling

Existing Organizations Have Capacity to Reach 3.0 Million by 2010



Three Things To Reach 3.0 Million Borrowers

1. Require Sustainable Operations

2. Raise Private Domestic Capital

3. Build the Human Resource Base

1

Require Sustainable Operations

Present Situation

Average interest rates in Pakistan for microfinance lending ranges around 18%

This is well below regional levels:

- Bangladesh 25%
- India 30%
- Afghanistan 35%

To extend microfinance outreach to 3M borrowers at 62% financial self sustainability implies

Shortfall in cost recovery of at least Rs 3 billion if the present ratio of number of loans per loan officer is maintained and the capacity building cost is continued to be provided.

Recommendation

Focus on improving access to finance – i.e. key to poverty reduction

Financially unsustainable model will hinder the growth prospects of the MF Sector

⇨Sustainability comes through effective cost recovery that calls for pricing loans in line with the transaction costs which could vary from client to client and from one region to another

Demand for formal microfinance industry will be there as money lenders charge higher interest rates relative to formal microfinance industry

⇨ Restrict subsidies only for poorer and resource deficit regions, capacity enhancement, innovation and growth rather then normal operational costs

Role of PPAF Operations and future strategy

Present Situation

Outreach 68 Partner organizations (Pos) 108 Districts, 23000 villages, 60,000 groups/ Community Organizations

Over 0.4 million active borrowers

Assistance for micro enterprises, community physical infrastructure, social services and Human Resource Development

PPAF provides credit to partner organization with focus on lending below the prime lending rate of banks

Growth is reliant on foreign currency government borrowings

Recommendation

PPAFs to define specific eligibility criteria for concessional financing to MFIs. Under this financing be restricted to those:

i. MFIs willing to enter into contractual obligations to eventually graduate to adopting financially sustainable models
ii. Poorer/resource deficit regions where exceptionally high transactional costs render it difficult to operate in a socially sustainable manner

PPAF to develop capacities and expertise to issue bonds and guarantees with supportive government credit enhancement to raise the required domestic liquidity for MFBs / MFIs/NGOs

PPAF w/support of PMN to set up a center of excellence for training microfinance providers and clients

PPAF to offer rating services that offers MFIs default risk with regard to its overall and client obligations

PPAF to focus on product innovation and best practices

Role of NRSP and its Operations

Present Situation

NRSP is a holistic program providing integrated rural development services

The Micro-credit is just one components out of several development interventions

Creation of Community organizations

The micro credit operations are not managed on cost recovery

– Only few districts operations are sustainable on operational basis, financial sustainability is yet to be achieved

– Has capacity to become one of the largest MFI with presence in rural areas

Recommedation

Transform NRSP into a nation-wide MFB to facilitate its development on a financially and socially sustainable basis: this would require

Raising its capital base to the norms of MFBs i.e. Rs 500 million

Allowing it to mobilize deposit and raise funding against its own balance sheet

Allowing it corporate flexibility to segregate its business lines and to seek blended financing with grant component for operations in difficult terrain

Developing its capacities to better reach unbankable areas through m-banking

Role of KB operations and future strategy

Present Situation

Extensive network of branches and service centers gives it distinct edge

Low pricing does not help in cost recovery

Holds high level of funding in T-Bills which covers its operational financing requirements

Subsidized perception ---a disincentive for private players to enter the market

Recommendations

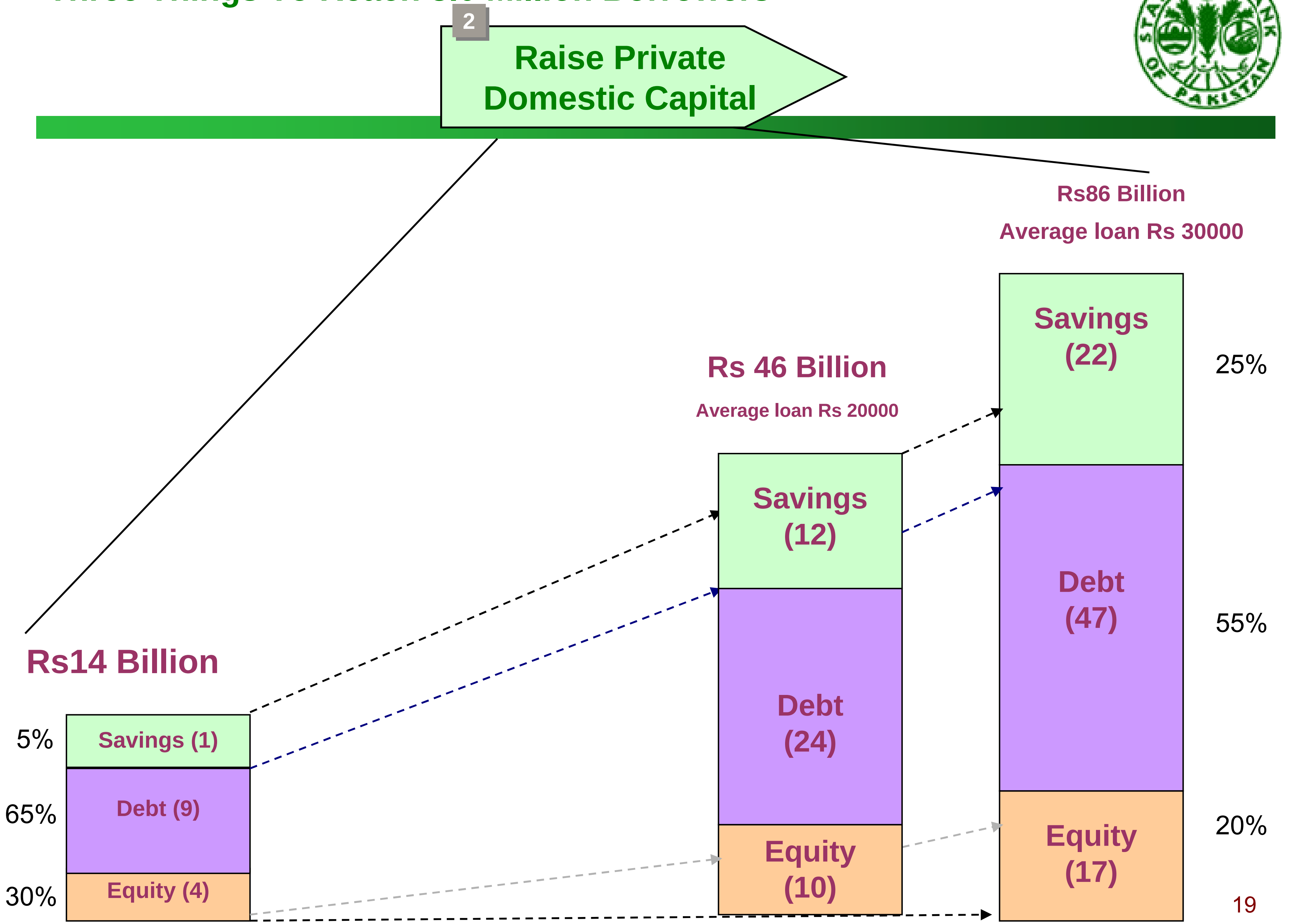
Bring KB under MFI Ordinance 2001 to offer a level playing field to all MFBs and to enhance KBs competitiveness

KB to be sold to a strategic partner and Government to exit from its shareholding

KB to enhance its operational efficiencies and align its prices in conformity with its cost structure

KB to ensure effective and efficient use of the available liquidity to increase outreach

Three Things To Reach 3.0 Million Borrowers



Equity

Assumptions

Capital adequacy to average 15%: Young Banks and NGOs,
Sources:

Retained earnings (sustainability + surplus)
Private Investors (increasing use of specialized microfinance funds
Subordinate Loans

Recommendations

Facilitate private investors
SBP to allow the subordinated debt as tier II capital for the MFBs

2

Raise Private Domestic Capital

Savings

Assumptions

Increased capacity to mobilize savings up from 5% to 25% of assets

Sources:

Microfinance clients

Institutions

High Net Worth Individuals

Recommendations:

MFBs to undertake the market research for designing the saving products for their customers- government to assist their capacity building through the PPAF

Procedures to access to wholesale deposit windows of the commercial banks

Require sustainability

Raising Debt

Assumptions

Organizations become sustainable. Do not over-sell weak or unsustainable organizations.

Sources:

- **Domestic (minimize FX and political risk)**
- **Private: returns to compensate for risk**
- **Instruments: Bank Debt, Syndications, TFCs Bonds**
- **SBP would promote Grameen Capital Fund for Pakistan with domestic and international banks and fund managers to provide credit enhancement that would enable MFIs to access competitive funds from capital and debt markets both locally and overseas and the fund could issue primary and secondary debt**
- **Securitization of remittances could be one option too to mobilize resources for microfinance but these flows would have to be backed by appropriate guarantees**

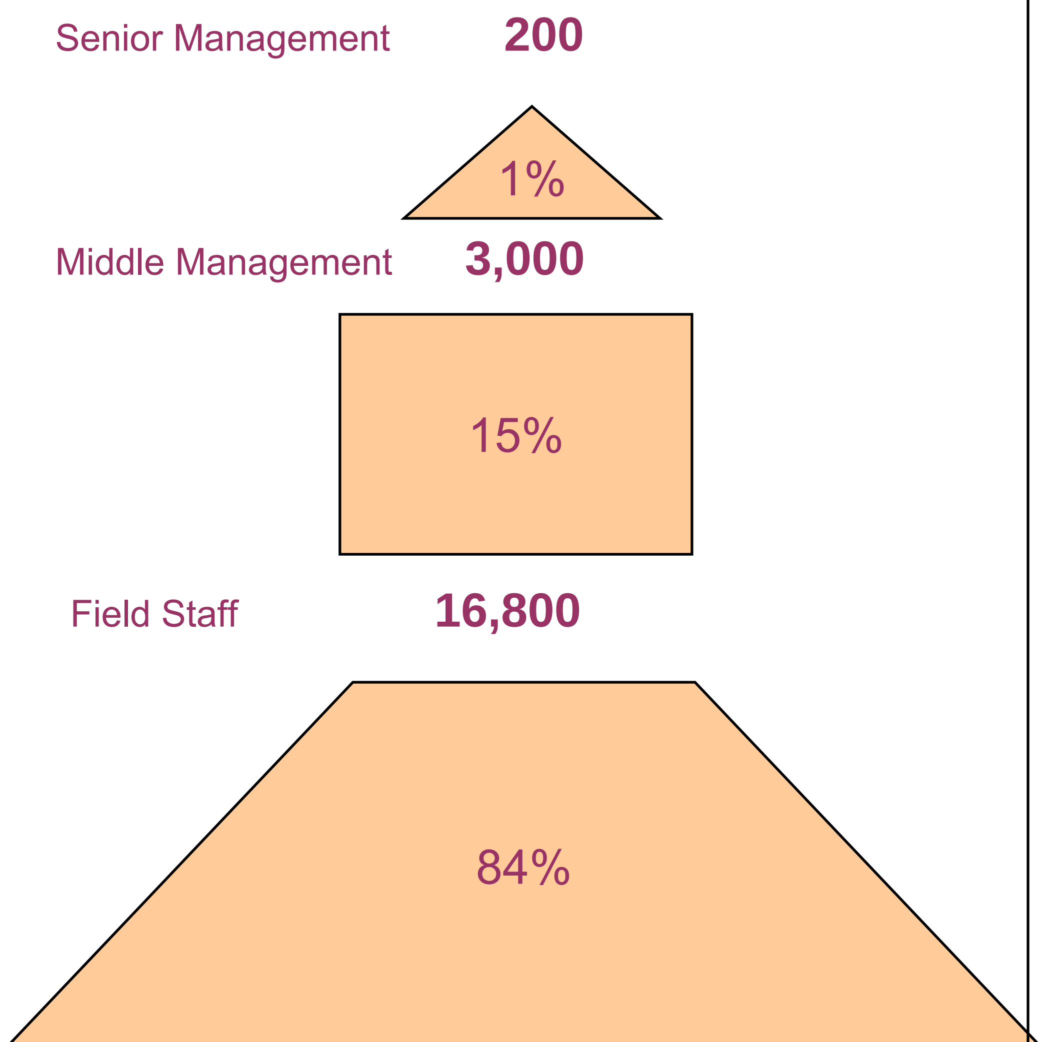
Recommendations:

Partially guarantee private debt transactions of MFBs

MFIs (source funds from Khushhal Pakistan Fund-PPAF to provide Guarantee for raising commercial debt only for viable and financially sustainable institutions)

Build the Human Resource Base

Total Staff 20,000



Trained Manpower of 20,000:

Senior Management: Know their jobs, additional needs are modest

Field Staff: Majority to be trained in-house and on-the-job. Organizations need to build stronger internal recruitment, training and retention

Middle Management: Typically the bottleneck for growth. Need generalized management training.

Recommendations

- **Ensure organizations build strong in house training**
- **Develop management training track at recognized centers:**
- **Academic Institutions: LUMS, University of Peshawar, IBA**
- **Professional Training: NIBAF, IBP**

Accelerating growth beyond 3.0 million after 2010

Efforts in 6 additional areas could yield large scale dividends past 2010

1. New Players
2. Credit Union Models
3. Technology
4. Introduction of Credit Bureau for Microfinance borrowers
5. Effective and synergistic use of Pakistan Post Office resources
6. Other policy and regulatory Initiatives

Early and coordinated progress in these areas would facilitate achieving the outreach of 3 million borrowers even earlier than 2010. It is, however, difficult to predict the exact impact at this juncture.

1. New Players

Requisite characteristics of new players:

- Growth led business model
- Focus on sustainability

Government to facilitate entry of MFIs with proven track record in achieving large scale outreach to attract institutions like BRAC Bangladesh /Afghanistan (plan to enter Pakistan Market initially as NGO), Compartamos Mexico and BRI Indonesia to set up MFBs in Pakistan

SBP and Grameen Foundation, USA are to structure a partnership to explore options for inviting Grameen Trust to offer "Build Own Transfer" Model in Pakistan and acquisition of sectoral know how

International players have approached SBP expressing interest to set up greenfield MFBs in Pakistan

- **LFS Financial Systems of Germany**
- **ASA International-Netherlands- Holding company of MFBs set up by ASA Bangladesh in collaboration with Catalyst Microfinance Investors (CMI) a group of High Network Individuals**

1. New Players

- Grameen Trust (GT) undertakes "Build Operates and Transfer" BOT program in countries or regions requiring immediate implementation of microfinance program to reach a large number of poor people quickly.
- BOT program positions local MFIs to adopt Grameen Model which involves fast tracking scale, based on right mix of sustainable microfinance delivery program backed by right and cost effective training
- Under BOT models key personnel are taken from Grameen, local staff is recruited and trained to offer the micro services
- GT prepares the project documents, develops the business plan and remains responsible for developing a viable microfinance program
- GT has supported 138 organizations in 37 countries including 7 projects under its BOT Program
- SBP is seeking partnership with GT for supporting:
    - MFIs in Pakistan under its "Build own Transfer" BOT Model to help scaling up the operations
    - Promote in Pakistan Grameen Bank replication Program through financial and technical assistance as also through equity participation and sub ordination of loan

2. Credit Union Model

Explore potential for setting up of credit unions (CUs) in Pakistan that are not for profit cooperative finance institutions, owned and controlled by its members and they cater to requirements of this defined segment of population that tends to be a local community with in well defined geographical areas

CUs help to enhance rural outreach, promote savings and full service range of financial products and being member-owned set up it generates better governance and involves group lending practices

In recent years, CUs have been successfully promoted in a number of countries e.g. Bolivia, Mexico, Brazil, Guatemala, Philippines, Indonesia, Malaysia, India ,South Africa and UK.

2. Credit Union Model

Two main complications key to success: CUs are prone to politicization and could run into financial difficulties under weak and unsupervised structures

Recommendations:

Credit Unions could be a fourth tier regulated micro finance institutions. Their role will be critical in community and social mobilization in fragmented society and in allowing some non structured NGOs to be converted into credit unions. CU will play an important role in small saving mobilization and develop a track record of intermediation in difficult areas. To facilitate creation of credit union SBP will approach World Council of Credit Unions to lay down the principle and regulated frame work and work with the MFI community to provide them with the required resources in the initial phases of development. Ultimately the goal would be to let them be financially sustainable entities with in their geographical domain

2. Credit Union Model

- *Experience of various countries in enhancing the outreach of financial services through the CUs can serve as a guide*

  - Brazil has 934 CUs with over 2 million members and about US$ 4 billion of loan- The CUs are regulated by the Central Bank of Brazil
  - Mexico has 39 CUs with about 2.5 million members and total loans of US$ 2 billion. The Office of the Secretary of Treasury and National Banking Commission regulates them
  - Philippines has 1070 CUs with about 0.8 million members and loans aggregating to about US$ 320 million
  - Indonesia has 979 CUs with about 0.6 million members and loans aggregating to US$ 785. Cooperative Development Authority regulates them

3. Technology

Adopt innovative and appropriate technologies that are designed for helping upscale microfinance operations. Rich experience has emerged in some countries in this area e.g. Brazil, the Philippines, India, South Africa and Kenya etc.

Various Models and approaches can serve as a guide

M-banking can help banks to extend their outreach -- more than 800 million mobile phones were sold in developing countries and Pakistan has active 35 million users

M-banking, using information, communication and technology such as cell phones, debit and credit cards and card readers, transact money from retail agents to un-banked and marginalized communities and customers, help reach branchless banking and un-banked areas too

Branchless banking can be through banks tie up with retail agents

Non-bank agents

3. Technology

Country specific models in operations: *Non Bank Models* include

- **G-Cash Philippines: e-money a/c tied to mobile phone subscriber information module (SIM card) and account can be loaded and unloaded by depositing or withdrawing cash at wide range of retail agents**
- **Safaricom-Kenya partnered with Commercial Bank of Africa with Vodaphone affiliation**

Bank led models include

- **Wizzit Bank South Africa: -- a technology firm that partnered with South African Bank of Athens**
- **MTN Banking South Africa**
- **Banking correspondent in Brazil**

Main issues involved in starting these type of operation involve

- **Improving efficiency in payment system**
- **Expediting payment systems and electronic fund transfer legislation**
- **Developing appropriate m-banking legislation which also sets regulatory framework for the use of retail customers to allow commercial banks and other agents to offer services outside convential bank premises and rope in retail agents**
- **Recognize that technology is merely a tool and more critical is the infrastructure and regulations for this new distribution channel**

3. Technology

Evidence does confirm effectivity of m-banking in enhancing outreach to un-banked and rural areas because it helps to reduce the cost of delivering financial services (e.g. 0.5% of the cost of banks in Brazil), relieve pressure off banks and prevents high cost branch network, and establishes presence in newer areas

Retail agents (called "banking correspondents" in Brazil) include supermarkets, pharmacies, small stores, and Post Offices etc.) benefit from getting involved in such businesses because conducting cash transaction yields transaction fee revenues from bank or nonbank sources tapping their facilities and augments their businesses with clients using their products

In Brazil, as of end 2005, there operated 58,000 banking correspondents which have been able to extend coverage to almost one half of municipalities and in India several private banks have used MFIs/NGOs and retail agents for both disbursement and collection of loans and deposits

3. Technology

SBP's Initiatives

- Studying the agent related and security risks
- Stakeholders conference arranged to demonstrate the G-Cash Model,
- Setting up of a Joint Working Group of SBP and MOIT to recommend the required IT infrastructure and develop supportive regulatory framework- Telecommunication companies to be brought on board subsequently
- CGAP expertise enlisted for assessment of best suited model for Pakistan and suggestions for resolving readily identifiable issues.

Some domestic technological solution providers have emerged and are now seeking alliances with banks and some MFBs are also looking at different options

Grameen foundation is willing to share its village m-banking experience

CBR has agreed to provide appropriate tax incentives for the supporting IT equipments

4. Credit Bureau

Credit information system solutions enable MFIs to share borrowers profiles and credit histories that help reduce problems of information asymmetry, optimize MFIs lending decisions and empower clients to leverage good credit reputations to graduate clients as they grow businesses

Evidence has confirmed that centralized data base of the credit histories facilitates microfinance delivery and, among others, reduces default risk of borrower's and transaction cost and induces borrowers to maintain good track record for getting effective pricing on what is by and large unsecured lending

SBP in collaboration with international experts is developing a right model for CIB in partnership with PMN, MFBs, MFIs and NGOs to pool information on borrowers to facilitate prudent lending decision for micro-borrowers

SBP would encourage setting up of this institution which will be a member based and fee based organization with representation from all NGOs, MFIs and MFBs that will be legally mandated to provide client information with supportive CNIC

5. Pakistan Post

Large network currently offering range of services including money transfers.

PP’s infrastructure can be used for enhancing outreach, on cost sharing basis

PP’s outlets can be used as Facilitation Centers for:

- **identification of borrowers**
- **issuance of forms**
- **initial scrutiny including verification of information**
- **marketing and dissemination of the products information**
- **post sanction monitoring and follow up for recovery and**
- **to serve as a Credit Delivery Centre**

5. Pakistan Post

PP can also be used exclusively for disbursement of small credits and serve as collecting agent for repayments on behalf of MFBs, MFIs or NGOs. Prerequisites of such an arrangements would include

- **Assessment of the operational capacity of Pakistan Post**
- **Development of strategic partnership framework between Pakistan Post and the MFBs, MFIs or NGOs**

Limitations: Possible failure of PPO to provide efficient support on an ongoing basis as per stakeholders' expectations

Way forward: Government, SBP and PPO to reach consensus on their capacity to facilitate access to financial service. Subsequent pilot testing could be initiated at selected PPO sites

6. Other Measures

Policy measures

- incorporate the requirement of public disclosure of social performance (e.g. outreach to women, rural areas) by MFIs and NGOs
- Institute disclosure requirements to ensure transparent lending practices and formulate Consumer protection laws
- Remove tax disincentives for MFBs

Regulatory measures

- Incentive through different capital requirements- Lower for smaller districts, higher where MFBs require higher loan ceiling per borrower
- Set performance criteria for MFBs to gain access to clearing house as members as well as having access to ATM Switches for their clients
- To evaluate the possibility of giving scheduled bank status to MFBs s to enable mobilization of institutional deposit
- Encourage setting up of Islamic microfinance banks and Shariah compliant products
- Modify existing guidelines to support introduction of new business lines and products

6. Other Measures-Micro Insurance

Micro Insurance refers to protection of assets and lives against insurable risks of the micro enterprises, small farmers, landless women and low income people

Micro insurance products are generally offered as a part of the micro savings and micro credit services

Micro insurance Products include

- Health Insurance
- Property insurance
- Disaster Insurance
- Life Insurance
- Unemployment Insurance

Micro borrowers are in general more vulnerable to above risks and insurance enables them an opportunity to meet their liabilities towards the service providers without impacting their future prospects to borrow-Some of the MFIs in collaboration with insurance companies have recently developed cost effective health insurance product

SBP is also exploring options, in partnership with Agha Khan Fund to strengthen the capacity of MFBs / MFIs NGOs to offer appropriate Micro Insurance products to borrowers

Up scaling Microfinance Services
Conclusion

Pakistan has launched and kick started microfinance industry well–

- **This has facilitated initial, albiet slow growth --almost 5-6 years for industry to reach about a million**
- **It has to be recognized that initial breakthrough in outreach requires lead time as businesses take time to start operations and to develop appropriate capacities and clients**

Financial and social sustainability would be key to upscaling microfinance and would need to be accompanied by some restructuring of existing large providers and shifting their emphasis from being subsidized lending providers to offering realistic market rates consistent with the pricing of cost of transactions and risks –allow microfinance providers to

(i) tap deposits which should augment lending, while promoting savings (and rural)
(ii) Develop partnership and alliances with convential banks to tap liquidity while offering their outreach
(iii) Tap PPAF to leverage large scale capital market funding through bond issuance and supportive credit enhancement

Establishing a policy and regulatory framework which facilitates MFBs/MFIs to exploit bank branch while tapping innovative technology solutions to exploit branchless banking modes

Boost retailing network and their capacities

Up scaling Microfinance Services
Conclusion

Financial and social sustainability will be promoted if initiatives launched to provide a core basic infrastructure for MFBs/MFIs/RSPs for:

(i) Credit bureaus,
(ii) Positioning PO to be a partner in microfinance development
(iii) Exploiting m-banking with supportive retail network and with supportive regulations
(iv) Developing resource capacities for both providers and micro-borrower clients

These initiatives need to be supported by targeted interventions to direct concessional funding from donors to exclusively support poorer and resource deficit regions in rural Sind and Baluchistan --both have been found to be high transaction cost environment and initial support will be critical to uplift them and to develop clients capacities

Adjusting focus and mission of PPAF and setting specific criteria for it to cater to needs of commercially viable MFs with more market based funding, while supporting the funding requirements of operators in difficult terrains

Facilitating transformation of NRSP and capable MFIs to MFBs so that they can start serving all encompassing financial services to micro clients

Thank you