# 9 PROMOTING INCLUSIVE FINANCE

The significance of financial intermediation in tackling poverty has been recognized since long. However, the formal mechanisms of facilitating financial intermediation generally fall short of providing appropriate and affordable financial services on sustainable basis to the poor. In many developing countries, including Pakistan, financial constraints – rather than lack of skills and market opportunities–can potentially impact the growth of access to finance for all sections of the society.

In recognition of this fact, the Government of Pakistan in collaboration with State Bank of Pakistan (SBP) has been actively promoting inclusive finance to help achieve the target of halving the income poverty headcount by 2015 and to eventually minimize the incidence of poverty in the country. To realize this objective, both the Government and the SBP have launched a coordinated strategy, and in doing so have created a conducive policy, legal and regulatory framework, while adopting flexibility to promote diversity and sustainability to extend the net of financial services to a larger segment of the population.

In Pakistan, financial exclusion is pervasive given the low geographical outreach of financial service providers, as a large segment of the population is based in rural areas whereas majority of bank branches are located in urban and peri-urban areas. Similarly, lack of an enabling environment due to the weak enforcement of contracts and commercial banks' reliance on traditional banking products also act as barriers to access. In addition, a large number of people have a low literacy level and face social and cultural barriers to access to finance.

Financial Inclusion is defined as "access to formal financial services including savings, credit, insurance, and payments through a formal financial intermediary, at an affordable cost". It is considered to be an essential prerequisite for sustainable economic growth as it facilitates exchange and allows poor people to undertake profitable investments and earn a return on their savings.[1] Robust financial sector reforms instituted since the early 1990s, coupled with consistent economic growth in the last few years, have considerably improved access to financial services in the country. However, the degree of financial exclusion shows that the extent of financial penetration in Pakistan is very low. The stark situation is reflected by the fact that only 17.0 percent of the population (30 million) has bank accounts and less than 4.0 percent (6.0 million) are borrowers. Moreover, only 25.0 percent of the total bank deposits and 17.0 percent of the total borrowers are from rural areas.[2] The relatively high scale of financial exclusion is evident from the private sector credit to GDP ratio which is only around 26.2 percent,[3] compared to over 40.0 percent in India, 50.0 percent in Indonesia and 75.0 percent in Thailand.

Limited access to financial services is also reflected in the low level of branch penetration, especially in rural areas, which has held back the growth of savings and has impacted credit distribution (**Table 9.1**).

**Table 9.1** gives the potential market size and the current penetration of financing in the underserved sectors of the economy. It is evident that in each sector, the potential to expand financial services is enormous. With the exception of credit to agriculture with outreach of 23.0 percent, more than 90.0 percent of the potential market in each sector remains untapped.

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[1] IMF WP/08/62
[2] "Financial Sector: Next 10-Year Vision & Strategy", Governor SBP's Address at SBP's 60th Anniversary Conference on July 1, 2008.
[3] As of November FY09.

**Table 9.1: Sectoral Outreach in terms of borrowers and amounts**

| **Sectors** | Outreach as on Dec. 2007 (Borrowers) | Potential Market (Estimates) | Current Outreach as percent of Potential Market |
|---|---|---|---|
| SMEs | 185,039 | 3.16 million potential SMEs in the economy ** | 5.9 |
| Agriculture | 1,517,820 | 6.6 million potential farm households *** | 23.0 |
| Mortgage Loans | 480,569 | 6 million houses required● | 8.0 |
| MF Loans | 1,591,126 | 30 million potential customers ~ | 5.3 |

Source: (** Economic Census of Pakistan - National Report May, 2005 - There are 3.2 million business enterprises in Pakistan out of which 99% are SMEs ***Farm households survey – 2005 ● I&HF Department SBP ~ Pakistan Microfinance Network)

There are both demand and supply side constraints which limit access to financial services especially in the poor and marginalized groups. In particular, banks or other financial institutions are generally not situated in remote locations, as a result of which the number of people served per bank branch is almost 19,000[4] in Pakistan. Besides geographical constraints, other non-price barriers also exist. For instance, regulatory requirements of banks which require proof of identification through CNICs prevent potential customers from rural areas from approaching financial institutions. Moreover, the female population is generally more disadvantaged relative to men.[5] Cultural constraints on women's mobility and the prevailing patriarchal system exacerbate their exclusion from the economic sphere and hence the degree of financial exclusion due to gender constraints. In some cases, banks' behavioral patterns as reflected in their reliance on the traditional modes of lending based on collateral and elaborate documentary requirements add to the degree of financial exclusion.

While the traditional banking models and approaches are ill-suited to serve the lower end of the market, non-traditional approaches including group-based lending with zero collateral requirements have demonstrated relative success the world over, as well as in Pakistan where the National Rural Support Program has successfully employed such mechanisms. While non-traditional financial institutions such as microfinance banks are now a established force in the financial sector, they face several supply side challenges. These challenges include inadequate domestic human resources, lack of financial and social sustainability, funding challenges and limited delivery channels. Even age-old commercial banks are hesitant in lending to the agriculture and SME sectors due to the uncertainties associated with the repayment capacity of such borrowers. For financial inclusion to entrench itself, a change of mindset is required in the conservative lending practices through adequate policy support and appropriately designed interventions to nurture the contribution of the private sector in this initiative.

In other words, tackling financial exclusion requires a paradigm shift from microfinance to inclusive finance i.e. from supporting microfinance initiatives in isolation to building an inclusive financial sector. Inclusive finance entails that a wide range of financial service providers work within their comparative advantages to serve poor and low-income people, as well as micro and small enterprises. Building an inclusive financial sector includes strengthening microfinance institutions (MFIs), private commercial banks and state-owned banks in extending their outreach. It also entails an enhanced financial infrastructure i.e. agencies and systems which provide payment, clearing and settlement services. Many of these institutions are quite well established and can use their economies of scale to extend services to the poor and the low-income strata through special windows or mechanisms.

[4] As of end-CY07. According to BSD estimates (based on the assumption that all banks would open the permitted number of branches in CY08 and that the population would grow by 2 percent), the number of people per branch for CY08 will reduce to 17,355.
[5] "Inclusiveness, Growth and Gender Equity", Speech by Governor SBP at the World Economic Forum, January 24th, 2008.

In recognition of the important role of financial inclusion, this chapter gives a detailed overview of the financial inclusion strategy which is being implemented by the SBP.

### 9.1 Financial Inclusion Program

State Bank of Pakistan has initiated and is diligently pursuing a broad-based policy for widening and deepening access to financial services with the ultimate goal of poverty reduction. The basic premise of the strategy is that financial inclusion can be increased through market based principles with appropriate intervention where market failures arise. It focuses on increasing the outreach of microfinance as an instrumental tool in reducing some of the barriers to financial access by employing new approaches and credit delivery models.

The Financial Inclusion Program (FIP) is being implemented with the help of a GBP 50 million grant from the UK Department for International Development (DFID), and aims to increase the level of access through in-depth analysis and understanding of sector credit issues, effective regulation, credit enhancement mechanisms for funding needs, up-grading technology and availability of information. The key policy focus of the Financial Inclusion Program is on the development of efficient and equitable market-based financial services for the poor. The program is being implemented in two phases, with an initial focus on microfinance and small enterprise finance, as well as on surveys and assessments to ensure that the evidence base for the program is sound. These efforts will continue in the second phase, accompanied by the launch of a number of complementary funds and programs that will be designed in the first phase, including a financial innovation challenge fund, a long term credit enhancement facility and a financial literacy strategy. Concerted action will be taken in the second phase on providing rural and agricultural finance and low income housing finance, alongside microfinance and SME finance.

The scope of the FIP encompasses the development of sector-specific strategies designed and approved by the SBP. These strategies include the National Microfinance Outreach Strategy,[6] SME Financing Strategy, and the Rural Finance and Agriculture Strategy. A summary of these strategies, along with current progress, future projections and coverage under FIP is discussed in the following section.

**Table 9.2: Outreach of Microfinance Institutions**
million Rupees

| | MFBs | | MFIs | | Total | |
|---|---|---|---|---|---|---|
| | CY06 | CY07 | CY06 | CY07 | CY06 | CY07 |
| Number of Branches | 145 | 340 | 847 | 868 | 992 | 1,208 |
| Advances | 3,444 | 4,456 | 4,907 | 8,288 | 8,351 | 12,745 |
| Borrowers('000') | 326 | 435 | 509 | 831 | 835 | 1,267 |
| Deposits/Voluntary savings | 1,420 | 2,330 | 930 | 794 | 2,350 | 3,124 |
| Depositors ('000') | 71 | 146 | 1,294 | 997 | 1,365 | 1,144 |
| Borrowings | 5,139 | 4,951 | 730 | 2,142 | 5,869 | 7,093 |

Source: OSED, State Bank of Pakistan and Pakistan Microfinance Network

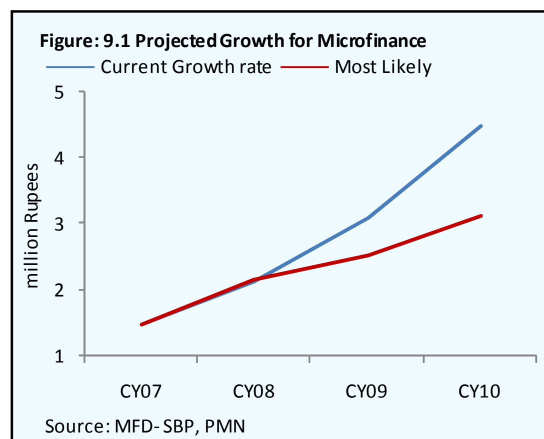
#### 9.1.1 National Microfinance Outreach Strategy

In realization of the vast demands of the un-banked market, the Government of Pakistan has approved a microfinance strategy, being implemented by the SBP, which targets three million microfinance borrower by 2010 and 10 million by 2015. The microfinance sector has shown tremendous growth during the last few years (**Table 9.2**). The total number of borrowers has increased to 1.2 million by end CY07, from 0.8 million at end CY06, depicting a growth of over

[6] Approved by the Prime Minister in February 2007.

51.0 percent.[7] Given this growth rate, the target of three million borrowers by 2010 is most likely to be met as depicted in **Figure 9.1**. This growth pattern includes the entire microfinance sector including microfinance banks (MFBs), and other microfinance institutions (MFIs) such as NGOs and Rural Support Programs (RSPs).[8]

Given the significance of deposits in the capital structure of an MFI as an alternative rather than primary source of funds, ShoreBank International has conducted a study on mobilizing savings from the urban poor which is summarized in **Box 9.1**.




The specified targets are intended to be achieved while ensuring that the growth of these institutions is self-sustainable. This would require a commercial orientation towards microfinance. To ensure commercialization of microfinance, the following are the main initiatives of the microfinance (MF) strategy:

- **Revamping the existing domestic institutions to ensure that they are able to compete for outreach:** This is aimed at ensuring that customers are offered competitive interest rates and service delivery. Additionally, Khushhali Bank's privatization is underway which was converted into a public limited company in April, 2008. The bank is now licensed by SBP and has started operations under the Microfinance Institutions Ordinance, 2001.[9] Likewise, some NGOs are also in the process of transforming their existing operations to acquire the status of formal microfinance banks under the MFIs Ordinance 2001, which bodes well for the expansion of the regulated microfinance sector. These steps will create a level playing field for the various market players, enhance institutional efficiencies, and minimize dependencies on subsidies in order to strengthen the microfinance sector.
- **Encourage entry of international MFIs in the domestic market to increase competition:** Currently BRAC Bangladesh[10] has already started operations as an NGO in Pakistan. ASA International[11] is in the process of incorporation as a company.
- **Introduction of Alternate Delivery Channels to extend the outreach of financial services to geographically diverse areas in a cost effective manner:** This includes the use of technology (mobile banking / branchless banking), and involvement of Pakistan Post for delivery of services and products by MFBs.
- **Creation of a funding window for MFBs and MFIs through the credit enhancement mechanism** to divert wholesale funds to the microfinance sector to address market failure and attain the desired outreach.

[7] Including all microfinance providers (MFBs, MFIs, NGOs)
[8] Refer Box 11.1 in Chapter 11, "Performance of Microfinance Sector" in Financial Stability Review 2006, State Bank of Pakistan for details of the types of microfinance institutions.
[9] The Bank previously operated under the Khushhali Bank Ordinance 2000.
[10] BRAC, following its registration as an NGO last year, began microfinance operations in Pakistan in August 2007. It plans on working on three programs – microfinance, primary health care and non-formal education, focusing on the bottom 50.0 percent of the poor through its microfinance and education agendas. BRAC brings with it 35 years of its experience in Bangladesh as well as an international presence in eight countries to Pakistan's microfinance sector.
[11] ASA provides technical assistance and consultancy services to other small and emerging MFIs, at home and abroad. Its various microfinance models are being implemented in different countries. In Pakistan, ASA will also work with and provide consultancy services to the existing MFIs.

**Box 9.1: Research Study on Mobilizing Savings from the Urban Poor of Pakistan**

ShoreBank International (SBI) and Pakistan Microfinance Network (PMN) conducted and published a joint research report in March 2008 titled "Mobilizing Savings from the Urban Poor of Pakistan – An Initial Inquiry", the first in a series of publications under the PMN and SBI's joint Pakistan Microfinance Initiative . The aim of this research study was to present a broader overview of the saving needs, behaviors and preferences of the urban poor, and derive some key considerations for financial institutions in designing, marketing and delivering savings product for them on sustainable basis. In other words the report tried to link the demand side findings of this report to practical, supply side considerations that affect the sustainability of saving operations.

Assessment in the report is based on 35 in-depth interviews (18 females and 17 males), and 24 group discussions which were also conducted by using in-depth interviews and Participatory Rapid Appraisal (PRAA) research methodologies. This research was confined to two urban centers i.e. Karachi and Lahore.

The major findings of this report are summarized below:

**Section-I: The Saving Needs and Practices of the Urban Poor**

The major factors behind the urban poor's need to save is the need for lump sum cash in excess of their routine income and expenditure, emanating from needs relating to Emergencies (accidents, deaths, illness and natural disasters), Life cycle events (births, education, marriages etc), and Asset-building opportunities like new business investment, business expansion, working capital etc.

The study finds that contrary to general perceptions, the urban poor do save to meet their lump sum cash requirements. Three savings approaches practiced by the urban poor are discussed in detail. These include: Save Up (saving in kind, home savings), Save Down (Interest free loans from friends, relatives or employers, loans from an MFI or money lenders, suppliers credit) and Save Through (committees, family gifts.)

**Section-II: Consideration for savings Product Design and Delivery**

Section-I of the report concludes that there is great potential for formal saving services amongst the urban poor. To transform this potential into a viable volume of deposits would depend on the design considerations of the financial institution's savings operations. Based on observed saving behavior and the preferences of the urban poor, this report recommends four broad decision areas or parameters for financial institutions that would serve as prerequisites for the design of appropriate savings products, marketing and distribution as discussed below :

***Consideration-I:*** There is a need to identify an overlap between saving needs/potential demand and the organizational capacity, strategy and systems to service that need.

***Consideration-II***: **T**hree types of formal savings products are recommended in the report, including demand deposits (liquid/semi-liquid deposits), contractual savings products and time deposits. The report points out that the lack of long term financial planning habits among the urban poor is a major factor that can help financial institutions to target this market with liquid and semi liquid savings products. Similarly, upon restoration of sufficient trust and awareness of savings in the financial system, it would be easier for financial institutions to launch less liquid or long term savings products.

***Consideration-III:*** This report stresses the need for effective and well thought out marketing strategies to tap savings from this almost virgin territory. The big challenges for financial intuitions are illiteracy, lack of trust on banking system and the reliance of urban poor on the informal savings mechanisms. In this context, the report suggests three main objectives of the bank's marketing strategy to deal with these issues and to attract a respectable volume of savings and a large number of savers from the urban poor market segment. These objectives are (i) building potential client's trust in banks, (ii) building potential client's awareness of savings through banks, and (iii) promotion of banks' savings products.

***Consideration-IV*****:** After designing the requisite savings products for the urban poor, the report stresses the need to design a delivery model that can support market response and viable savings operations for financial institutions. The delivery models include distribution channels (like services branches, satellite branches, smart cards and ATM, mobile units, lockboxes), bank processes and customer services. Financial institution have to be vigilant in selecting the delivery model because their decision can affect the urban client in term of transaction cost, perception about trust, reliability, friendliness and relevance. Moreover, the study also points out some other considerations that should be properly addressed before finalizing any delivery model, like proximity of point of transaction for low transition costs, simple processes for quick accessibility and a welcoming environment to inculcate the feeling that a bank's products are relevant to their needs. These concerns are very relevant in determining the bank's cost of delivery and thus the pricing of the services offered to the client and the overall viability of the saving operations.

Source : Mobilizing Savings from the Urban Poor of Pakistan – An initial inquiry, ShoreBank International, March 20, 2008

- **Alternative Institutional Set-up:** This involves exploring the possibility of setting up alternative institutions that lower costs and serve the needs of the clients. Presently, the concept of credit unions is being explored, as explained in **Box 9.2** which describes the potential role of credit unions.

**Box 9.2: Credit Unions: Effective Vehicles for Serving the Financially Under-Served**

Credit unions are member driven organizations which comprise of a group of people who agree to save their money and extend loans at reasonable interest rates. Membership is defined by a common bond between members based on the place of residence or employment, or common religion or ethnicity. People may become members by purchasing shares and credit unions display democratic values with each member having one vote. The boards of directors are usually made up of members elected at an annual general assembly. Credit unions present certain advantages for expanding outreach to those under-served by mainstream financial institutions. The primary advantages presented by credit unions for accelerated increase in outreach include:

1. Savings mobilization; as credit unions provide low transaction costs with a variety of savings services.
2. Member driven products; especially member's financing requirements which determine the credit union loan product offering.
3. Cost consciousness.

Credit unions usually are able to cope with covariance credit risk if they have diversity in membership or mixed outreach in terms of income levels. Service to the poor is blended with service to a broader spectrum of the local population. Recently credit unions have attempted to reach the down-market through group-based savings and lending products used in microfinance. Group-based methodologies provide vehicles to reach large numbers of very poor clients in difficult to reach areas.

Many credit-only group programs especially in Pakistan are dependent upon external sources of funds which in the present stage of development is limited especially from commercial sources. The Pakistan Microfinance Network/Shore Bank International estimates that in order to reach the target of three million microfinance clients by 2010, funding of Rs. 86 billion is required. While the actual amount required may be open to debate, it is true that a gap does exist. Hence, credit unions may offer group-based products to reach the down-market and meet some of the funding gap of the microfinance industry as member savings can be a source of funding.

Credit unions have been known to face governance challenges. They faced a crisis in Pakistan in the 1980s as they suffered from politicization. In order to address inadequacies of governance, credit unions may be governed by a federated network with shared resources managed and optimized by a second tier organization with branches that share an institutional image. The network in turn may be governed by a regulatory authority such as SBP or SECP. Regulatory oversight by an independent body will help minimize challenges in governance.

Source: Various sources, listed in chapter references

### 9.1.2 Development of Small and Medium Enterprises (SMEs)

SMEs contribute one-third of the GDP, and are the second-largest recipients of bank credit. They constitute 99.0 percent of the total 3.2 million business enterprises in Pakistan. Their share in industrial employment according to an estimate is 78.0 percent, and in value-addition approximately 35.0 percent.[12] These factors underscore the significance of the SME sector. Based on current market estimates, credit needs of both small and medium sized businesses amounts to over Rs. 1000 billion,[13] whereas the outstanding credit amount is only Rs 405.9 billion as of June 2008.

In order to narrow this financing gap, SBP is developing an SME strategy. The strategy focuses on regulatory reform, promotion of credit guarantee schemes, venture capital funds, establishment of an SME ratings agency, and training centers and capacity-building for the front-line SME finance staff in banks and other financial institutions. Moreover, the strategy also entails the analysis and study of SMEs through surveys and standardization of credit risk through the scoring

[12] Economic Census of Pakistan-National Report May, 2005 (www.statpak.gov.pk)

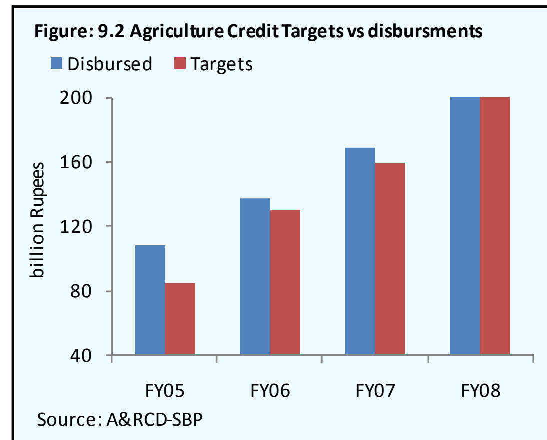
[13] Shorebank, USA. Demand Survey carried out by Business & Finance Consulting in Punjab.

mechanism. The outreach target is 500,000 borrowers by 2012 from the existing base of 185,039 as of December, CY07 (**Table 9.3**)

### 9.1.3 Increase Outreach of Agriculture Credit

Agriculture accounts for about a quarter of Pakistan's GDP and generates half of the country's employment.[14] During the last five years, SBP has taken a number of initiatives to increase the flow of institutional credit for the agriculture sector, in particular through a revolving credit scheme, in addition to providing capacity building. Consequently, there has been over 370.0 percent rise in agricultural credit disbursements from Rs. 45.0 billion in FY01 to Rs. 212 billion in FY08.[15] **Figure 9.2** shows significant growth in disbursements which has even crossed the targets of agriculture credit during the last three years. However, disbursements are still about 45.0 percent of the total estimated credit requirements of the agriculture sector, with coverage of only 1.5 million agricultural borrowers[16] out of the estimated 6.6 million rural households in the country.[17]

**Figure: 9.2 Agriculture Credit Targets vs disbursments**




Source: A&RCD-SBP

**Table 9.3 Facility-wise Credit to SMEs**

amount in billion Rupees and No. of borrowers in thousands

| | Dec-05 | | Dec-06 | | Dec-07 | |
|---|---|---|---|---|---|---|
| Facility | Amount | Borrowers | Amount | Borrowers | Amount | Borrowers |
| Fixed Investment | 34.1 | 12.1 | 41.8 | 16.2 | 60.3 | 18.7 |
| Working Capital | 267.7 | 141.5 | 308.4 | 141.1 | 309.1 | 157.9 |
| Trade Finance | 59.6 | 11.1 | 58.1 | 15.0 | 67.9 | 12.6 |
| **Total** | | | | | | |
| SME Credit/No. of Borrowers) | 361.4 | 164.7 | 408.3 | 172.3 | 437.4 | 189.2 |

Source: SBP Database

SBP has drafted a Rural Finance and Agriculture Financing strategy to increase the outreach of agriculture credit. The strategy aims to remove policy and regulatory hurdles to promote agriculture finance as a commercially viable business for banks, seeks to build capacity of commercial banks in this area, restructure and reorganize specialized rural finance banks, in addition to creating linkages between stakeholders.

## 9.2 Financial Innovation

Extending outreach of financial services to the un-banked and underserved areas in a cost effective manner is a major step towards poverty alleviation. Emerging progress in information and communication technology and its widespread usage offers a tremendous opportunity to achieve this goal by making available non-traditional ways of providing financial services.

Given that people residing in rural areas generally find it difficult to visit bank branches due to the incurrence of high transaction costs, appropriate mechanisms have to be devised for banks to reach out to a large cross-section of the un-banked population through a variety of devices such as weekly banking, mobile branch banking, satellite offices, rural ATMs and post offices. As a

[14] Federal Bureau of Statistics, 2006.
[15] Agriculture & Rural Credit Department (A&RCD), State Bank of Pakistan.
[16] Development Finance Review 2007, A&RCD, State Bank of Pakistan.
[17] Farm households survey – 2005

regulator, the role of SBP is to provide an enabling environment in which the risks associated with such products and service innovations can be appropriately balanced with the benefits of using these new channels, and where new technologies are put to use on the efficient frontiers of the risk-return trade-off.

### 9.2.1 Mobile Branch Banking

Banks face major constraints of access to potential clients residing in remote geographical locations due to the high administrative costs of providing formal financial services. In order to rationalize such costs, SBP has recently issued a draft policy paper on the regulatory framework for mobile banking under the framework of newly issued guidelines.[18] According to these guidelines, any licensed branch of a bank can cover an area of about 50 km radius through mobile banking services. Banks may either utilize mobile teams or service centers within defined parameters of the licensed branch. Service points may offer withdrawal facilities and loans to clients, but are prohibited from taking deposits.

### 9.2.2 Branchless Banking

SBP has also issued Regulations for Branchless Banking (BB),[19]with a view to encouraging innovation within banks' delivery systems, thereby increasing outreach in a cost-effective manner. These regulations provide a framework for offering BB services and also provide a set of minimum standards for data and network security, customer protection and risk controls for banks. According to these regulations, only authorized financial institutions may provide BB services limited to BB accounts, account-to account and person-to-person fund transfers, cash-in and cash-out, bill payments, merchant payments, loan disbursements and repayments, and remittances. The BB framework is based on the bank-led model as defined in **Box 9.3**.

There may be several challenges that BB regulations pose for the existing regulatory framework. Requirements such as Know Your Customer (KYC), Anti Money Laundering (AML) and restrictions on undertaking of cash payments outside the bank's authorized place of business need modifications. To facilitate rapid implementation of mobile banking in the un-banked sector, SBP could consider a risk-based KYC system where identification requirements vary according to the nature of account operations. Accounts with restricted transaction volume or turnover limits could have less stringent KYC requirements, a practice already in place by Microfinance Institutions which are allowed to extend micro-credit by establishing identity through other appropriate means in far-flung and remote areas where people, particularly women, do not have identity cards.

### 9.2.3 Credit Information Bureau

The current credit information infrastructure in Pakistan, though a relatively recent development, is well diversified with private sector participants operating on a commercial basis. Commercial banks, MFBs and NBFCs are required to report loans of all amounts to SBP's e-CIB system. Furthermore, SBP is in the process of assessing the potential for the establishment of a credit information bureau (CIB) for the microfinance sector, including MFBs, RSPs, and other NGO based MFIs. The establishment of a specialist CIB will support improved access to financial services and lower cost service through improved information systems, reporting and transparency.

### 9.2.4 Credit Rating Mechanism

Although the existing credit rating agencies in Pakistan do assign ratings in the microfinance and SME sector, they primarily cover major industrial corporates, financial institutions, and debt instruments. The small and micro enterprise sector needs a specialized rating service with core

[18] Draft: Policy Paper on Regulatory Framework for Mobile Banking in Pakistan, Banking Policy and Regulations Department.
[19] Branchless Banking Regulations, Banking Policy and Regulations Department, March 31 2008, State Bank of Pakistan

competencies in assessing the risk of micro and small enterprises. As part of its scope, FIP will conduct feasibility for a specialized credit rating agency for small micro enterprises and encourage institutions to use these ratings in the assessment of their credit applications.

**Box 9.3: Bank-Led Model of Branchless Banking**

Branchless banking is largely dependent on the operating vehicle of mobile phones. Mobile phone banking can be implemented by using one of the following models:

**One-to-one (1-1) Model:** In this model a bank offers mobile phone banking services in collaboration with a specific telecom operator either through a joint venture or an agency agreement between the bank and the telecom provider. It offers the advantages of greater customization, good service standards, and the possibility of co-branding and co-marketing. The disadvantage of this model is that its outreach is limited to customers of one telecom provider only.

**One-to-many (1-∞) Model:** A bank offers mobile phone banking services to customers using mobile connections of any telecom operator. While enabling extended outreach by offering defined banking services to any bankable customer who has a mobile phone connection, the drawbacks in this case pertain to the advertising / marketing expenses which are entirely borne by the bank itself, in addition to the potential lack of access to a dedicated line from the telecom service providers to enable quick and efficient provision of services.

**Many-to-many (∞-∞) Model:** In this model many banks and many telecom operators join hands to offer services to virtually all bankable customers. Under this system, a central transaction processing system (TPS) is necessitated, which must be controlled either by a single financial institution (FI), or by a subsidiary owned and controlled by an FI or a group of FIs, or by a third party service provider under proper agency agreement with a bank. This system is similar to the network of bank ATMs operating in the country.

**Alternate Channels:** Branchless banking could be implemented using agents other than telecoms (including oil distribution networks, Pakistan Post, chain stores and so forth) and using technologies is not limited to mobile phone (GPRS and POS terminals). These three sub-models (one-to-one, one-to-many and many-to-many) can also be applied to this type of branchless banking.

In each case customer account relationship must reside with some FI and each transaction must hit the actual customer account and no actual monetary value is stored on the mobile-phone or TPS server (the balances shown on mobile phone are merely a reflection of actual account balances). Consequently, the use of the term e-money to represent the services offered under these regulations is prohibited as being technically incorrect.

Source: Draft-Policy Paper on the Regulatory Framework for Mobile Banking in Pakistan, BPRD, State Bank of Pakistan.

### 9.2.5 SMART Subsidies

To cover remote and difficult geographical areas, FIP uses the idea of smart subsidies to financial institutions so that they can reach out to all segments of the country. **Box 9.4** gives details of smart subsidies for widening the net of financial inclusion.

## 9.3 Financial Inclusion Program and Financial Sustainability

Financing a variety of activities for the underserved segment could serve as an appropriate risk diversification mechanism,[20]as inclusive finance can potentially spreads risks across various market segments and institutions. However, financial sector expansion without appropriate risk pricing and mitigation, and stable sources of funding for both equity and debt could make the sector vulnerable to various shocks. Moreover, empirical studies indicate that financial development positively affects economic growth and is pro-poor, while financial instability, if it arises, is detrimental and weakens the positive impact of financial development.[21] Instability demonstrably undermines poverty reduction because the poor are generally more vulnerable than the rich to unstable and malfunctioning financial institutions. Inclusion thus affects stability

[20] Srinivasan N., 2007, Policy Issues and Role of Banking System in Financial Inclusion. Economic and Political Weekly July 28.

[21] Jeanneney G. S. and Kpodar K., 2007, Financial Development and Poverty Reduction: Can there be a benefit without a cost? IMF WP/08/62, Washington D.C.

indirectly through negative macroeconomic impacts such as volatility in growth and rapid inflation.

**Box 9.4: Smart Subsidies for Widening the Net of Financial Inclusion**

Smart subsidies means recognizing that the same forces driving efficient outcomes in free markets i.e. hard budget constraints, clear bottom lines, and competitive pressures, can also be deployed in the context of subsidies. Effectiveness of subsidies depends on their design and implementation keeping three basic rules in mind: 1) Transparency, 2) Rule-Bound, and 3) Time Limited.

In the context of development finance in Pakistan, a new breed of institutions is serving the financially underserved markets. These include MF and SME institutions, and the renewed focus of commercial banks in non-traditional modes of financing including Islamic finance. In order to enhance the ability of these institutions to increase the percentage of the adult population with bank accounts from 37.0 percent, SBP's Financial Inclusion Program has incorporated the concept of smart subsidies in the following manner:

1. **Crowding-in Investment through Credit Guarantee Scheme for SMEs:** The aims of credit guarantee scheme is two-fold—increase the flow of credit to SMEs and share the risks of loans with the lenders. The scheme, if well-designed, will serve to build reputations of SMEs and once the territory becomes familiar, banks will be willing to lend more to small businesses, making the need for the scheme to disappear with time. The credit guarantee is appropriately subsidized as eventually the need for the subsidy will die out and will crowd-in future investment.

2. **Start-up Subsidies for Innovation:** In order to reach lower income MF clients and SMEs, the market requires testing of innovative products and technologies and delivery channels that lower costs and are more suited to clients' needs. However, due to information asymmetries, high risks and limited investment capital, financial institutions do not undertake high cost innovation. The *Financial Innovation Challenge Fund* will provide matching grants as well as staff trainings for introducing new innovations. The fund will be designed to stimulate innovation and information sharing about profitable business models for widening access to financial services. The fund will also encourage partnerships between MFBs, NGOs and other private sector actors to promote business development and non-financial services. Smart subsidies are justified since innovations take time to create economies of scale

Source: Various Sources, listed in chapter references

The Financial Inclusion Programme plans to not only provide better livelihood opportunities to the poor and marginalised groups, it will also provide insurance against adverse developments, improved skills and higher investments in health and education at the household level. FIP further plans to seek to promote financial stability and social sustainability through the following outcomes:

***(i) Economies of scale:*** Given the direct relationship between profitability and scale of operations, larger banks and MFIs are able to evolve business models and growth strategies to reach out to poor clients. This is of particular significance, given that microfinance is a high volume, low margins business.

**(*ii) Proper funding mechanism:*** Sustainability requires that MFIs largely rely on deposit mobilization to finance their businesses. In the initial stages of development, however, MFIs end up developing alliances with commercial financial institutions. These arrangements offer opportunities for foreign and/or local currency funds for expanding business.

***(iii) Transformation of NGOs into MFIs:*** NGOs need to be encouraged to restructure themselves into legally established banking companies, licensed preferably by the central bank, so that they can operate under effective and transparent ownership with adequate capital base. Backing such MFIs by supportive prudential regulatory framework helps in the proper leveraging of funding, while providing comfort to depositors and borrowers.

***(iv) Strategic alliances of MFIs with financial markets*** are increasingly important in promoting access to financial services at a reasonable cost. The sector has two options: (i) strategic alliances, which includes mergers and acquisitions, joint ventures and contractual arrangements, or (ii) alliances with commercial banks to set up and launch MF operations.

***(v) Governance of financial institutions:*** Proper governance of banks/MFIs is essential to safeguard stakeholder interest in particular depositor funds. The functions of a board of directors and senior management with regard to formulating and implementing policies and monitoring compliance are key elements in the control function of a financial institution. In addition, governing bodies play a critical role in establishing the values and culture of an institution, including its ability to make sound technical decisions on products and pricing, manage risk, innovate, adapt, change and grow.

***(vi) Role of small, locally-oriented financial service providers*** should not be minimized; they are often the most significant, if not the only, financial service provider in many communities. Small financial service providers can be expected to further penetrate their respective markets, seeking alliances with others and through networks to offer a greater range of products and services.

In order to maximize client-level benefits, it is essential to ensure the social sustainability of financial service programs. While intertwined with financial sustainability, social sustainability demands:

***Effective community and social mobilization**,* which involves using a participatory process to raise awareness, mobilize and involve local leadership, institutions and communities to organize collective action for common goals and objectives to reach the poor people especially women and the disadvantaged.

***Social performance*** which requires keeping a close watch on the financial bottom line through better retention of clients and reduction of costs, quality of services, improvements in clients' standard of living through provision of business opportunities and other social services. Moreover, social performance requires that institutions ensure staff capacity and enjoy a good reputation in the communities in which they work.

FIP aims to create a well-functioning financial sector that can have an important direct impact on poverty, to the extent that the poor have much improved access to financial services – savings products, credit, payment services etc. These poverty-reducing effects are achieved in a number of ways through the wider availability of bank accounts to more people which enables individuals to accumulate savings in a secure manner over time – thereby avoiding the risk of theft etc., improved access to credit which enables more poor people to borrow funds, and thereby strengthens their productive capacity by enabling them to invest in micro-enterprises, or in education and health, all of which can play an important role in improving their productivity. Moreover poor people's vulnerability to adverse shocks is reduced by minimising the negative impact that income shocks can sometimes have on long-term income prospects.

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