Executive Summary

Rural financial services were defined in comprehensive terms and should include provision of credit, savings mobilization, insurance coverage and a payments system for transfer of funds to and away from the rural sector. In view of low incomes and high risks in rural areas, effective provision of these services serves important goals of accelerated growth, poverty alleviation and reduced exposure to vulnerability. The diversity within the rural sectors requires a variety of diversified formal and informal institutions for the provision of each component of rural financial services to its clients.

In the last fifty years or so, Pakistan has had a rich but generally disappointing experience in the provision of rural financial services in support of national goals. The Committee on Rural Finance was mandated to review the situation and recommend policy directions to improve the institutional arrangements.

Main Findings

The major finding of the Committee is that rural sector has suffered from policy neglect, poor design and weak implementation of delivery system for each of the four financial services. The services provided have been inadequate as well as inconvenient, inappropriate, unsafe, unaffordable and causing a great deal of inconvenience. In relative terms, most attention has been paid to provision of agricultural credit to and mobilization of deposits from the wealthy people in rural areas. Provision of insurance, credit for non-farm purposes and for the landless and small farmers and the mobilization of savings of the poor and the poorest in rural areas have not received much attention from the policy makers. Salient findings are summarized for easy reference:

First, despite long experience with formal financial institutions i.e. ADBP, Commercial Banks and Cooperative Banks, the percentage of agricultural credit needs met in volume terms has been low and has not exceeded 30%. The performance on the basis of percentage of farmers covered (at 15%) has been all the more dismal.

Second, there has been an extremely unequal distribution of credit within the agricultural sector. The bigger farmers have hijacked a major share of loans from ADBP, Commercial Banks and Cooperative Banks. The benefit of subsidized credit from these institutions has gone mainly to the influential farmers. The bigger farmer bias is based on availability of collateral and political influence.

Third, the ADBP and the Cooperative Credit Institutions have depended on cheap lines of credit from the State Bank of Pakistan and have failed to mobilize deposits with their own efforts. The staff in these institutions had mostly agricultural science as their academic background. Being not trained in banking, it is not surprising that these institutions had failed to mobilize deposits and quality of their loan portfolio was bad. In view of the low recovery rate, high transaction cost and

politically motivated lending, these institutions became bankrupt, unviable and poorly positioned to continue playing the role assigned to them by the government.

Fourth, the commercial banks in Pakistan, prior to the introduction of financial sector reforms, were faced with low interest ceilings on deposits. High inflation had resulted in low rate of return on deposits, thus discouraging mobilization of savings. This situation has been remedied somewhat after introduction of reforms. In view of large saving capacity in rural areas, the scope for banks to mobilize funds is enormous.

Fifth, advances by commercial banks are mainly concentrated in large cities and cater predominantly to the urban industrial and trade needs. The newly licensed private banks in geographically distant urban areas during 1990s also have a more pronounced industrial bias as more than 80 percent of their advances are concentrated in 3 or 4 cities.

Sixth, the low penetration of commercial banks in lending for rural areas is explained by the banking culture being highly urbanized and industrially oriented and by high protected profits in urban activities. The high cost of lending to rural clients further inhibits loaning to rural activities.

Seventh, the success of different NGOs, especially rural support programmes in providing new innovative channels for savings, flexible repayment schedules and group-based loaning has led to high savings by the poor and the poorest, almost 100% repayment recovery and a wide coverage of the borrowers. This experience provides an ample proof of the untapped savings potential. The lack of appropriate saving products has often necessitated recourse to savings in kind i.e. livestock rearing.

Eighth, high-risk levels and absence of insurance in rural areas have forced rural people to diversify their activities excessively. Appropriate insurance products can lead to improved allocation of rural areas.

Ninth, the Post Office department has an extensive physical and human infrastructure spread throughout Pakistan. It can play a more expanded role in mobilization of savings, insurance coverage and effective system of payments in addition to its historical role in delivery of mail.

In brief, the lack of appropriate saving products, almost total absence of insurance, limited access to credit for the poor and rural non-farm activities and an inefficient payments system has deprived rural people from productive employment and high and broadband growth. As a consequence, the rural economy is mired in a vicious circle of low growth, low productivity, low savings, weak employment generation, rising poverty and abject helplessness. The fact that there is no permanent institutional mechanism, which can analyze the situation in the area of rural finance and come out with policy proposals to rectify the policy mistakes, makes it all the more difficult to break out of the vicious loop in which rural areas are caught.

Policy Recommendations

In view of the major shortcomings of the existing rural finance policies and institutions and the large productivity and welfare gains from enlarged supply of financial services, the Committee on Rural Finance has made major recommendations for creation of new institutions, restructuring and reorientation of the existing institutions and adopting new principles and guidelines for the provision of the rural financial services. Only a brief discussion of proposed changes is given:

Policy Guidelines

In line with new paradigm of the increased reliance on market forces and the private sector, the new rural finance institutions need to stay clear of government-owned and run institutions. The foolproof guarantee to achieve efficiency is to operate the new institutions in the private sector. The already existing institutions in the public sector should either be privatized and/or at least restructured and run on commercial criterion without undue government interference. A strong system of oversight and supervision should guard the public interest of depositors and other economic agents.

The second guiding principle should be to induct richer segment of rural people who are already involved in economic activity in rural areas to become new banking entrepreneurs. The local links and knowledge of the local terrain is needed for successfully managing the rural financial institutions.

Last but not the least, there is a need to create synergies and linkages between different organizations involved in providing rural financial services i.e. savings, credit, insurance and transfer of funds. The innovative financial products, based on best practices in national and for international experience and suited to different kinds of clients are helpful in improved delivery of services.

Specific Policy Changes

I. Establishment of New Institutions:

1. The Government of Pakistan should establish rural banks in the private sector. Under the Microfinance Ordinance, three tiers of district, provincial and national, licenses can be granted with different capital requirements for establishment of the private banks. The Committee recommends that a new fourth tier with a capital requirement of Rs.125 million be added for a regional licenses, covering at least three contiguous districts**.** *It should be done through an enabling low which either amends. The current MF ordinance or by enacting an entirely new and specific Rural Finance Act.*

   The Committee further recommends that a negative list of 20 largest cities be announced. The new banks should be set up in locations other than these 20 cities and should lend only for rural activities. *Within the permissible geographic area* there should be no bar on the type of lending for these banks.

2. In view of high transaction costs, incentives need to be provided to these rural banks. A subsidy of between 2% to 5% on the loans to be advanced by new banks be given. The subsidy should be time bound and should be eliminated within five years. There should be a facility of upto 30% equity participation on pre-determined buy-out terms from State Bank of Pakistan or other donors.

In addition, State Bank of Pakistan should provide training and technology to the new banks on a subsidized basis with matching contributions from the banks.

3. Existing commercial banks, private or nationalized, should be allowed to set up new rural banks as their subsidiary institutions.

II. Re-orientation of Existing Institutions

The Committee is of the view that all existing rural financial institutions may be re-oriented towards improving their performance. Specific suggestions for improvements are listed below:

1. ADBP should expand its branch network to at least the Markaz level. It should get into the business of mobilizing deposits and providing life insurance attached to deposit mobilization as an additional incentive for deposit mobilization.

2. State Bank of Pakistan should squeeze the available spread in the urban-industrial sector to induce commercial banks to start lending to rural sector.

3. The non-genuine cooperative societies should not be allowed to operate. Viable cooperative banks may be encouraged to convert themselves into rural banks. Equity to the genuine societies to the tune of upto 50% may be provided by the State Bank. These societies may also be made eligible for the subsidy on their advances upto 5% but like rural banks, the subsidy should be eliminated in five years.

4. The Committee recommends that micro-finance institutions should expand their network. Pakistan Poverty Alleviation Fund's next tranche from the World Bank should be increased. It should nurture at least a dozen new NGOs in micro credit. The Khushhali Bank should increase its client base to increase its outreach.

5. The Post Office Department should be encouraged to expand its insurance and savings mobilization alongside its traditional function of mail delivery and operating the payments system.

6. State Bank of Pakistan should create a new Rural Finance Department within itself. It should serve as a catalyst in providing different aspects of rural finance. It should have a strong research, training and supervisory capability. It should involve all stakeholders in rural finance and provide a platform for informed debate on rural finance.

III. Reform of Micro and Agricultural Sector Policies:

The Committee is of the view that reforms in the rural finance services should be complemented by improving the wide-ranging macro and sectoral incentives for the broad-based growth in agricultural and rural development. The precise sequencing of different measures needs to be determined carefully to optimize benefits from increased provision of rural financial services by guaranteeing high profitability of the farm sector through improved technology, adequate price and non-price incentives. Stable macro management should precede the improvements in sectoral interventions.

The Main Report

1. Scope of Rural Finance

Rural finance does not only mean agriculture credit or savings. The Committee on Rural Finance has defined the rural finance in broader terms including the following:

1.1. Rural Credit:
Agriculture credit will be the major component of rural credit but our definition includes the requirement of credit of all rural business and agricultural related activities including retailing-wholesale activity, rural SMEs (Small and Medium Enterprises), agriculture and livestock credit, forestry, fisheries and credit required for marketing rural produce, etc.

1.2. Savings Mobilization:
Mobilization of rural savings is perhaps as important for accelerated agricultural and rural development as provision of credit. While policy efforts have been made on the credit side, very little attention seems to have been paid to this important component.

1.3. Insurance Services:
Access to insurance for various risk mitigating purposes is an integral part of the finance sector and availability and penetration of Insurance in the rural sector is an integral part of the Rural Finance market.

1.4. Payment System:
The remittances, transfer and payment of funds form the last part of our definition of rural finance. The geographical dispersion and long distances between economic agents of the rural sector point to the importance of this component to the subject of rural finance.

2. Present Status of Rural Finance:

2.1. In Pakistan, rural credit market consists of formal and informal providers of credit. The former category includes the Agricultural Development Bank of Pakistan (ADBP), Commercial Banks and Co-operatives while the latter comprises professional money lenders, friends and relatives, village shopkeepers and commission agents, etc. The predominant share of credit is provided by the informal sources of credit.

<u>Formal Credit Market</u>
Prior to independence, institutional credit was available to the farmers either in the form of “taccavi” loans or from such co-operative societies as were functioning in the country at the time. The small farmers and the landless, particularly, had to depend on informal sources for meeting most of their credit requirements. In order to overcome this inadequacy, two specialized institutions i.e. Agricultural Development Finance Corporation and the Agricultural Bank were established in the 1950s. These were merged to form the Agricultural Development Bank of Pakistan (ADBP) in 1961.

The commercial banks (CBs), towards the end of 1972, were also given mandatory agricultural credit targets. Keeping in view the input rates, the credit targets were raised annually. The banks were penalized in case they failed to achieve the prescribed targets.

The legislation on Co-operative Credit System was introduced in the Subcontinent in 1904. At the time of independence, the Co-operative banks were engaged in financing commercial activities mainly and had neglected the financing of co-operative societies. In 1976, "Establishment of Federal Bank for Co-operatives and Regulation of Co-operative Banking Ordinance" was promulgated. Various steps undertaken by the government have failed to revive the role of Co-operatives in financing the rural sector.

<u>Informal Credit Market:</u>

Informal credit market is characterized by low transaction costs, very high interest rates and rapid disbursement of credit. Its share in total credit has declined. However, it still appears to be the major source of rural credit. Close familiarity of borrowers with informal lenders in conjunction with coercive loan collection by and the inability of formal institutions to reach the poor has led the poor to depend on the informal market. This has been so despite charging of exploitative interest rates ranging from 50% to 100% per annum. Most informal lenders have limited loan portfolios and operate within narrow area of their influence.

2.2. <u>Agriculture Credit Market:</u>

The most easily accessible data are available for Agricultural Credit. Traditionally, the requirement and actual disbursement of credit is measured in terms of volume of credit. According to these data, institutional credit is meeting around 30% of the actual requirement– (Annex-1). Actual requirement of credit is worked out in an exhaustive manner. The report with the detailed discussion of methodology in determining the credit requirement is attached as Annex-1-a.

The fact that 70% of Agriculture Credit requirements not being met had resulted in charging of extremely high (50% to 100%) interest rates by the informal agricultural credit providers from the needy farmers in every province of Pakistan.

It is even more unfortunate that the percentage of actual credit disbursed relative to the credit requirement has either been static or has declined over the years. Any increase in credit in one particular year, attributed to special programmes or incentives for rapid credit disbursement, has always been followed in by a sharp decrease in the following year. (Note: para on some of the special agri credit schemes)

This dismal picture has emerged despite SBP's mandatory quotas for agriculture credit assigned to all Nationalized Commercial Banks (NCBs) with penalties for non-compliance and many Billions of credit provided by SBP to ABDP and Federal / Provincial Co-operative Banks.

It is evident that Pakistan has failed to find a sustainable method of delivering Agriculture Credit to the capital starved farming community of the country.

The critical shortage of capital in rural areas is further confirmed by the fact that the rural poor readily pay the 20% mark-up charged by Micro Finance institutions like the National Rural Support Programme (NRSP) and the Khushhali Bank (KB).

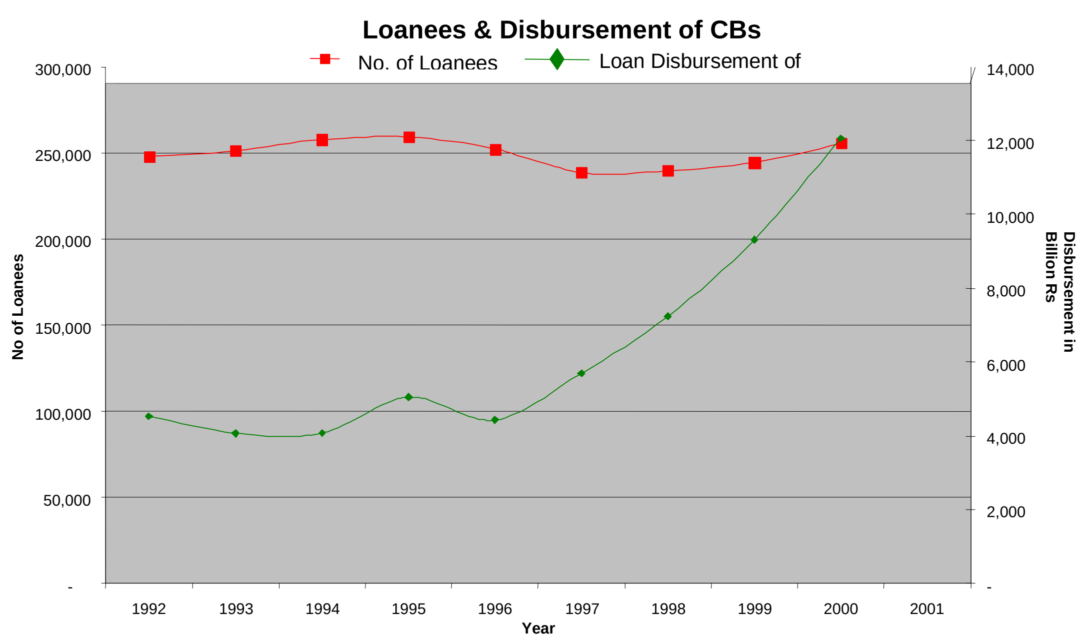
The CRF has tried to further investigate the status of availability and the coverage of Agriculture Credit by taking a different approach. Instead of using the traditional measure of credit access by the **volume** of credit, the CRF has approached the issue by using the **actual number** of beneficiaries of institutional agricultural credit and comparing the number of beneficiaries with the potential number of clients using the agricultural census and other sources of statistics on the number of farms and farmers operating in rural areas.

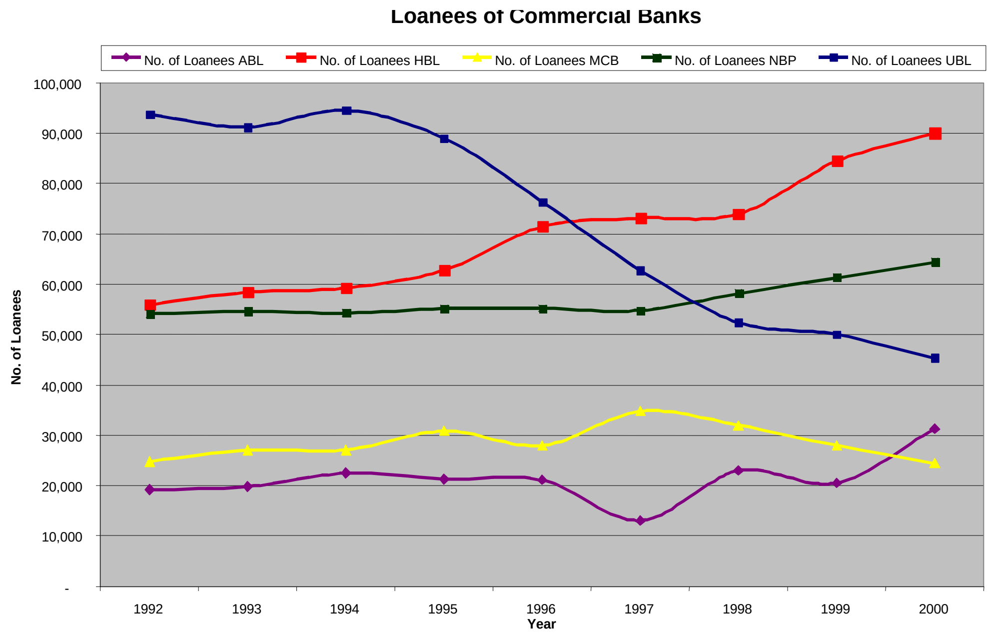
The picture presented by this alternative measure turns out to be even more dismal than that shown by the traditional method. This highlights the problem of lack of equity in the actual spread of agricultural credit achieved so far.

2.3. <u>Commercial Banks:</u>

Although in volume terms agricultural credit by CBs rose from Rs. 4.5 Billion in 1991-92 to Rs. 12.06 Billion in 1999-2000, the **number of clients** has stagnated around the 250,000 mark for the entire period. It was 248,000 in 1999-92 and 255,000 in 1999-2000. (Annex-Ib)

Individual banks have had experienced substantial fluctuations in the number of borrowers (Annex-Ic and Id). However, the clients dropped by one bank seem to have been picked up by another bank.

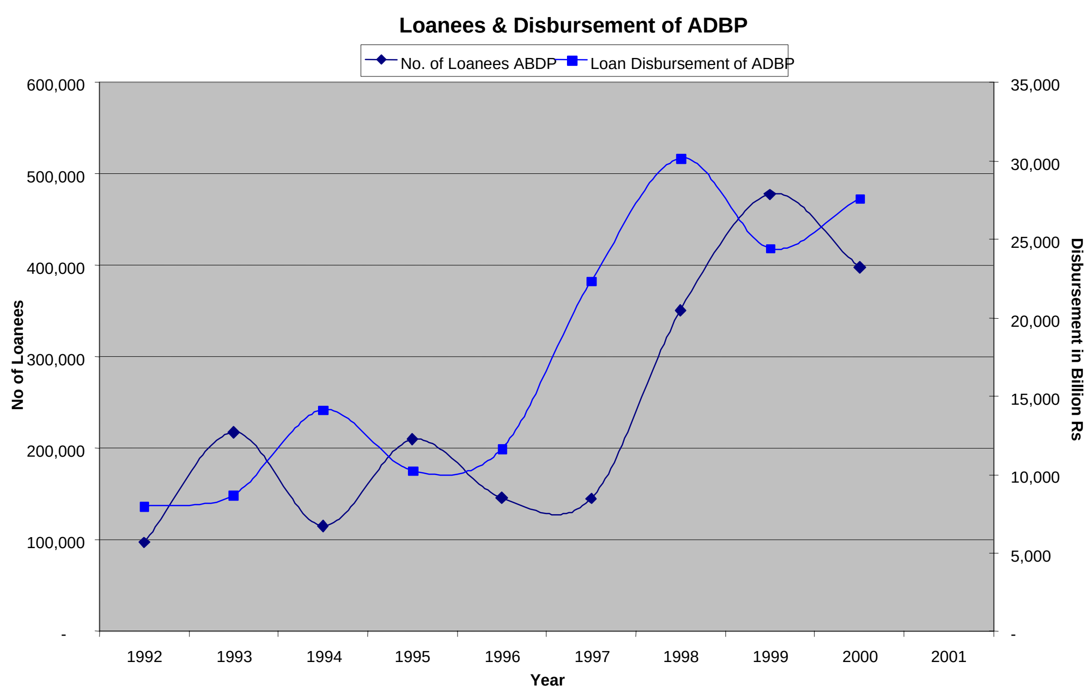




The glaring conclusion is that all CBs have only been focusing on a very narrow base of farmers, presumably the more influential and better off among the farming community.

2.4. <u>ADBP:</u>

ADBP shows a different pattern with the number of clients rising from 97,655 in 1991-92 to 397,660 in 1999-2000 while the volume of annual credit disbursed rose from Rs. 7.99 Billion in 1991-92 to Rs. 27.61 Billion in 1999-2000.



The interesting thing to note is that ADBP served between 150,000 to 200,000 clients annually prior to 1998. The number dramatically increased from 145,671 in 1997 to 351,126 in 1998. This quantum jump was mainly due to the "One Window" agricultural credit operation organized by the Punjab Government, which considerably simplified the agricultural credit system by issuing Agricultural Passbooks and sanctioning loans in one day at one geographical location.

The combined number of clients of all CBs, ADBP and Co-operative Banks came to 720,000 in 1999-2000.

NUMBER OF LOANEES	
ADBP	397,660
CBs	255,456
Co-Operatives	66,000
Total	719,116

Source: State Bank of Pakistan

It needs to be pointed out that the number of clients reported and the volume of credit disbursed relates to a 12-month period. During this time two complete crop cycles, i.e. "Rabi" and "Kharif", take place.
As nearly 80% of the Agriculture Loans are Production loans, i.e. payable at the end of each crop cycle, it appears quite probable that the figures include a significant amount of double counting.

The CRF has analyzed this issue of double counting of borrowers by using the statistics presented in the semi annual meeting of the Agricultural Credit Advisory Committee (ACAC) of the SBP held on 7th February 2002. According to these statistics the total number of clients borrowers in the half year 1st July 2001 to 31st December 2001 comes to only 435,334 (Annex– 1 j) compared to the annual figure of 719,000 in the year 1999-2000 (Annex-1-i). Clearly a significant element of double counting is present in the data on borrowers.

To find out the exact number, net of double counting, is a complicated exercise and would take an inordinate amount of time; therefore the CRF has taken a crude measure of number of clients / borrowers by assuming that at the very least 50% of borrowers in "Rabi" would also borrow in "Kharif". This is a very conservative assumption as clients of institutions who already possess Agriculture Passbooks etc. would be more inclined to borrow in each crop season.

The number of farmers availing all types of Agriculture Credit from all Banks in Pakistan can therefore be safely assumed to be no more than 577,000.

The total number of farms in Pakistan is 5.07 million according to the 1990 agriculture census (Annex – 2). If it is assumed that 75% are potential clients needing agriculture credit then the total potential customers of agriculture credit come to **3.8 million.**

According to this measure only 15% of farmers are availing institutional agricultural credit. This is exactly half of the coverage shown by the traditional measure of volume of credit.

Unfortunately, this may not be the true picture either. Agriculture Credit seems to have been hijacked by the large and influential farmers. The needs of these farmers are much more than the Individual lending limits assigned by the SBP from time to time. Therefore, to circumvent this policy, it is common knowledge that large farmers borrow from ADBP and CBs in the name of their "Haris" and servants and family members. The manipulation of the revenue record in collusion with local petty revenue officials is quite easy.

ADBP managers, in the feudal dominated areas of Pakistan, routinely keep private diaries which show the record of the loan portfolios actually borrowed by local feudals or other influentials/land owners. A diary will therefore show the following.

- Mr. X — Total borrowing - Rs. 5 million
  Number of cases - 650

- Mr. Y — Total borrowing - Rs. 9 million
  Number of cases -1,000

2.5. Punjab Economic Research Institute (PERI) study:

PERI conducted a study "Flow of Commercial Banks Agriculture Credit" in 1986 on behalf of the Pakistan Banking Council. Some of the main findings of the study are given below:

a. Out of the sample loans, 35% were proxy and fictitious loans and 65% were 'loans actually got'. Out of the later category, 7% were family loans.
b. Out of proxy loans (i.e. 35%), 25% were 'disguised proxy', 5% each of 'proxy at will' and 'straight proxy'.
c. Out of 'loans actually got' (i.e. 65%), 23% were genuine loans, 22% with area over reported and 20% with area under reported.
d. Main beneficiaries of proxy loans were landlords who got 77% of the loans.

The obvious conclusion is that the already dismal picture in which only 15% of farmers have access to loans is actually much worse than that figure.

2.6. Savings Mobilization

In Pakistan, national savings at 13.9 percent of the GDP (mp) are low as compared with the countries at similar stage of development. Banks are a major mobilizer of financial savings in he country. In the absence of rural-urban break-up of savings, total bank deposits and their rural-urban distribution have been used as a proxy. Rural areas contribute 20.5 percent of total bank deposits and these are largely used for lending in urban areas. This is true of even new banks which were given licenses in the early 1990s, specifically to have headquarters in relatively small and far-flung cities to reduce the concentration of banking facilities in the country. There is lack of institutional channels for savings in the rural areas. As a result, people in rural areas invest their savings largely in livestock. Small farmers and landless rural families keep small number of livestock animals as saving and insurance to take care of unanticipated events and social ceremonies. However, investment in livestock as saving and insurance is vulnerable to a number of hazards and uncertainties.

Saving potential in rural areas is quite large. The RSP experience shows that even the poor and poverty stricken people of Pakistan do possess the natural propensity to save. What is required is appropriate environment including adequacy of commercial banks branches and other avenues of investment.

2.7. Post Offices

Post Office Saving Banks, with a widespread network of offices, are not only mobilizing financial savings in rural areas but are also looking after a segment of problem of payments system in the country. Also, Post Offices are very active in providing postal life insurance at a comparatively economical rates. The Post Office Savings Banks handle about a million clients with total deposits of Rs.34 billion. The main source of Post Office deposits are Rs.8.50 billions in pensions. Also, Post Offices handle Rs.9.34 billion of home remittances every year. At present, Postal Life Insurance covers 222,000 individuals annual with premium income of Rs.51.4 million. Because of their widespread network, their traditional image of credit-worthiness and relatively economical insurance products, Post Offices have the potential of playing still greater role in mobilizing savings, extending life insurance facilities and further improving the payments system.

2.8. Insurance

There are two types of insurance relevant to rural areas, namely, crop insurance and life insurance. Crop insurance has been tried in various countries but with little success because of vulnerability of the sector to a host of hazards. On the other hand, life insurance has made inroads to rural areas.

In Pakistan, insurance companies were nationalized in 1972 and were merged in the form of one company. As a result, State Life Insurance Corporation of Pakistan is the largest life insurance company in Pakistan with 80% of the total premium income. In 1992, private life insurance companies were again allowed to operate. As of now, there are four major insurance companies: 1) State Life Insurance Corporation of Pakistan serving 150,000-200,000 individuals a year, 2) EFU selling life insurance policies to above 20,000 individuals a year, 3) Metropolitan Life Insurance and 4) American Life Insurance Company.

The life insurance coverage of the total population in Pakistan at only 8% is rather low. The life insurance market in Pakistan comprises Group Insurance and life insurance. Group Insurance business is two thirds of the total market while one third is individual life insurance. There are clear indications that insurance business in rural areas is growing and one company, namely, EFU Insurance has shown strong presence in the rural areas in Sindh. Bulk of the rural customers are providers of agricultural services like Artis, small traders and shopkeepers. The available information and data indicate that there is a large market in rural insurance and can be tapped with innovative approaches.

3. Rural Credit Market – a profile:

3.1 It is not an easy to gather statistics on the actual amount of rural credit in Pakistan as banks do not show that credit by rural and urban areas. The CRF has requested commercial banks to bifurcate their branch network in to rural and urban sectors. The CRF has then taken the advances from each sector and used them as an estimate of the rural – urban credit divide.

The rural credit market can be broadly segmented into the following:

3.1.1. Agriculture commodity primary processors like Ginners, Rice shellers, FlourMills, etc who are being substantially financed by Commercial Banks.

3.1.2. Agriculture service providers such as “Aarties”, agriculture input dealers and shopkeepers who are being very sparsely serviced by institutional finance and depend primarily in their own cash capital.

3.1.3. The non-poor and better off farmers which are being serviced by existing institutions like ADBP, Commercial Banks (CB’s), Co-operative Banks, etc.

3.1.4. The poor landless or small landholding farmers, who do not possess the necessary collateral to access institutional credit, are dependent on a handful of NGOs providing collateral free Micro Finance or the informal sector lending at rapacious interest rates.

The major CBs in Pakistan had a total of 6,696 branches as of 30th June 2001 (Annex-IIb). Of these, 3,183 or 47.50% were classified as rural and the balance i.e. 3,513 or 52.50 % as urban bank branches. The volume of advances in the urban sector came to Rs. 362 billion which means average advance per urban bank branch was Rs. 103 million. In the rural sector advances were Rs. 21.5 Billion showing the advance per branch at Rs.6.75 million.

Advances of rural branches are therefore only 5.6% of total advances.

Commercial Banks Urban-Rural Profile

CBs	Rural	Urban	Total
Branches	3,183	3,513	6,696
Deposits (Billions)	Rs 159.00	Rs 582.00	Rs 741.00
Advances (Billions)	Rs 21.50	Rs 362.00	Rs 383.50
Advances as %age of Deposits	13.44%	62.27%	51.77%
Branch Profile			
Deposits / Branch (millions)	Rs 50.00	Rs 165.00	Rs 111.00
Advances / Branch (millions)	Rs 6.75	Rs 103.00	Rs 57.30

Source: *State Bank of Pakistan as of 30-06-2001*

The first segment and part of the second segment of the rural credit market are the ones that are availing the bulk of the rural credit advances of Rs. 21.5 Billion. Needless to say, even this more sophisticated type of rural credit customers are not being adequately serviced while the latter two segments remain the most deprived in the matter of credit provision.

a) <u>The “Aarti” Market (Informal Credit Market):</u>

The neglect of the rural finance market by the CBs is best shown by their lack of interest in pursuing what the CRF has named as the **Agriculture “Aarti” Market.** The entire marketing of agriculture produce is conducted and facilitated by a chain of “Aartis” or wholesalers all over Pakistan. These “aarties” range from really small operators in small rural villages all the way up to the rich, large “aarties” running licensed shops in the fruit and vegetable markets in all big cities of Pakistan.

The CRF interacted with “aarties” from all provinces of Pakistan. “Aarties” were invited to a meeting of the CRF at Karachi. In addition, separate meetings were held in all provincial capitals where a broader cross-section of “aarties” was heard.

The most surprising point that came out of these meetings was an almost complete disconnect between the “aarties” and the CBs. It should be remembered that although these “aarties” deal with rural produce they live, operate and conduct their regular business in an urban setting. In spite of this, CBs have remained shy of aggressively developing products catering for the “aarties” financial needs. The majority of such “aarties” are men of means with considerable assets at their disposal that could be used as collateral. Apart from a few very large operators, most said that they would welcome bank financing as a means of increasing their turnover but were wary of bankers mostly due to their perceived complexity of obtaining and operating bank credits.

One of the amazing anecdotal evidences to come out of these meetings was that in the vegetable and fruit market of Lahore, in which Billions of rupees of business is conducted every day and through which the entire agriculture produce consumed by the population of Pakistan’s second largest city changes hands, CBs have actually closed existing branches terming them “unprofitable”. Such a logic stretches the commonsense a little too much. The CRF refused to believe that a bank branch in a market, with millions of rupees in daily transaction, could not have been profitable if a genuine effort had been made by the bankers.

The CRF is of the view that disconnect between CBs and “aarties” is highly damaging. Redressing this shortcoming is a promising way of increasing scope of rural finance. CBs from their existing urban branch network can easily extend lending activities to commission agents by modifying their lending procedures. The “aarties” are acting as lenders in the rural finance sector by giving out credit to their regular customers from their own funds. Increased availability of funds at their disposal could actually lead to wholesaling of rural finance by “aarties” to the rural sector.

The CRF also holds the view that this type of lending would specially benefit the small farmers in the long run as the total supply of credit available for small farmers would increase significantly and would put a downward pressure on the interest rates being charged by the informal sector.

The CRF strongly feels that the CBs are ideally situated for this type of credit and should come up with a focused plan to fully exploit this segment of rural finance. Success in this endeavour would ultimately bring a large part of the informal finance sector into the formal institutional finance sector which would have multiple benefits for the economy of the country.

The outcome of discussions with “aarties” showed a strong willingness on their part to access institutional credit against collateral provided a running finance product is available to them which gives them maximum flexibility.

3.2. Agriculture Credit:

3.2.1. Agriculture Development Bank of Pakistan (ADBP)

Agriculture Development Bank of Pakistan (ABDP) has long been the most important flag bearer of agricultural credit. A detailed discussion and analysis of its performance has been attempted.

a) Its past and present performance.

The history of ADBP reads most like a case study on how not to run a bank, especially an agricultural bank. In fact, ADBP has never operated as a Bank. It has been used only as a “Disbursing Agency”. Throughout its long history, policy makers have never sought to make it operate as an actual Agricultural Rural Bank.

Historically, ADBP has also been used as a subsidy delivery vehicle by successive governments, lending to its client at below market interest rates.

The natural result of subsidized lending was that CBs were precluded from the developing rural/agricultural credit market as a financially viable activity when the interest rate subsidy provided by ADBP made it attractive for large influential farmers to borrow from ADBP.

To make matters worse, ADBP has been mostly run as just another Government Department rather than as a Bank with the Finance Ministry making decisions rather than the Board of Directors of ADBP.

A write-up on the ADBP’s historical relationship with SBP, written by Mr. Ashraf Janjua, Economic Advisor to Governor State Bank of Pakistan, is attached as Annex – IV).

ADBP’s financial statements dated 30^{th} June 2001 are attached as Annex-IVa. The Salient features are given below:

i. Of its total lending of Rs. 93.97 billion a hefty sum of Rs. 30 billion has been provided; of which Rs. 13.33 Billion is in the form of principal and the Rs. 16.67 Billion is interest.

ii. Of the current outstanding advances-net of provision of Rs. 63.97 Billion, Rs. 34 Billion or 55% are 5 years and older. Advances of up to one year are only Rs. 17.3 Billion or 27%. (Financial Statements dated 30th June 2001 – Annex - IV a)

iii. Continuous overstaffing at all levels and a complete disregard of efficiency has resulted in ADBP operating cost reaching a huge figure of Rs. 2.6 Billion. This is primarily made up of salaries, wages and related items.

iv. The committee would also like to point out that ADBP actually reaches a very small number of farmers. Data on the number of clients on an annual basis for the last ten years are shown below. It is also pointed out that these figures are on an annualized basis, i.e. the number of loans disbursed in a year. As 80% of ADBP loans are production loans recoverable in six months it is entirely possible that regular ADBP clients are borrowing twice a year and are being double counted. This is also reflected from the statistics for the first half of the year 2001-02, wherein the total number of loans disbursed is only 229,488.

No. of Loanees ADBP

Financial year	No. of Loanees ADBP	Loan Disbursement of ADBP (Billions)
1992	97,655	7,985
1993	217,832	8,702
1994	115,454	14,138
1995	210,149	10,254
1996	146,147	11,655
1997	145,671	22,354
1998	351,126	30,171
1999	477,830	24,424
2000	397,660	27,610

Source: State Bank of Pakistan

Total Borrowers & Disbursements for Farm and Non-Farm Sectors

Bank	No. of Borrowers			Disbursement		
	Pakistan	Punjab	%age	Pakistan	Punjab	%age
ABL	13,492	3,573	26.48	641.299	189.913	29.61
HBL	41,543	24,555	59.11	2,180.763	1402.934	64.35
MCB	23,940	1,706	7.13	1372.058	788.663	57.48
NBP	83,174	70,254	84.47	2,983.170	2183.069	73.18
UBL	2,754	1,783	64.74	949.344	484.012	50.98
Sub-Total	**164,903**	**101,871**	**61.78**	**8,126.634**	**5048.591**	**62.12**
ADBP	229,488	182,053	79.33	12,885.097	9183.315	71.27
FBC	40,011	40,011		708.800	708.800	
Bank of Punjab	932	932		118.247	118.247	
Total	**435,334**	**324,867**	**74.62**	**21838.778**	**15058.953**	**68.96**

Source: ACAC meeting Feb 2002
State Bank of Pakistan

v. In spite of these inefficiencies, the amazing thing is that ADBP remains a basically highly profitable institution. The main reason is the highly subsidized funds made available to ADBP by the State Bank of Pakistan (SBP). The financial statements, given in the Annexure 4-a, show that while ADBPs' yield on total advances is 15.5%, its cost of funds is only Rs. 2.77 Billion for advances of Rs. 63.97 Billion. Therefore the real cost of funds of ADBP is only 4.5 %.

This results in an available spread of 11.1%. Even after paying for its huge operating cost which are 4.15% of total advances, ADBP has a potential profit of 7% of advances or Rs. 4.48 Billion.

vi. Unfortunately, provisioning and write offs consume the entire profit generated from the interest the bank has received from its current clients.
This is most blatant example of good clients paying for bad clients and ADBP's operational mistakes.

vii. Up to 1998, ADBP's cumulative provisions were Rs. 9.135 billion, Rs. 1.136 billion in the 1998-99, Rs. 2.638 billion in 1999-2000 and Rs.3.671 billion in the year 2000-2001. Cumulative provisions up to 30th June 2001 now stand at Rs. 13.61 Billion.

viii. The new management of ADBP has initiated a portfolio audit which should have been available by the 30th of June 2002. The bank will be in a better position to determine the level of future provisioning that will be required. However, one can safely assume that in the light of provisioning of Rs. 7.445 billion since 1998, the existing portfolio of the ADBP must be a lot cleaner presently.

All the ills of ADBP cannot be blamed on the past managements alone. A disturbing statistic is the recovery percentage of current loans which has stayed around a dismal 70% in the last 5 years (showing on next page). Obviously, no financial institution can hope to survive if a full 30% of its loans are not recovered on time each year. The current management has done good work in boldly highlighting the problems of ADBP and seeking to solve them professionally (see Chairman ADBPs paper on Post Re-structuring Scenario Annex – IVc). The immediate challenge before the new management is to ensure that the recovery position of the latest year, i.e. 2002 or even in the coming 2003, stays above 95%. The pertinent point to note is how does the management propose to improve recovery performance if they cannot ensure over 95% recovery of current loans *which are being approved by the new and restructured management?*

Note: Financial Statements dated 30-06-2002 have also become available. (Annex Iva) These also show more of the same pattern except that an extra-ordinary amount of Rs. 2.85 billion has been charged to expenses under the head of "Provision for employees post retirement medical benefits."

Good clients, therefore, continue to pay for ADBP's post operational mistakes.

ADBP Status

SBP Loan	51	48	48	46	42
GOP Loan	11	11	11	11	10
Equity	5	5	5	3	7
Net Advances	64	62	62	52	51
Disbursement	28	24	30	22	12
Recoveries	32	30	26	19	15
Current Dues Recovery	73%	71%	70%	70%	65%
Principle Repayment SBP	1	NIL	NIL	NIL	NIL
Return on Equity	Loss	5%	36%	Loss	3%
Source: ADBP Action / Business Plan May 22, 2002					

3.3. Commercial Banks:

The record major rural finance failure is traced to the dismal performance of CBs. With 3,183 rural branches compared to just 346 branches of ADBP, the burden of satisfactory performance and of reaching to the rural finance sector in a comprehensive manner aand in a meaningful way has always been and will always be the primary responsibility of CBs. Unfortunately, the nationalization of CBs in 1972 aborted the natural development of the CB Sector.

However, other reasons, rooted in an elite urban culture, have also played a role in the lack of attention paid by the CBs to the rural sector.

The decision-makers and the professional bankers in our country are highly urbanized. They are most uncomfortable in dealing with rural problems in a meaningful manner.

This cultural complexity has been further compounded by a single-minded focus on industry to the detriment of agriculture that has been the hallmark of policy-making beginning in the 1960s and continuing till the early 1990s. For most of this period, resources were continuously transferred from the rural to the urban sector using coercive economic policy. **The cotton farmers of Pakistan were forced to suffer a huge income loss when domestic prices of cotton were kept 40% below the international prices by imposing an export duty on raw cotton.** ***<u>The powerful Textile spinners managed to receive one of the biggest and longest subsidies ever at the cost of impoverishing millions of poor cotton faarmers</u>*** **The wheat farmers of the country were made to subsidize the urban consumers from 1947 to 1999,** as the Government had denied them a level playing field by putting restrictions on the physical movement of wheat from surplus areas and by fraud and coercive procurement of wheat at low prices. The same story was repeated for rice. Measures other than low and depressed commodity prices for the agricultural commodities were also at play in transferring resources out of agriculture. The major instrument used in this context was the highly overvalued currency resulted from a protected industrial sector.

An adverse outcome of the major transfer of resources from agriculture to the industrial sector had led CBs to concentrate a disproportionate share of their business in a few large cities and industrial clusters. A massive 80% of total advances by all CBs are concentrated in just 7 cities. An astounding 64% of total advances are concentrated in Karachi and Lahore alone. In view of high guaranteed profits, banks decided to operate mainly in urban areas as they could make money without much difficulty.

City Wise Advances – Deposits (Rs. In Million)

30/6/2001

City	Advances	Deposits	% age Advances	% age Deposits	Advances as % age of Deposits
Karachi	335,130	375,840	38.78%	29.45%	89.17%
Lahore	218,015	176,670	25.23%	13.84%	123.40%

Islamabad	40,957	116,897	4.74%	9.16%	35.04%
Rawalpindi	25,979	54,140	3.01%	4.24%	47.98%
Peshawar	14,710	36,389	1.70%	2.85%	40.42%
Sukkur	2,945	28,490	0.34%	2.23%	10.34%
Faisalabad	38,241	27,267	4.42%	2.14%	140.25%
Sialkot	8,010	20,303	0.93%	1.59%	39.45%
Multan	21,229	16,595	2.46%	1.30%	127.92%
Quetta	3,063	13,905	0.35%	1.09%	22.03%
Gujranwala	4,749	12,895	0.55%	1.01%	36.83%
Hyderabad	8,009	11,867	0.93%	0.93%	67.49%
Mirpur (AK)	5,095	10,945	0.59%	0.86%	46.55%
Sargodha	2,173	7,000	0.25%	0.55%	31.04%
Sahiwal	2,053	4,821	0.24%	0.38%	42.58%
Bahawalpur	2,346	3,801	0.27%	0.30%	61.72%
Sheikhupura	1,694	3,318	0.20%	0.26%	51.05%
Haripur	1,519	3,146	0.18%	0.25%	48.28%
Rahim Yar Khan	1,776	3,082	0.21%	0.24%	57.62%
Mardan	1,137	3,047	0.13%	0.24%	37.32%
Total – 19 Cities	738,830	930,418	85.49%	72.91%	79.41%
Others	125,431	345,678	14.51%	27.09%	36.29%

Source: *State Bank of Pakistan*

The CRF had analysed the behavior of the new private CBs which have been given licenses in the last decade. In this period, the SBP had deliberately attempted to geographically disperse the headquarters of the new licensee banks in an effort to broaden the base of banking in the country. Unfortunately, this effort has also come to naught as these banks have again managed to concentrate a greater proportion of their business in the traditional industrial urban centres.

The CRF also looked at concentration of credit of individual banks including newly licensed private CBs.

Bank Al-Habib, headquartered in Multan, *manages to have* 85% of its advances in Karachi and Lahore alone and 96.5% in just four cities.

Askari Commercial Bank, headquartered in Peshawar, has 91% of its advances in just 6 cities.

Bolan Bank, headquartered in Quetta, has 88.6 % of its advances in 5 cities excluding Quetta and just a little over 2% in it's headquarter city of Quetta. (Annex – V)

The CRF had further looked at the Advances and Deposits of CBs broken down on a district-wise basis (Annex – V b)

Profile of two Rural Branches

Habib Bank, Jamal Din Wall	
Population of Jamaldinwali	13,000
No. of Depositors	2,899
Deposit up to 30-6-01 (millions)	24.640
Advances (millions)	9.286
Loanees	77
Staff	6
Profit year ending 30-6-01 (million)	2.1
Ave. Size of deposit	8,500
Ave. Size of advance	120,000
National Bank of Pakistan, Naushero Feroz	
Total staff	12
Advances (millions)	20
Deposits (millions)	60
Depositors	6,000
Profit (millions)	0.50
Ave. Size of deposit	10,000
Ave. Size of advance	100,000
Branch opened in 1975 – closed 2001	

Source: *Data requested from respective bank branch*

The data reinforce the extreme concentration of advances of the commercial banking sector. The data on deposits in rural branches demonstrate that rural savings are available inspite of low bank presence in rural districts.

While the Committee on Rural Finance (CRF) was deliberating on its Terms of Reference, a positive change took place in the banking sector including the sanctioning of new banks and liberalization of regulation, to enlarge the scope of operation of banks. State Bank of Pakistan must continue its current efforts of making the banking sector more competitive so that adequate resources become available for rural finance.

NCBs are in the process of shutting down a significant number of rural branches. In some cases, these branches are showing profits but are still being shutdown as their profits compare unfavorably with urban branches. Profiles of two rural branches obtained by the members of CRF are shown in Annex – 5 – c. The CRF feels that the policy of closure of bank branches is not justified for the financial health of the banks. The closing of bank branches has further aggravated the dearth of banking facilities in the rural areas even more acute.

All these branches, being already profitable, could be made even more profitable if a serious effort was made by the managers of these branches.

3.4. The Micro Finance Sector:

The Micro Finance Sector services the need of the "poor" segment of the Rural Finance market i.e. households who either do not possess the collateral necessary to obtain institutional credit or even when they do possess a few acres of agricultural land, it is not sufficient to guarantee them the access to credit on the required scale.

The CRF has tried to establish the potential of the Micro Finance market in Pakistan in the following manner:

3.4.1. The rural population of Pakistan comes to 94.90 million.

3.4.2. Using an average of 7 individuals per household, the number of households come to Rs. 13.56 million.

3.4.3. Poor rural households are calculated at 1/3rd of the total households. The number of poor households comes to 4.53 million (Annex - VI).

3.4.4. The CRF conservatively assumes that 60% of these are the **potentially accessible Micro finance clients.**

3.4.5. The CRF further assumes that for the "poor" segment **two individuals per household (male & female) are potential clients.**

3.4.6. Therefore, the potential clients of rural micro finance in Pakistan number 5.44 million.

<u>Note:</u> *The planning commission of Pakistan has recently carried out an exercise to define the poverty threshold in the Pakistani Context. According to them the poverty line has been demarcated at an income of Rs. 650 per month. Individuals with incomes of less than Rs. 650 per month are defined as living below the poverty line. The Planning Commission estimates that 28% of the population of Pakistan currently exists beneath this newly defined poverty line.*

The list of the approximate number of people who have been accessed by Micro Finance institutions in Pakistan as on 30-6-01 numbers only 147,000 individuals.

Number of Clients of Microfinance institutions as of 30th June 2001

National Rural Support Programme	58,422
Punjab Rural Support Programme	34,699
Agha Khan Rural Support Programme	24,000

Khushhalli Bank	13,020
Sarhad Rural Support Programme	7,534
Others	10,000
Total	**147,675**

The real growth in the number of people with access to credit in this sector is being carried out by two institutions.

The first is the Pakistan Poverty Alleviation Fund (PPAF). The PPAF has been set up by the GOP as an autonomous body to administer a World Bank $100 million poverty alleviation fund which is designed to be spent through NGOs rather than Government Agencies. The Micro Credit portion of the fund is $ 45 million. The PPAF has done excellent work in not only supporting existing Micro Finance Institutions like NRSP and AKRSP but also by nurturing and supporting at least a dozen smaller NGOs by building their capacity and providing funds to these NGOs for Micro Finance at 6% and 10% for onward lending to the poor.

The Khushhali Bank

The other institution is the Khushhali Bank. This bank has been set up under the Asian Development Bank Micro Finance Sector Development Programme. The main features are:

a) Creating a conducive policy environment.
b) Developing appropriate financial infrastructure.
c) Developing linkages with NGOs and Community Organizations.
d) Investing in building social capital.
e) Mitigating risks of poor households.

This is a welcome initiative. It correctly targets the weakest and the poorest population of the country.

The Khushhali Bank has the following main features:

a. Paid-up capital of Rs. 1,705 million contributed by 16 Commercial Banks including two foreign banks.
b. Major shareholders are NCBs.
c. Branch network extends to 27 districts.
d. Micro-credit was disbursed at Rs. 278 million (approx.) to 30,739 borrowers. (Annex – VIa)
e. Average loan size is Rs. 10,000/-.
f. ADB credit line is equivalent to US$ 68 million.

The CRF, taking note of the history of ADBP and the way it became top heavy, bureaucratic, highly expensive, allowed agriculture credit to be hijacked by the better off and influential farmers and consequently failed to fulfill its designed purpose, would like to emphasize a note of caution for the Khushhali Bank. With a branch network in 27 districts and with only approximately 30,739 borrowers,

the bank seems to have too wide a geographic spread with too few clients per district. Unless the number of clients increases significantly, the Bank will be in serious danger of becoming too top heavy like ADBP.

The CRF has noted that the data provided on the Khushhali Bank to the SBP (Annex – VIb) shows that the number of its clients stood at 11,214 on 30th June 2001.

This number has increased to 30,739 as of 31st March 2002, a net addition of only 19,525 clients in 9 months of operations in 27 districts.

It could not be ascertained if these figures also contain an element of double counting as was the case with ADBP and CB's agricultural credit. For instance, it needs to be clarified how many of the 11,214 borrowers as of 30th June 2001 may have since repaid their loans and got repeat loans and were counted in the number of borrowers in subsequent months. If this is happening then the actual number of borrowers reached by the Khushhali Bank may be even lower than reported.

The RFC did not have access to any financial numbers or the business plan of the Khushhali Bank apart from the information given above. We assume that the Khushhali Bank's operations are based on a well thought out business plan with a break even client number which will be achieved in the near future. However, if branches have been opened on demands of local power elites or without a rigorous cost / benefit analysis then there is an extreme danger of Khushhali Bank following the ADBP route.

It should always be remembered that ADBP was for many years the favorite of the Donor agencies also. Many millions in credit lines were given to the Bank for onward lending to the Agriculture sector. For a long time the results looked very rosy but the rot had set in much before it came to the notice of policy makers.

Too often the desire to declare a new initiative as a success has led to the demise of that very initiative.

An update on the provision of rural micro finance services by RSPs written by Dr. Rashid Bajwa CEO-NRSP is attached as Annex – VIc.

3.5. Co-operative Finance Sector:

The Co-operative sector was sustained by an enormous subsidy from the SBP from 1985 to 2001. The SBP would lend to the Federal Co-operative Bank at just 0.5%. The Federal Bank would keep a percentage-based fee and pass on the subsidized funds to Provincial Co-operative Banks. These would then on-lend to the Co-operative Societies established in the provinces and registered and regulated under the aegis of the Provincial Co-operative Societies Department at a considerable profit (8% - 10%). A write up on the history of the Cooperative Banking Institutions and their relationship with SBP written by Mr. Ashraf Janjua, Economic Advisor to the Governor SBP and the Secretary of the CRF, is attached as Annex – VII.

The whole system of cooperative credit became mired in inefficiency, corruption and outright fraud. Everybody connected to the subsidized credit tried to use whatever local power and influence was available to enjoy a free drink from the subsidized tap provided by the SBP subsidy.

The Punjab Economic Research Institute (PERI) conducted an evaluation of the Co-operative Credit Programme in Punjab in August 1986 (Annex-VIIa).

Its main findings were:

i. One man co-operative societies were found to be 35%
ii. One family owned co-operative societies were 39%.
iii. Totally bogus co-operative societies were 22%.
iv. The genuine co-operative societies were only 4%.

Another study entitled "A Study of the Semi Formal Financial Institutions (Co-op Credit)" was carried out by PERI in December 1997 for the SBP in collaboration with IDA. The executive summary of the study is enclosed as Annex – VIIb.

The salient features of its findings are:

i. As per estimates of the Subsidy Dependence Index (SDI) which measures the percentage increase in the financial institution's average on-lending interest rate required to fully compensate for the elimination of subsidy, the Punjab Provincial Bank was heavily subsidy dependent. It would have to increase its on-lending interest rate to 25% instead of 14% at present to fully eliminate the subsidy in 1994-95.

ii. By including the reserve requirement, the situation is worsened in the same year with SDI computed at 120.4% in 1994-95. This indicates that the Punjab Provincial Cooperative Bank would have to increase on-lending interest rate in this year by 14.7%age points of adjusted rate, i.e. from 14% per annum to 29%, if the subsidy element in the interest rate is to be eliminated.

iii. In Punjab only 3.9% of the sample societies were genuine. About 35.3% of the sample societies were one man societies and 21.6% were fictitious societies, while 39.2% were family societies. In case of AJK, about all sample societies were one man societies. In case of genuine societies all the sample members reported availing credit facilities, while in case of one man societies 16.7% of the members of the respective societies were availing group based credit in Punjab. Only 49.2% of the interviewed members of the family societies availed credit.

iv. Responding to the question of who brings inputs in the village for members, 74.8% of the sample members in Punjab pointed out that they had never seen input (fertilizer) brought into the village and distributed among the needy members. In case of AJK, 45.2% of the sample members provided negative responses in this regard.

v. The main factor resulting in apparently efficient performance of the Cooperative Societies is the peculiar repayment strategy developed in both the study regions, i.e. Punjab as well as AJK. **The cooperative societies' loanees pay the interest and 2% to 3% of the principal amount depending upon the repayment duration and the interest amount to so-called input dealers who would pay the principal amount of the loan. Simultaneously, a new pay-order of loan is issued in the name of the agreed input dealer. This strategy is executed with the assistance of the front line worker of the Cooperatives Department, and apparently helps in presenting a better picture about the performance of the Cooperative Department, but in reality none or very few of the target group farmers may have been the beneficiary of the input supplies on credit for enhancement of agricultural production.**

vi. In Punjab about 74.8% and in AJK 45.2% of the sample members of cooperative societies were not provided the inputs through cooperatives. This happened, as the pay orders were generally converted to cash on payment of 5% of the amount indicated on the pay order, to input dealers. Thus, the input dealers were having thriving business without handling of inputs.

A report on the Co-op Credit system, prepared by Mr. Shaukat Durrani, current MD of the Federal Co-op Bank, is enclosed as Annex-VII.

A write up on the illegal "Co-operative Scam" written by Mr. Ashraf Janjua, Economic Advisor to the Governor SBP and Secretary of the CRF is attached as Annex-VIId.

The CRF finds it surprising that despite the two studies sponsored by the policy-makers, one in 1986 and the other in 1997, which showed that the bulk of the lending by the co-operative sector was to the non-genuine societies and was hijacked by the better off influential farmers and input dealers, policy makers did not connect the policy failures. The patronage continued as before.

There is little hope of this sector even playing a role in Rural Finance in the near future unless a comprehensive restructuring of the cooperative credit system is made. It is doubtful that this sector can make the difficult jump from being totally based on subsidies to the real world of market based interest rates.

4. Saving Mobilization

The National Savings rate for year 2000-01 is 12.7% and Domestic Savings Rate is 14.5 %.

Unfortunately, the break down of Domestic Savings Rate for the rural and urban areas is not available. Official Statistical Organization does not generate this information.

The CRF, again, depended upon the rural – urban classification of bank branches to provide some sectoral classification of savings.

The total amounts of CB's deposits as of 30th June 2001 were Rs. 741 Billion. Of these Rs. 159 billion or 21.50% were deposits in branches classified as rural branches.

Commercial Banks Urban-Rural Profile

CBs	Rural	Urban	Total
Branches	3,183	3,513	6,696
Deposits (Billions)	Rs. 159.00	Rs. 582.00	Rs. 741.00
Branch Profile			
Deposits / Branch (millions)	Rs 50.00	Rs 165.00	Rs 111.00

Source: *State Bank of Pakistan*

Deposits per rural branch came to Rs. 50 million and deposits per urban branch came to Rs. 165 Million.

This data clearly show that the rural sector is generating significant deposits on a national scale. The CRF, then, compared the ratio of advances – deposits in the rural and urban sectors which are detailed in Annex-IIIa.

The significant number is that whereas in urban branch sector 62.27% of total deposits went back as advances to the urban sector only 13.44 % of rural deposits went back to the rural sector as advances. Looking at it on a per branch basis whereas deposits per branch in the rural sector averaged Rs. 50 million advances averages a paltry amount of Rs. 6.7 million.

While the share of rural bank deposits in total deposits is significantly greater than the share of rural advances the institutional sector has by no means done an adequate job in accessing rural savings, especially those of small and medium size farmers or small and medium rural entrepreneurs.

In the absence of institutional outreach manifested by the lack of access to banks and the absence of savings products specifically designed for this market this segment has channelized its savings into the Livestock Sector. It is common knowledge that small farmers as well as landless rural families always keep a small number of livestock animals which are seen as a combination of savings and insurance.

The animals are used as savings when sold, i.e. liquidated to finance events like marriages, births and deaths etc. and are used as insurance when sold for purposes of financing catastrophic illness or used to survive in the event of crop or market failure. While this segment of the rural population has evolved this savings / insurance mechanism to cater for its unmet needs it is inherently an extremely inefficient way of savings. Apart from the fact that such Savings cannot be used to finance Investments in the national economic equation, it also has the following associated problems:

- Is highly inefficient in terms of milk and meat production. This is perhaps so as the prime purpose of investing in cattle is a means of savings and not income generation.
- It is vulnerable to disease and there is no Insurance Cover.
- Needs forcible sale at distressed prices whenever urgent requirements occur.
- Requires valuable agriculture land to be set aside for uneconomical fodder production.

With the right products and the correct methodology it will be possible to transfer these savings into bank deposits with far reaching positive impact on the national economy.

4.1. <u>The RSP Experience:</u>

Regular savings by the Community Organizations (COs) is one of the main pillars of the Rural Support Programme philosophy.

A write-up on Savings by RSP Community Organization members, written by Dr. Rashid Bajwa, GM, NRSP and the co-opted member of the CRF, is attached as Annex – VIb.

The number of COs with total number of members together with the Savings accumulated by each RSP is given in Annex – VIc.

What this proves is that even the poor, poverty stricken people of Pakistan do possess a positive propensity to save. Given an established programme of motivation and by establishing a simple linkage to existing commercial bank branches, the poor have demonstrated an amazing ability to save.

It needs to be pointed out that this is happening even in the absence of specialized savings products designed for this segment.

4.2. <u>Post Office Savings Bank:</u>

The Post Office Savings Banks handles 1 million clients with total deposits of Rs. 33.9 billion. Data on rural – urban division could not be made available. The CRF was informed that a substantial proportion of this figure consists of rural deposits.

The main source of Post Office deposits are the Rs. 8.50 billion in pensions and the Rs. 9,338 million in foreign remittances handled by the Post Office Department every year.

5. The Post Office

The Post Office operation falls within the definition of rural finance in three ways:

5.1. In the absence of an adequate Banking network, the Post Office handles the bulk of the rural payment system through its money order and foreign remittance system. The Post office handles Rs. 19.4 Billion worth of money orders annually. While separate figures for rural areas were not available, anecdotal evidence suggests that the bulk are indeed used in rural area. Basic data on Post Office infrastructure is given in Annex-VIII.

5.2. The Post Office is also an important element in gathering rural savings. The Post Office Savings Bank handles a million clients with total deposits of Rs. 33.9 Billion. Again data on the urban – rural divide was not available but the role and potential of the Post Office Savings Bank in mobilizing rural Savings is important. It can indeed be further strengthened.

5.3. The third most important Post Office activity is Postal Life Insurance (PLI). Currently, the PLI covers 221,909 individuals with annual premium income of Rs. 51.441 million. Again, figures on the rural – urban divide were not available and the extent of the PLI in rural areas could not be determined.

The fact that the Post Office activities impinge on three crucial aspects of rural finance and given the extensive rural infrastructure of the Post Offices and the large number of postmen active in the rural areas clearly point to the enormous potential of the Post Office department becoming a very important vehicle of rural finance.

The Annual Report of the Pakistan Post Office is attached as Annex-VIIIa.

Dr. Rashid Bajwa, General Manager NRSP, and a co-opted member of the CRF has written a report on innovative ways and means of using the Post Office department in the development of rural finance which is attached as Annex-VIIIb.

Another report by Dr. Zafar Altaf, a CRF committee member and former Federal Secretary Agriculture is attached as Annex – VIIIc.

The assets that the Post Office department brings to the rural finance universe are:

- A significant rural dispersion of its Post Offices.
- A large numbers of Postmen who are in the normal course of delivering the postal mail are physically reaching a large number of rural households; much more than any other institution.
- An ability to capture rural savings probably arising out of the large remittances and pensions handled by the Post Office department.
- The ability to offer Life Insurance products with a broad coverage of clients cost effectively.

6. Insurance

Crop insurance has been tried in various countries at various times but with little success. The fact that agriculture is at the mercy of Mother Nature and that it is always exposed to risk not only from the weather but also the unexplained and sudden flare up of insect pests, viruses, etc. for which risk assessment is almost impossible and actuaries tables cannot be prepared.

The only type of insurance that has made inroads into rural finance internationally has been Life Insurance. MFIs and other Rural Finance institutions internationally have begun to form partnerships with established Life Insurance companies to introduce Life Insurance to rural areas. (Reference: CRF meeting with Mr. Jimmy Roth of ILO, Geneva).

6.1. Life Insurance in Pakistan:

Up till 1972, there were 52 Insurance companies in West Pakistan and 36 in East Pakistan. Those in West Pakistan were nationalized in 1972 and merged to form one company. As a result the State Life Insurance Corporation is the largest in Pakistan with 80% of the total premium income. In 1992, private Life insurance companies were again allowed to operate in Pakistan. To date only four new companies have started operations which are:

6.1.1. EFU Insurance:

EFU has 60 % of the private sector business and sells life Insurance to about 20,000 individuals in one year

6.1.2. State Life:

State Life serves 150,000 to 200,000 individuals.

6.2. Metropolitan Life and American Life are the two other major players.

6.3. Post Office:

The other significant player in the Life Insurance market is the Post Office department which is discussed separately.

6.4. The Life Insurance Market:

Life Insurance coverage of the total population of Pakistan is only 8% which is a very low figure in the international context.

The Life Insurance market of Pakistan is divided into Group Insurance policies or Individual Policies. Group Business in which companies buy a Life insurance cover for their employees comprise two thirds of the total market. These policies are for only one year and are renewable and negotiable at the end of each year.

The remaining 1/3rd of all life insurance policies are Individual Life Insurance Policies.

- The average premium is Rs. 3,000.
- Historical average value of policies is Rs. 30,000 to Rs. 40,000.
- Currently the level has risen to Rs. 90,000 to Rs.100,000.

- The lack of a tax incentive in Pakistan which is available in almost all countries has considerably hindered the growth of the Industry. Moreover, life insurance premium is not a tax deductible item.

An interesting fact that came out of the Committee's meeting with Insurance companies is that Insurance in the rural areas is a growing business. Although hard figures of the rural urban divide were not available **all the company representatives reported evidence of a greater demand in rural areas for Life insurance which they attributed to the lack of competing saving products.**

EFU Life Insurance gave the committee some data which showed a strong presence in rural Sindh.

56% of their Life insurance Business is in the Sindh province but surprisingly nearly 30% of its clients are from rural Sindh; whereas 26% are from Karachi. The bulk of their rural customers are Agriculture service providers like "Aarties" or small traders and shopkeepers. (Annex – IX)

This evidence seems to strongly support the RFC's contention that savings are available in the rural areas but are not being tapped due to the lack of attention of the Banking sector.

6.5. Role of Insurance in Banking:

One of the most promising innovations in Life Insurance that has recently come about is called "Bancassurance". This is a French word and means the selling of insurance products by banks through their own distribution channels. "Bancassurance" has become well established in Europe as shown by the fact that the percentage of new life and pensions premium sold via banks in Spain has been 73% of total new business sold in 1999. This percentage has been 60% in France.

An article detailing the what and why of "bancassurance" written by Mr. Jamshed Islam of EFU Life Insurance is attached as Annex-IXa.

This innovative idea can be one of the means of attracting the rural savers to the formal banking network. The section on the recommendations of this report further shows how this idea can be used to mobilize savings.

7. Conclusions of the RFC summarized

7.1. The available data have clearly shown that all the Financial Institutions put together have singularly failed to cater to the needs of the Rural Finance Sector.

7.1.1. Agricultural Credit:

- ADBP has ended up serving mostly the privileged and the better off farmers. It has lost billions of rupees in its business in meeting the needs of the better off farmers.
- The Commercial Banks have ventured into the agriculture credit sector only reluctantly. They too have primarily dealt with a small number of better off farmers.
- Coo-operative Banks have played an even smaller role. The huge SBP subsidy has resulted in even greater hijacking of the agriculture co-operative credit by influential farmers.
- The result has been that only 30% of the requirement of agriculture credit has been met in **volume terms** and less than 15% in term of **number of borrowers**.

7.1.2. The reason for the low recovery rate of agriculture credit is not the result of an intrinsic dishonesty on the part of farming community. It is rooted in the agriculture finance institutions' inability to reach their real and stipulated target goals. The bulk of the agriculture credit has been hijacked by the influential and powerful farmers.

A secondary reason is the high transaction cost of acquiring loans due to unofficial payments that are required to be paid by the clients in the laborious and complex method of obtaining Agriculture Passbooks and agriculture loans.

7.2. Rural Credit:

7.2.1. The credit market in Pakistan is highly concentrated. It seems to primarily exist to service the urban and industrial needs.

A massive 80% of total advances are concentrated in just 7 cities.

7.2.2. The effort of the SBP since the 1990's to grant licenses for new private banks on a geographically dispersed basis have not succeeded. The new private CB's have turned out to have an even greater urban industrial bias as over 80% of their business is concentrated in just 3 or 4 cities.

7.3. The real problem is that the culture of banking in Pakistan is highly urbanized. It is industry-oriented. The owners, senior management and other bank officers are uncomfortable in rural settings and operating in or for rural markets. If they are comfortable in any activity in rural areas, it is only deposit taking.

7.4. The rural sector is capable of mobilizing savings far and beyond what is being captured by the formal sector at present.

Wherever and whenever an effort was made to induce people to save (RSPs) or when innovative or fresh products were offered (EFU Life Insurance in rural Sindh) the rural sector responded immediately and with fervor. This potential for saving in rural areas needs to be harnessed and can immensely benefit the national economy.

The lack of relevant saving products available to the rural sector has led the rural sector to concentrate its savings primarily in livestock rearings.

7.5. **The acute shortage of capital, the resultant exorbitant interest rates charged by the informal sector, the lack of appropriate saving products for the rural sector and the inability to reduce risk through appropriate insurance products has led to reduced farmer profitability and suffocation of rural entrepreneurial activity. As a result, the growth of existing rural activity has been severely constrained.**

The rural economy is mired in a vicious circle of low growth, low productivity, weak employment generation, rising poverty and abject helplessness.

7.6. There is a necessity to bring the diverse cultures and the linkages between rural and urban areas to function in a manner that the flow of economic factors could be evenly and equitably distributed between rural and urban areas. It is also necessary to induct rural commercial interests into the banking network to create a new culture in the banking sector. **There are ample cash holdings available with people who do not form a part of the formal financial sector. People with cash holdings need to be brought into the banking sector. The success of rural banking will only come about if people of means who are already involved in economic activity in rural areas become new banking entrepreneurs.**

7.7. **The local links and knowledge of the local terrain is a crucial factor. This has never been factored in previously in any study of rural finance. It is not surprising that the rural financing policies have been irrelevant.**

7.8. Government-run institutions have generally failed to be efficient. These institutions have consistently failed to achieve the targets conceived by policy makers for such lending institutions.

Appointing private sector majority boards to such institutions has not and will not solve the problem. As the private sector members of these boards are appointees of the government, they have no personal shareholding at stake. Furthermore they can be removed at will by the government.

Even if the current policy makers find and appoint the best possible individuals, the successive governments, with a different outlook, can easily revert to the policy of using these directorships as elements of political patronage.

7.9. **The CRF concludes that any new policy direction must stay clear of government owned and run institutions. The only alternative is to operate through the private sector financial institutions and independent Micro Finance Institutions.**

7.10. The Post Office remains perhaps the single most important institution in the delivery of rural finance to the rural populace.

Given that the Post Office is facing increasing private sector competition in its core activity of mail delivery, it is a natural evolution for the Post Office department to gravitate towards increasing its role in rural finance activities.

However, the CRF recognizes that the Post Office department remains a government-run institution with all the associated problems and baggage. It may not be possible to bring large-scale change to the Post Office unless the management is corporatized or made more autonomous as is necessary.

7.11. The potential of Life Insurance in the rural sector has not been tapped. A breakthrough can only be made by the creation of innovative linkages between existing Insurance Companies and the purveyors of Rural Finance.

7.12. Another major constraint is the absence of any permanent institutional mechanism which is able to understand, analyze and suggest policy initiatives for the furtherance of rural finance.

7.13. The CRF has observed that the greatest missing link is the absence of an institution to create synergies by combining the efforts of the various and diverse purveyors of rural finance by providing the necessary linkages.

8. Recommendations of the RFC

8.1 The Government of Pakistan should foster the development of a new set of Private Sector Rural Banks focused on providing a whole range of Rural Finance products for the exclusive benefit of the rural sector.

It should be done through an enabling law which could either be an amendment of the existing Micro Finance Ordinance or by enacting an entirely new specific Rural Finance Act.

8.1.1. The capitalization requirement in the Micro Finance Ordinance at present, has only the following three tiers:

8.1.1.1. Rs 100 million for a District License
8.1.1.2. Rs 250 million for a Provincial License
8.1.1.3. Rs. 500 million for a National License

It is suggested that a fourth tier with a capitalization of Rs. 125 Million be added for a Regional License. (The bank under this license should cover a minimum of 3 contiguous Districts).

8.1.2. It is necessary to define the concept of rural area in concrete and specific terms. A rural area should be defined as areas outside the municipal limits of major cities and/or industrial areas. A list of 20 largest cities / industrial centres for the distribution of industrial credit needs to be given. A rural bank must only be setup outside these areas.

However, within the defined rural areas there should be no bar on mobilizing the savings or the type of lending by the rural bank.

The bank may undertake any type of lending i.e. working capital for Agri-product processing factories, all kinds of credit for agriculture or non-agriculture small and medium enterprises, agricultural credit to farmers or flexible running finance products for “aarties”.

8.2. The CRF suggests that a set of additional incentives be provided to attract the private sector to set up the proposed rural banks.

Due to physical and geographical dispersion of the credit market, small size of average loan, penetration into a new market, development of new products etc. the delivery of rural finance will entail a higher transaction cost for the rural banks.

It is a well established fact that even successful credit institutions like the Grameen Bank, Bangladesh and the Bank for Agriculture and Agriculture Cooperatives, Thailand were not able to sustain their operations without subsidy and incentives in their lending rates.

The CRF recommends the following incentives. Additional incentives be added to the list of incentives in the light of experience with these incentives.

8.2.1. A subsidy of between 2% to 5 % on the loans advanced by a rural bank may be given depending on the local conditions the bank is operating under. A Bank operating in, say Central Punjab, should be entitled to 2%, Southern Punjab and Sindh 3-4% and Baluchistan and North Western Frontier 5%. However, some richer areas of these two provinces (Charsada, Mardan, Quetta etc) may be entitled to lesser level of subsidy. An economic criterion for the subsidy needs to be laid out to make the granting of subsidy transparent.

8.2.2. It is important that the subsidy provided to banks should be time bound and should be on a declining scale. The maximum time allowed for the subsidy to be eliminated should be no more than 5 years. The decline in the subsidy level should be on an annual basis i.e. it should decline by a pre-fixed percentage every year. The subsidy should be subject to an annual review. It can also be tied to targets of deposit mobilization.

8.2.3. Equity participation should also be available from the SBP as the effort is to attract a new breed of Banking Entrepreneurs who are comfortable in the Rural Culture and who bring the local knowledge of the terrain to the Banking sector.

8.2.4. A facility of up to 49% equity participation with pre-determined buy out terms should be available for those who want it. The SBP may place a proportional number of directors on the Board of the banks.

8.2.5. Instead of going through an exercise of finding the right directors every time they are required or to avoid using SBP officers as directors the SBP should prepare a panel or list of eminent professional persons who could be appointed as directors on the Board of Directors. They should be paid for their services as they can play an important role in the development of Rural Banks.

8.2.6. Trained manpower is not available in the rural areas. The SBP should provide training of staff hired by these Banks with a large element of subsidy. It is proposed that the cost of training should be shared on a 20/80 basis between the private banks and the State Bank of Pakistan.

8.2.7. Training of banking staff should be made mandatory as it helps in professionalizing the banks from their inception.

8.2.8. Introduction of upto date and appropriate technology is critically important in the successful operation of these newly setup institutions. This is so as new entrepreneurs are to be inducted into the rural finance market. Provision of appropriate technology, i.e. modern software for monitoring and control of rural loans must be ensured to the new banks on 50% subsidized basis.

8.2.9. Existing commercial banks should also be allowed to setup rural bank subsidiaries under the new dispensation. This would allow them to take a fresh look at their policy of closure of rural branches and will help in increasing access of the rural sector to banking services.

The main aim and objective of the proposed incentives for the banks is that new private sector and local rural entrepreneurs are attracted as providers of rural finance. Existing commercial banks need to be encouraged to spin off their existing supposedly less profitable rural branches in to new locally anchored rural banks.

At the same time a careful monitoring is needed to be maintained so that the incentives are not abused.

8.3. All current institutions active in the field of rural finance must enhance their role in their own individual ways.

8.3.1. ADBP:

After the effective restructuring of ADBP, preferably with private sector participation, the bank should open branches below tehsil level in an effort to get closer to the farming communities.

ADBP must turn itself into a real bank by mobilizing rural deposits and not remain dependent on SBP handouts.

8.3.2. Commercial Banks:

Until the Urban – Industrial market is fully saturated, CBs will not venture into the rural market. CBs continue to make more than adequate profits while remaining confined to the Urban – Industrial market.

The reason is the large spread available between their cost of capital and the interest rates they can charge.

The SBP must make efforts to open up the banking sector in such a way so as to make for a more competitive environment in an effort to squeeze the available spread in the Urban – Industrial sector. The CBs will only venture into the more difficult realm of rural finance if their profits from operating in the Urban – Industrial sector are squeezed and banks are unable to meet their profit projections.

8.3.3. Co-operative Sector:

The CRF recommends that the genuine co-operative credit system should be given the opportunity to convert itself into rural banks under the new proposed law.

8.3.4. Micro Finance Institutions:

MFIs are perhaps the most important institutions as their efforts are aimed directly at alleviating rural poverty.

This sector needs special focus also as it is currently covering under 3% of the potential market.

The CRF recommends that the Government of Pakistan should build on the outstanding performance of the PPAF in utilizing the $ 100 million World Bank loan and in nurturing at least a dozen new NGOs into Micro credit.

The quantum of the next tranche of PPAF should be enhanced as much as possible.
The CRF also recommends that the Khushhali Bank increases its client base at least as fast as it has increased its infrastructure.

8.3.5. The Post Office Department:
The Post Office has the physical infrastructure as well as the manpower (postmen) to extend its out reach of Rural Finance Services of Saving mobilization and Insurance to a large percentage of the rural population in a short period.

The CRF recommends that the PO department should actively seek to leverage its existing infrastructure and manpower developing linkages with CBs and RSPs. The opportunity available to the PO department must be fully seized.

8.4. The CRF recommends that the SBP should play a pro-active role by demonstrating its own will to facilitate a quantum leap in providing Rural Finance services.

In order to fulfill this purpose it is recommended that the SBP should convert its existing agricultural credit department into a new Rural Finance Department.

The CRF suggests the following role and organization of the new proposed Rural Finance Department.

8.4.1. The role envisaged is that of a bridge and of a facilitator between the various institutions that play a role in the universe of rural finance. There are a large number of synergies possible between the Post Office department and Micro Finance providers, between the existing Insurance companies and the new proposed rural banks and between new rural banks and Micro Finance institutions. The SBP should serve as a bridge between International best practices in Rural Finance and local institutions. There are many successful examples like BRAC (Annex- X), Grameen Bank of Bangladesh and the Bank for Agriculture And Agriculture Co-operatives, Thailand, whose past rapid development and the associated problems need to be studied and experience shared with local institutions to help them avoid some of the pitfalls and problems these successful institutions may have faced and overcomed.

8.4.2. In order to give the rural Finance Department the necessary clout and importance it should be headed by an Executive Director.

8.4.3. It should be manned by an adequate level of trained, experienced and qualified manpower to effectively monitor, supervise and regulate the activities of all banks notified under the Micro Finance Ordinance or Rural Finance Act and other Acts operating in the rural finance sector.

8.4.4. It should be equipped for on-site monitoring of Rural Finance Institutions.

8.4.5. It should supervise all agriculture and rural credit as well as saving mobilization.

8.4.6. It should evolve training modules for Rural Finance operations and co-ordinate the large scale training in Rural Finance for the rural banks.

8.4.7. It should have a large research and development wing which should design and facilitate linkages between various players, e.g. Insurance Companies, Banks or Post Office and Rural Support Programmes, etc. This wing should also seek to develop new products relating to rural finance.

8.4.8. In order to attract entrepreneurs to the opportunity of setting up rural banks an awareness campaign in specific areas targeted towards specific target groups must be a part of the promotion package. Separate funds should be allocated by the SBP for this purpose.

8.4.9. The Rural Finance Department should monitor Rural Finance progress and the role of each Institution as per the two matrices attached as Annex – X and Annex– Xa.

8.5. Agriculture Profitability:

8.5.1. As the rural economy depends on Agriculture, success in rural development is closely tied to the performance of the agriculture sector. It is necessary for the government to enhance the farmers' productivity and to provide a milieu in which rural finance can play its due role in the process of accelerated agricultural development.

8.5.2. Farmer profitability can be increased by both increasing yield per acre as well as ensuring that large crop surpluses do not lead to price failure.