



Final Report

Poverty and Social Impact Assessment: Pakistan Microfinance Policy

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ABBREVIATIONS

ADB	Asian Development Bank
AE	Administrative expenses
AKRSP	Aga Khan Rural Support Programme
ASCA	Accumulating Savings and Credit Association
BoK	Bank of Khyber
CF	Cost of funds
CGAP	Consultative Group to Assist the Poor
DFI	Development finance institution
DFID	Department for International Development (UK)
DPF	Deposit Protection Fund
FATA	Federally Administered Tribal Areas
FSD	Financial sector development
FSSA	Financial Sector Stability Assessment
FSSP	Financial Sector Strengthening Programme
GOP	Government of Pakistan
IFC	International Finance Corporation
II	Increasing income
I-PRSP	Interim Poverty Reduction Strategy Paper
K	Capitalisation rate
LL	Loan losses
MF	Microfinance
MFI	Microfinance Institution (in this report, used only for MFIs licensed under the MFIO, 2001: see Box 3.1)

MFIO	Microfinance Institutions Ordinance
MFP	Microfinance provider
MIX	The Microfinance Information eXchange
MRDO	Marvi Rural Development Organisation
MSDP	Microfinance Sector Development Programme
MSME	Micro, Small and Medium Enterprise
NABARD	National Bank for Agricultural and Rural Development
NBFI	Non-bank financial institution
NGO	Non-governmental organisation
NRSP	National Rural Support Programme
NWFP	North West Frontier Province
OPP	Orangi Pilot Project
PIHS	Pakistan Integrated Household Survey
PKSF	Palli Karma-Sahayak Foundation (Bangladesh)
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
PRSP	Poverty Reduction Strategy Paper (2003)
PSES	Pakistan Socio-Economic Survey
PSIA	Poverty and Social Impact Assessment
PSLM	Pakistan Social and Living Standards Measurement Survey
RMF	Risk Mitigation Fund
ROSCA	Rotating Savings and Credit Association
RSP	Rural Support Programme
SACCO	Savings and Credit Co-operative Society

SBP	State Bank of Pakistan
SDC	Swiss Agency for Development Cooperation
SHG	Self Help Group
SME	Small and Medium Enterprise
SRSP	Sarhad Rural Support Programme

EXECUTIVE SUMMARY

The MF sector in Pakistan, while a late starter, is less far behind the sector in other countries in South and South-East Asia than might be apparent at first glance. Indeed, despite the fact that the mainstream MF sector in Pakistan is relatively young compared with those of other countries in the region, it is definitely in the same league as many of them in terms of key measurements, such as the number of beneficiaries and the average size of loans.

In some areas, such as the range of types of service providers, Pakistan is actually ahead of many comparable countries. There are still some serious issues to be addressed, in areas such as access, sustainability and efficiency. Perhaps the most urgent and difficult area to address is that of financial sustainability.

The findings of this PSIA report on this point conform with a recent study by Stephens, Tazi *et al.* (2006) and merit quotation at some length (pages 69-73):

‘Future growth, however, is significantly compromised by the sector’s high dependence on subsidized funds to cover costs and maintain operations. To ensure the sustainability of the industry, Pakistani MFIs should build on their exceptionally low cost structures and consider re-pricing their products and services to enhance their financial revenues and become self-sufficient. ...

‘One alarming feature of current sector growth is that it is being led by unsustainable institutions that are heavily subsidized. The poor require regular and reliable access to financial services, but the majority of MFIs are unable to generate sufficient revenues to cover their cost of operations. ...

‘Moreover, the asset side of the balance sheet shows that MFIs are using their assets inefficiently. ... There are several reasons why MFIs do not optimally utilize their resources. Across the country, microfinance is regarded as a charitable activity. Institutions thus charge exceptionally low interest rates and do not regard their credit operations as a significant means to raise revenue. ...

‘The challenge to MFI profitability in Pakistan thus appears to stem from a charitable vision of microfinance that has adverse effects on product pricing, asset allocation and credit risk throughout the sector. MFIs are averse to charging sustainable interest rates since these are perceived as usurious and counter to the movement’s mission of alleviating poverty. Microfinance providers thus wind up on a low cost low yield curve, running heavily subsidized programs.’

Also, and of particular relevance to this PSIA, the MF sector has yet to demonstrate its potential in terms of its social and poverty impact.

These issues, however, are characteristic of an early-stage MF sector. The PSIA supports the view that the MF sector in Pakistan is now in a position to consolidate the

gains it has made during the years since the passing of the MF Ordinance in 2001, and is ready to embark on a major expansion in size and scope, given the right conditions.

In terms of size, our analysis confirms the views of the providers covered in the case studies, that there is scope for a major expansion in the number of beneficiaries in the next decade, from hundreds of thousands to millions.

In terms of scope of services, the case studies and the surveys demonstrate that providers and users share similar aspirations – for example, for more access to savings and insurance products, and for more flexibility in microcredit.

So what will ‘the right conditions’ be? How can MF policies be maintained or adapted to provide the conditions for expansion of the MF sector and to maximise its social and poverty impact?

The broad conditions required for this expansion, at the highest level, are obviously macroeconomic stability, and continued development of the banking sector.

At the MF sector level, the analysis supports the consensus of the current providers that the sector is ready for take-off, that the GOP’s catalytic role in the ‘start-up’ phase has been a success, and that it is now time for the GOP to step back and let the MF industry evolve under its own momentum. The GOP no longer needs to be a provider of MF services, nor the main financier of those services, nor does it need to take an interventionist approach to the scope and nature of the services provided by NGOs, MFIs and banks. The time has also come when the role of subsidies needs to be changed to ensure that any future subsidies are used to build the efficiency and financial sustainability of the institutions. The key role of MF policies at this stage of the development of the sector is to provide an enabling environment in which the sector can grow.

It would therefore be appropriate for consideration to be given to a number of policy options aimed at liberalising regulations and restrictions that were useful in the early stages of MF development, but that are now in danger of creating an artificial segmentation of the sector that might inhibit its growth. Particular consideration might be given to the following issues:

- **regulating by function or institution ?** - Currently, MF providers are regulated, or not regulated, according to what kind of institution they are (bank, MFI, NGO etc). Consideration might be given to regulating MFPs according to the kind of service provided (MF loans, deposits, transfers etc). This would mean, for example, that the regulation of MF services provided by MFIs under the Ordinance would be the same as, or comparable to, the regulation of the same services provided by commercial banks.
- **tax structures** - currently, an NGO would be penalised by becoming a deposit taking MFI under the ordinance, as it would have to pay corporation tax; this would also have a detrimental effect on the interest rates that NGOs would need to charge. However, favourable fiscal treatment to NGO MFPs could cut across the norms of fiscal policy in Pakistan, undermine the principle of regulation according to function rather than institution and prevent MF services

being offered on a level playing field. - Tax is a complicated issue, but would nevertheless merit further consideration by GoP.

- **the use of subsidies** - It is a necessary condition for rapid growth in the next stage of development that microfinance services will be provided by institutions that are fully financially sustainable, or can become fully sustainable in a very short time. That requirement is undermined by subsidies that are passed straight to the borrower in the form of lower interest rates, and/or by subsidies that are used by MFIs to avoid the need to leverage lending services in order to build adequate capital. Any subsidies planned for the next few years, therefore, need to be very carefully designed to ensure that they are used purely for capacity building, or for building the MF infrastructure at the macro- and meso- level, and not used to maintain non-sustainable services and institutions.
- **poverty monitoring and evaluation** - the recent literature suggests that MF providers that make poverty reduction an explicit goal and make poverty reduction a part of their organisational culture are far more effective at reaching poor households than those providers that do not. The same literature also suggests that MF institutions underspend on monitoring and evaluation and this failure while cutting costs in the short-run does so at the expense of long-term social and economic goals.¹
- **restrictions on loan size** - after five years of experience, the loan limit of Rs 100,000 on MF credit under the Ordinance needs to be re-examined. The MFIs argue that it is a disincentive to lending to MF entrepreneurs, and in particular that it prevents an MFI from developing a relationship with a growing enterprise: as a microenterprise grows and requires larger loans, it moves outside the scope of MFIs, but its borrowing requirements are not yet large enough to interest normal commercial banks. If that is indeed the case, it would represent a significant constraint on the Micro, Small and Medium Enterprise (MSME) sector in Pakistan.
- **the definition of eligible borrowers** - The same re-examination is advisable in relation to the MFIO definition of eligible borrowers as 'poor persons', defined as 'persons who have meagre means of subsistence and whose total income or receipt during a year is less than the minimum taxable limit set out in the law relating to income-tax.' The poverty line defined in the PRSP is significantly lower than the MFIO's poverty line. Amongst other things, this leads MFIs to believe they are more poverty focused than they are in practice.
- **interest rates** - Throughout this PSIA, evidence has been cited from around the world as well as from Pakistan that demonstrates that people on low incomes continue to take out loans either from the informal or formal sector even at interest rates that, in different circumstances, might be regarded as very high. The large increases in output that result from investment at low levels of capital intensity generate the large increases in revenue that in turn can help

¹ Morduch and Haley, op.cit..

repay investment loans at high interest rates. Access to credit is therefore usually much more important to people on low incomes than the costs of credit.

Given the need - also demonstrated in this PSIA - for MFPs to become financially sustainable, it would be advisable to consider allowing the market to determine interest rates by removing explicit or implicit caps on interest rates.

- **services to ROSCAs, using the example of NABARD?** - Given the prevalence of ROSCAs in Pakistan, there is merit in considering ways in which the formal financial sector can better serve the informal. Indeed, as the case of NABARD in India demonstrates, such mechanisms can, in the right circumstances, support very rapid expansion of MF services. It would be useful for Pakistan to study the NABARD case to establish whether there is scope for facilitating a similar linkage between self-help groups and the banking sector, within or outside the MFP structure.

CHAPTER 1: INTRODUCTION

1.1 Purpose of this study

In 2000 and 2001 the Government of Pakistan (GOP) took clear steps to use microfinance (MF) policy to address poverty. Five years on, the Ministry of Finance in conjunction with the UK Department for International Development (DFID), have commissioned this Poverty and Social Impact Assessment (PSIA)² to understand:

- how MF service levels and financial sustainability have evolved;
- how access to MF services has changed and how financial services may have impacted on the poor and other socioeconomic groups (e.g. the rural population, women);
- the issues that might need to be addressed by future developments in policy.

The timing of the study is opportune for four reasons: firstly, Pakistan is currently completing the design of the second Poverty Reduction Strategy Paper (PRSP2).

Secondly, experience around the world suggests that after 5 years of operation it is reasonable to expect that a new MF policy should have delivered results. The regulatory environment should have become established and within this new environment MF providers (MFPs) should have emerged to deliver services to the poor.

Thirdly, the apparently small size of the MF sector in 2005 (approximately 450,000 active clients served by only four main providers) has raised concerns that there may be structural problems that are impeding the growth of the sector. A PSIA might therefore help in diagnosing and addressing such problems.

Fourthly, the financial support that has underpinned the development of some of the main MFPs (e.g. Asian Development Bank, World Bank, DFID) will be reviewed in a few years, and these reviews will need to take into account the performance of the sector as a whole, as well as the prospects of the MF sector in achieving goals for growth, sustainability and poverty.

1.2 Background

1.2.1 PSIA

Poverty and Social Impact Assessment is a new name for an old activity. PSIA is simply an analytical exercise that attempts to understand the likely poverty and social impact of particular policy choices. PSIA often draws on a wide range of analytical

² Terms of reference for the study can be found in Annex A.

tools and data sources in attempting to understand policy impact. These tools range from those that are highly qualitative and participatory, to those that are quantitative and often driven by economic theory.

The scope and content of PSIAs are usually driven by the policy agenda of the day and the time frame in which the studies need to be completed. Some recent PSIAs have been very substantial and resource intensive and have lasted a couple of years. However, most recent PSIAs have lasted a few weeks or months, and have used relatively limited resources to provide policy makers with a quick review of the main policy choices and their consequences. This current PSIA fits into the latter category.

A large number of PSIAs have been undertaken since 2002/03, when new poverty-focused lending instruments encouraged their use. Since then PSIAs have been undertaken on a wide range of policies. These include: macroeconomic policies (e.g. the poverty impact of policy on the size of the fiscal deficit); fiscal policy (e.g. the impact of fuel taxes); public investment policy (e.g. the impact of alternative public investment plans in agriculture); pricing policy (e.g. agricultural subsidisation); and sector policy (e.g. water and irrigation).

1.2.2 Microfinance – some background

Providing loans and banking services to poorer households in both rural and urban areas is not an entirely new idea. As early as the 1960s both Agricultural Banks and Development Banks were tasked with providing subsidised loans in order to stimulate the uptake of fertilisers, pesticides, high yielding seeds and agricultural machinery. Most careful evaluations of these development banks show that these efforts largely failed to achieve their goals, and above all failed to improve the livelihoods of the poor.

There were a number of reasons for this failure. Firstly, in the absence of real market tests (i.e. projects with the highest potential returns are favoured for investment over projects with low returns) credit was given to those with influence and power, and not necessarily to those investing in high-return projects – the result was failed investments and non-performing loans. Secondly, with seemingly unlimited supplies of finance, the development banks failed to develop savings products and deposit-taking activities and thus failed to provide this important service for the poor and to become self-sustainable; thirdly, the arrival of cheap credit tended to squeeze informal sector suppliers and so reduce overall access to the financial services that the poor in particular relied upon. Finally, politicians were often tempted to pressurise banks to write off bad debts. The outcome was poorly developed and managed organisations that failed most tests of financial sustainability, and more widely failed to play their part in promoting growth and reducing poverty.

When the poor were not able to save or borrow money, or indeed to insure themselves against risks, through formal sources, they relied on the informal sector to help them do this. Friends and family would often provide cash to deal with emergencies and to finance investments. Outside of friends and family, Rotating Savings and Credit

Associations (ROSCAs)³, landlords, employers and local moneylenders could provide opportunities for savings, for credit and for insurance.⁴

However, whilst local knowledge helps to ensure that lenders are well informed of the risks of a loan, and whilst local peer support / pressure can help to ensure that loans are repaid, the informal sector suffers a number of drawbacks. These include limited sources of capital, high transaction costs, and covariant risks that threaten loan repayments and risk drawing down of savings.

MF attempts to provide solutions to the problems both of the development banks and of informal financial markets. MFPs use the benefits of large scale to reduce costs, manage risks and access capital, but they also use innovative contracting and close engagement with clients and their communities to mimic the strengths of informal financial markets, i.e. improved information on clients and their enterprises; the means to support borrowers and enforce contracts.

1.3 Outline of this PSIA

The study is structured into six further chapters. The following chapter (Chapter 2) provides a series of conceptual frameworks for understanding the impact of MF policy on MFPs and on poverty. These conceptual frameworks are interwoven with a discussion of the international literature.

In Chapter 3 the recent evolution of MF policy in Pakistan is outlined.

Chapter 4 describes how the MF sector has developed in recent years. In this chapter the structure of market is outlined in order to understand the roles that government; wholesalers, Apex organisations and donors; retailers and consumers have played in the recent past. Seven detailed case studies of major MFPs (one of the three main 'tools' used in this PSIA) are used to understand the performance of the sector and in particular to attempt to explain the reasons for the apparent small size of the sector.

In Chapter 5 a range of quantitative survey tools is used to understand questions about access and impact. In particular, the results of a small survey of 100 households that was conducted as part of this PSIA are used to understand the impact of MF services on their living standards. In addition, an analysis of national household surveys conducted in 2001 and 2002 is used to provide further evidence of financial services behaviour. Recent impact evaluations that have been undertaken for two of the major MFPs are also reviewed.

Chapter 6 draws some conclusions about the impact of MF policy: on the size of the market and the coverage of MF provision; on the range of services that are provided; on the potential for growth in the MF market and the constraints to that growth; and directly and indirectly on poverty. The implications for policy are reviewed. This chapter pays particular attention to the role that policy might play in: improving both

³ ROSCAs are more commonly referred to in Pakistan as 'committees' or *Bisis* or *Kustunas*.

⁴ See Briefing Note Hurrell, Alex (2006) 'Note on a low-bid 'boli' committee - an insurance ROSCA from Pakistan'.

access to MF services and the range of services provided; increasing the access of the poor to MF services.

A separate note discusses options for the future of PSiAs.

CHAPTER 2: CONCEPTUAL FRAMEWORK AND INTERNATIONAL EVIDENCE

In this chapter we attempt to provide a way of thinking about MF (and financial services more generally) and the way that it can impact directly and indirectly on the poor. We start the chapter with some definitions; we follow by briefly outlining the role of finance in economic growth and its indirect ability to reduce poverty; we then discuss the measurement of access to financial services; from there we go on to discuss how financial services can help the poor and non-poor to manage risk and vulnerability, and how the mobilisation of savings and credit can support income growth of the poor.

In the final section of this chapter we discuss the classification and operation of formal and informal MFPs. We then discuss the concepts of 'financial' and 'operational' sustainability for MFPs. If MF is to have a real impact on poverty levels in Pakistan then MF services will have to be provided on a scale that is many times larger than present levels. Whilst government can provide an appropriate policy and regulatory environment, and donor money and philanthropy can provide some of the early support necessary to help MFPs develop their organisations, in the long run 'strong microfinance institutions need to charge enough to cover their costs. Cost recovery is not an end in itself. Rather, it is the only way to reach scale and impact beyond the limited levels that donors can fund.' (CGAP, 2004a)

To illustrate the current international consensus on MF issues, we have reproduced in Annex B the Key Principles of Microfinance developed and endorsed by the Consultative Group to Assist the Poor (CGAP) and its 31 member donors, and further endorsed by the Group of Eight leaders at the G8 Summit at Sea Island on 10 June 2004, and in Annex C the Statement of the Advisors Group to the UN International Year of Microcredit, 2005.

2.1 Definitions

2.1.1 Microfinance

There are many definitions of MF, but perhaps the most concise and useful for the purposes of this PSIA is the definition offered by the CGAP:

*'Microfinance is the supply of loans, savings, and other basic financial services to the poor.'*⁵

People living in poverty, like everyone else, need a diverse range of financial instruments to run their businesses, build assets, stabilise consumption, and shield

⁵ CGAP website, www.cgap.org/about/faq01.html. CGAP is a consortium of 31 public and private development agencies established as a global resource centre for MF standards, operational tools, training and advisory services.

themselves against risks. Financial services needed by the poor include working capital loans, consumer credit, savings, pensions, insurance, and money transfer services. Thus it is important to recognise that **microfinance** covers a wide range of services that includes, but is by no means confined to, **microcredit**, which is the provision of credit for the poor (see section 2.2.3 below).

2.1.2 Poverty

For the purposes of this study we follow the GOP's own operational definition of poverty, i.e. the poor are those whose *per capita* monthly incomes fall below Rs 909 at 2005 prices.⁶

National surveys, such as the Pakistan Integrated Household Survey (PIHS) and more recently the Pakistan Living Standards Measurement (PLSM) survey, show that individuals with monthly expenditure levels at or above the poverty line consume enough calories to meet national nutritional standards. Individuals with expenditure at these levels are also able to purchase basic non-food items (clothing, shelter, etc.) necessary to sustain life. The poor, whose monthly expenditure falls below the poverty line, are those who have inadequate access to food and non-food consumption.

When this study refers to 'the poor' it means those with a *per capita* consumption level below the government's poverty line.

2.2 Poverty: credit, savings, insurance, financial services

2.2.1 Financial sector and economic growth

There is now widespread evidence that deeper and larger banking systems run parallel with economic growth and that a dynamic MF sector can augment this effect but not substitute for it (Peachey and Roe, 2006). Indeed it is the financial system that helps to mobilise the enormous volumes of capital necessary for economic growth by moving the funds of savers to the needs of entrepreneurs.

2.2.2 Financial sector development, access and poverty reduction

Although the link between financial sector depth and poverty reduction is now widely accepted, the extent to which access to financial services directly impacts on the poor, and the mechanisms through which this impact occurs, are still imperfectly understood. The key question was summed up by the World Bank's Brazil access survey team as follows: 'It is increasingly accepted that greater financial system *depth* and *soundness* contributes to broad-based economic growth with poverty reduction. ... But

⁶ Following the PIHS of 2001/02 the GOP announced a poverty line of Rs 748.6 *per capita* per month. The inflation rate between PIHS 2001/02 and Pakistan Social and Living Standards Measurement Survey (PSLM) 2004/05 has been calculated as 21.46%. Thus the poverty line for 2004/05 is inflated as follows: Rs 748.6*1.2146 = 909.25.

beyond the association of financial depth and stability with growth and crisis prevention, can the financial system also accelerate the reduction of poverty through targeted interventions designed to broaden the *distribution* of financial services?⁷

The discussion in the literature to date of the role of the financial sector might be summarised (albeit in a brutally simplified form)⁸ as follows:

- financial depth is a major contributor to economic growth (King and Levine, 1993; Levine, Loayza and Beck, 2000; Levine, 2005)⁹;
- the poor benefit as much as the rich from economic growth (Dollar and Kraay, 2002);
- some are sceptical about whether financial depth is in itself pro-poor, or in itself reduces inequality (Greenwood and Jovanovic, 1990);
- but an increasing number of studies in recent years are concluding that:
 - financial depth contributes to lower inequality (Li, Squire and Zou, 1998; Clarke, Xu and Zou, 2003);
 - financial depth contributes to lower poverty (Honahan, 2004a);
 - financial development has a positive impact on changes in inequality and changes in poverty; it is a causal factor in pro-poor growth (Beck, Demirgüç-Kunt and Levine, 2004);
- the studies to date say a lot about the causality and its direction, but relatively little about the mechanisms through which financial sector development (FSD) contributes to lower poverty and inequality;
 - some point to the alleviation of credit constraints for poorer households (Li, Squire and Zou, 1998; Clarke, Xu and Zou, 2003);
 - others place more weight on the impact on firms (Beck, Demirgüç-Kunt and Levine, 2004; Beck, Demirgüç-Kunt, Laeven and Levine, 2004);
 - others emphasis the economic effects of the legal, regulatory and informational infrastructure (Honahan, 2004b);

⁷ World Bank, 2004. The work of the Brazil survey has now been published, as Anjali Kumar *et al.*, *Access to Financial Services in Brazil* (World Bank, 2005a), a comprehensive and authoritative study.

⁸ This summary is based on Stone (2005).

⁹ The applicability of the findings of King and Levine's seminal 1993 study to developments since 1990 has recently been challenged by Rousseau and Wachtel (2005), who also cite a number of other challenges to the current consensus on the finance-growth relationship. They conclude that a more nuanced approach is required under which 'the systematic study of the financial development experiences of individual countries becomes all the more critical as the next step in furthering our understanding of the nexus.' This does not, however, negate the point for the purposes of this PSIA: indeed, it reinforces the case for assessments such as this one.

- for any sector, including finance, measuring impact on poverty requires a sector-specific approach that distinguishes between: (a) impact on growth in general; (b) impact specifically on pro-poor growth; and (c) direct impact on poor communities and households (EME, 2004);
- those who emphasise the growth impact of FSD (like the second two sub-bullets above), when they deal at all with access, tend to focus on the access of **firms**;
- those who emphasise the direct pro-poor impact of FSD (like the first sub-bullet above), when they deal with access, tend to focus on the access of **households**;
- there is, however, a certain blurring - it is not always clear whether the focus of specific studies is on access by firms or access by households, perhaps because access is not their primary interest and / or microenterprises are virtually indistinguishable from households;
- there are some interesting studies which throw light on the direct impact of FSD on poverty, especially on the correlation between access to credit and child labour (Deheejia and Gatti, 2002; Beegle, Deheejia and Gatti, 2003);
- there is also a considerable body of work done in the USA which shows or postulates positive links in the USA between access to financial services and poverty alleviation, asset building and equality (see citations in Solo *et al.*, 2005).

Apart from such specific studies, however, the literature throws insufficient light on the role of access in poverty reduction, especially in low-income countries. As the World Bank puts it: 'It stands to reason that being excluded from direct access to finance must represent a barrier to prosperity for the poor, and to growth and productivity improvement for micro and small-scale enterprises. But the evidence that could guide public policy initiatives remains thin and tentative largely due to inadequate data sources.'

2.2.3 Access to financial services

If access to financial services is important for predicting the pro-poor impact of financial sector development, then how can we think about and measure access? This is particularly important if we are (at least conceptually) to understand whether MF services have reached the poor in Pakistan during the last 5 years.

A recent note (World Bank, 2005a) offers a useful route into the problem. It suggests four questions that it is important to address:

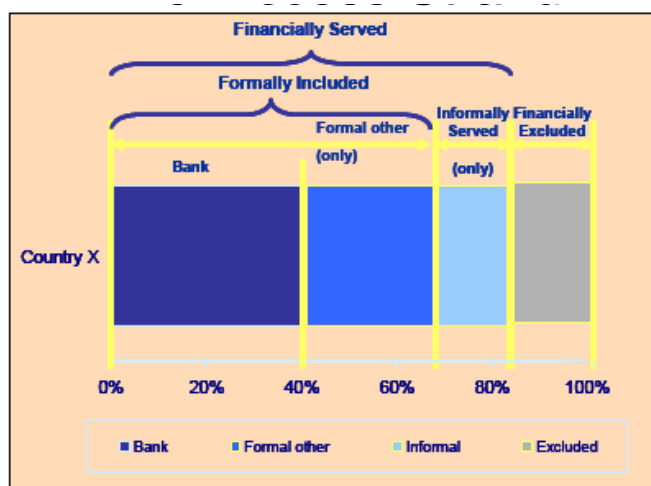
- Should a distinction be made between usage of financial services and access to financial services? - 'people might have access to financial services but may not wish to use them', 'people might have access to financial services but might be excluded because they are a credit risk';
- Should access be measured in terms of financial institutions, financial services or specific financial products?

- How should a distinction be made between low and high levels of access?
- For whom should access be measured, the household or the individual?

The note proposes a set of indicators that provide a broad overview of those who have access to what financial services. The indicators place a given population along a continuum of access depending on the usage of formal, semi-formal and informal financial services, and those excluded from the use of financial services. Figure 2.1 shows a system that allows the population access to financial services to be characterised by four core indicators:

- ‘the banked’, i.e. the proportion of the adult population that uses a bank or bank-type institution;
- ‘the formally included’, i.e. the first two segments in the figure that show the proportion of the adult population that uses financial services provided by banks and by other formal financial service providers (e.g. MFPs);
- ‘the financially served’, i.e. the first three segments, or those who are either formally served plus those who use only informal financial service providers;
- ‘the financially excluded’, i.e. those who are either voluntarily or involuntarily excluded.

Figure 2.1 One way of thinking about ‘access’ the ‘Access Strand’



Source: Indicators of financial access: household surveys (World Bank, 2005)

2.2.4 Impact of financial services on the poor

All households, regardless of their income levels, at some points will want to transfer the ability to purchase goods and services across time and / or space. This transfer of purchasing ability may be facilitated using either formal financial services or via other informal mechanisms. For example, any household making or receiving remittances is effectively transferring purchasing ability from ‘here’ to ‘there’ or vice versa. This

transfer may be effected through formal methods, e.g. a money transfer service, or informally, e.g. carried by hand to the recipient.

Similarly, a household may want to transfer spending across time, for example to deal with an emergency or take advantage of an investment opportunity, shifting financial resources from 'now' to 'then' or vice versa. It can do so using either formal saving, or saving services offered by banks or MFPs, or use informal methods such as participating in a committee or taking a loan from family or friends.

2.2.4.1 Some evidence: households, financial services and markets – how households behave

A vivid insight into how households behave in relation to financial services has been provided by Stuart Rutherford in his groundbreaking essay *The Poor and their Money* (Rutherford, 2000). One of his key points is that financial services are used by the poor principally to enable them to cope with times when they need exceptionally large sums of money for:

- life-cycle events (e.g. childbirth, marriages, funerals);
- emergencies (e.g. sickness, injury, earthquakes, wars);
- investment opportunities (e.g. investment in existing or new business, buying land or other productive assets).

Rutherford demonstrates that, from this perspective, saving (in the conventional sense), borrowing, and revolving savings schemes such as ROSCAs are in reality all forms of **savings** – what Rutherford calls saving up, saving down and saving through, respectively, as described in Box 2.1.

The exception to this characterisation of financial intermediation for the poor as essentially the facilitation of savings, as Rutherford acknowledges, is the provision of **transaction services**, particularly in relation to remittances.¹⁰ These services are also important for the poor, and have been investigated as part of this PSIA.

¹⁰ For the relationship between remittances and growth, see Guiliano and Arranz (2005).

Box 2.1 Savings as the core of financial services for the poor (Rutherford)

'Financial services for poor people exist to then get hold of usefully large sums of cash on the many occasions when they *need* the cash or have an *opportunity* to invest it.

Assets (*stocks*) can be sold to raise cash, but this method is limited by the fact that the poor hold few assets.

Mortgaging or pawning assets (exchanging them temporarily for cash) is an important financial service for the poor, but once again it is limited by the poor's lack of assets.

The only reliable and sustainable way of raising lump sums of cash is to find a way of building them from one's capacity to save small amounts from time to time, here referred to as basic personal financial intermediation, which may involve:

- **Saving up:** where you accumulate savings *first* and take the resulting lump sum *later* (savings as traditionally understood);
- **Saving down:** where you take the lump sum *first* as an advance (or loan) against future savings (e.g. borrowings or advances from relatives and friends, moneylenders or microfinance institutions (MFIs));
- **Saving through:** where you take a lump sum *at the time it is needed* in exchange for a continuous stream of savings (e.g. the normal use of ROSCAs, or insurance policies when they are available to the poor); or
- some combination of all three.

In each case, saving is the essential ingredient, and the devices and services are the ways of converting savings into usefully large lump sums.

That is why the poor need to save.'

Source: Rutherford (2000, p.10).

Rutherford and others have provided extensive evidence for this framework through fieldwork conducted in the form of financial diaries (Rutherford, 2002; Sinha and Patole, 2002; Ruthven and Kumar, 2002).¹¹ The findings of this diary research are used to give a perspective on our findings in Pakistan in Chapters 5 and 6, below.

This framework also illustrates why microcredit is perceived by the poor as part of the spectrum of possible financial services, and why microcredit is judged by the poor in terms of its relationship with the borrower's potential stream of savings to pay the loan. In that context, when poor people who need a lump sum do not borrow money, it

¹¹ An extensive financial diaries project has also been undertaken, SALDRU in South Africa, as reported in www.financialdiaries.com. See the summary in SALDRU (2005).

is usually because they do not have access to a loan rather than because they cannot afford the repayments. There is a considerable body of evidence that 'The poor generally consider ongoing access to credit more important than the actual cost of credit.' (Helms and Reille, 2004).¹² The conclusions of the CGAP study on this point are summarised in Box 2.2. The issue of MFI costs and interest rates is further discussed in section 2.3.2, below.

Box 2.2 How can poor people afford such high interest rates?

'The poor generally consider ongoing access to credit more important than the actual cost of the credit. Impact studies show that clients benefit from MF loans. They also show that MF clients can and do repay such loans - in many cases returning to borrow again. High repayment rates and repeat borrowing testify to the positive benefit that clients derive from microcredit. Further, high repayment indicates that the loans are affordable (if not, their inability to repay would show up in default rates).

'Because the absolute amount is small, microcredit interest costs are generally affordable compared to the income streams and total business costs of poor clients, particularly those of non-agricultural microentrepreneurs. A study in the Dominican Republic, Colombia, and Chile, for example, found that even a 6% monthly interest rate represented only 0.4-3.4% of a microentrepreneur's total business costs. Returns on certain tiny businesses, especially commercial traders, are also higher per unit of capital than those on large businesses. Research in India, Kenya, and the Philippines found that the average annual return on investments in microenterprises ranged from 117% to 847%.

The higher costs of microcredit have not necessarily excluded poor customers. Data from the Microfinance Information eXchange (MIX) indicate that leading MFIs have succeeded in reaching large numbers of poor clients precisely because they have been allowed to charge interest rates that reflect their true costs, including the costs of growth. In 2004, the MIX analysed MFIs reaching poor clients (defined as microlenders with an average balance per borrower of less than either 20% of GDP *per capita* or US\$150). MFIs serving this lower-end market with interest rates that covered their costs reached six times as many borrowers as their non-sustainable peers also serving that market.'

Source: Helms and Reille (2004).

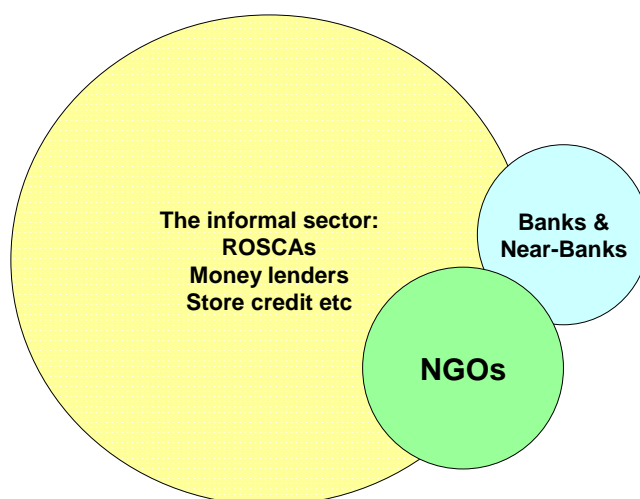
¹² For an overview of the evidence and a discussion of access relative to price, see also Christen *et al.*, (1995) and Robinson (2001).

2.3 Markets for financial services

2.3.1 Informal and formal markets

In order to measure the impact of MF policies in Pakistan, it is important to identify the whole range of financial services provided to the poor, since MFPs covered by the policy framework are only part of a wide spectrum of informal and formal financial services available to or used by the poor. It is clear that in all developing countries traditional or informal providers are a major, if not the major, source of financial services used by the poor.¹³ The informal services described by Rutherford (2000) undoubtedly provide important financial services, but there can be a big difference between the range, quality and price of these services and those which are provided by, for example, a commercial bank. In between these two extremes is a wide variety of types of provider, differing in the degree of formality and in the range and quality of the services provided (World Bank, 2005a).

Figure 2.1 Where the poor get financial services



There is no single definition of the dividing line between 'formal' and 'informal' financial services. A criterion favoured by the World Bank (2005a) defines:

- **formal** services as those in which the provider has a legal status (whether because incorporated as a firm, or as a recognised cooperative or charity); and
- **informal** services as the rest;

¹³ See Stone (2005), section 5.2 for a discussion of the evidence from household surveys on the extent of informal financial services, and Annex G for a comparison of the results from 25 household surveys. See also Qadir (2005), pp. 5ff for a comparison of the size of the informal market in Pakistan with that of other Asian countries.

- within the formal sector a further distinction is made between **broad spectrum intermediaries** (such as banks), providing a range of depository, lending and payments services, and the rest, or **specialised providers**.

An alternative taxonomy, also widely used, was proposed by Joanna Ledgerwood (1999). It was adopted by the Asian Development Bank (ADB) in their review of the commercialisation of MF in South and South-East Asia (Charitonenko, Campion and Fernando, 2004). This classification recognises:

- **formal institutions**, defined as those that are subject not only to general laws and regulations, but also to banking regulation and supervision;
- **semi-formal institutions**, which are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under banking regulation and supervision;
- **informal providers**, to which neither special banking laws nor general commercial laws apply.

Neither of these classifications is perfectly suitable for application in Pakistan, mainly because in both cases MFIs under the Microfinance Institutions Ordinance 2000 would fall under the same category as non-governmental organisations (NGOs) that provide MF services. In the first case they would both be defined as 'specialised formal providers', and in the second as 'semi-formal institutions'. As we shall see in Chapter 4, there are important differences between MFIs under the Ordinance and other providers of MF services; most significantly, those that are not MFIs are not authorised to take deposits. For the purposes of this PSIA, therefore, the range of MFPs is classified as shown in Table 2.1

Table 2.1 Classification of microfinance providers (MFPs)

		Examples
Formal	Full service, broad spectrum	Bank of Khyber
	Full service MF specialists	First Microfinance Bank
	Restricted service MF broad spectrum	National Rural Support Programme (NRSP)
	Restricted service MF specialists	Khashf Foundation
	Apex institutions	Pakistan Poverty Alleviation Fund (PPAF)
Informal	Community-based services	ROSCAs, Accumulating Savings and Credit Associations (ASCAs)
	Commercial services	Moneylenders, stores
	Family and friends	Mr and Mrs Hassan of Mingora

Source: PSIA authors

2.3.2 Sustainability of microfinance providers

One of the central purposes of this PSIA is to understand whether MF policy has helped to promote institutions that will be able sustainably to provide MF services on a scale that is able to have an impact on the poor.

2.3.2.1 Operational and financial sustainability

The 'financial sustainability' of an MFP refers to the ability of the organisation to cover both the costs of operations and the costs of capital from its revenues. The 'operational sustainability' of an MFP refers to the ability of the organisation to cover its operating costs but not its capital costs from its own revenues.

Many MFP providers receive subsidies and subventions from government, donors and philanthropists. These subsidies will often cover the costs of capital and, in the early years of MFP organisational development, will often cover a proportion of operating costs.

Reliance on donors and even reliance on depositors for sources of capital can severely limit the opportunities for growth and limit the scope of services provided to poor people. Increasingly, the larger MFPs rely on capital markets to provide the quantity of capital that they require, at a low cost, and at a speed necessary to transform themselves from 'niche' players into providers of a national level service.¹⁴

2.3.2.2 The cost of microfinance services

MFPs supply financial services that generally involve lending small amounts of money to large numbers of clients. On a like for like basis, the comparative cost structure of MFPs is likely to be considerably higher than that of commercial banks. For example, a single loan of Rs 100,000 issued by a commercial bank is likely to incur considerably lower administrative and management costs than the numerous separate transactions that an MFP will incur in lending the same Rs 100,000.

2.3.2.3 The cost of financial sustainability

An entry point to understanding the structure of an MFP's costs is the calculation of the interest charged to borrowers.

The simplified formula for calculating interest rates for financial sustainability (GCAP, 2002b) is:

$$R = \frac{AE + LL + CF + K - II}{1 - LL}$$

Where:

R is the effective annualised interest rate
 AE is administrative expenses
 LL is loan losses
 CF is the cost of funds
 K is the desired capitalisation rate, and
 II is investment income.

MFPs use a wide variety of contracting methods, business operations and client engagement to contain costs. Ultimately these costs are reflected in the interest rates that they charge to customers.

2.3.2.4 The issue of high interest rates

As mentioned in Box 2.2, above, there is a considerable body of theory and a large body of evidence that demonstrates that poor people with very limited access to capital are often willing and able to pay interest rates on loans that a larger business would be unable to afford.

In economics the theory of 'diminishing marginal returns to capital' suggests that, at low levels of capital, production or output can increase significantly. At higher levels of capital the increase in output will decline. Thus a mechanised food mixer can significantly increase the output of a food stall if it replaces hand mixing and a sewing machine the output of a tailor where hand sewing was used previously. Whilst a second food mixer or sewing machine could still increase output, this percentage increase is unlikely to be as large as when the first mixer or sewing machine is purchased.

The large increases in output that result from investment at low levels of capital intensity generate the large increases in revenue that in turn can help repay investment loans. At higher levels of capitalisation, increases in output and revenues tend to diminish and therefore only lower levels of interest can be afforded.

Moving beyond theory to the evidence, large amounts of evidence from around the world and also from Pakistan demonstrate that people on low incomes continue to take out loans either from the informal or formal markets with interests rates that, in different circumstances, might be regarded as very high. The international evidence is summarised in Honahan (2004b).¹⁵ For Pakistan the evidence is brought together in Adnan Qadir's *Study of Informal Finance Markets in Vietnam* (2005). The point is also illustrated by the estimate by the State Bank of Pakistan that the return on the purchase of a motorised tricycle in Karachi is about 170%: in such a case, an operator who borrows to buy a tricycle is relatively insensitive to 5-10% differences in interest rates - access to the loan is more important than its cost, within the range of current interest rates.

¹⁴ The importance of financial sustainability is stressed in Principle 4 of the Key Principles of Microfinance in Annex B, and in paragraphs 23 and 26 of the Statement of the Advisors Group to the UN International year of Microcredit in Annex C.

¹⁵ For specific examples, see also Harper (1998) and Hossain and Diaz (1999).

Indeed the results from the small survey conducted as part of this PSIA show clearly why it might be that the poor - when using credit to finance small-scale investment - are prepared to pay high interest rates, i.e. rates of return are very high (see below).

2.3.2.5 How interest rates can be reduced

High rates of interest on investment or consumption loans are not desirable in themselves, and are no substitute for efficient and effective MF service delivery.

Returning to the simple model of interest rates (section 2.3.2.3), it is clear that interest rates can be reduced only by reducing administrative expenses (AE), loan losses (LL), the cost of funds (CF) or the capitalisation rate (K) or increasing income from the investment of capital that is not used in mainstream operations (II). For example, the group lending arrangements that have been discussed above enable MFPs to reduce AEs and LLs. Sourcing capital funds from donors or from the money markets can help to reduce the CF. However, in a regulated MF sector, K is determined by government policy, and below a government determined level of capitalisation, it is not a cost that can be controlled by the MFP.

CHAPTER 3: THE EVOLUTION OF MICROFINANCE POLICY IN PAKISTAN

3.1 The context – the financial sector and poverty reduction

MF policy in Pakistan combines the GOP's approach to financial sector reform with the principles of the Poverty Reduction Strategy. It is therefore necessary to describe those two elements in order to understand the evolution of MF policy.

3.1.1 Structural reform and the financial sector

Structural reforms in Pakistan's economy, and particularly in the financial sector, were initiated in the early 1990s and consolidated after 1999. These reforms were characterised by:

- greater openness and liberalisation - these became the hallmark of the economy, allowing for further competition and more open policies attracting foreign and local investment;
- privatisation of state-owned enterprises, in particular of four of the five main public sector banks, was a key pillar in this strategy. It has resulted in visible improvements in the nature, form, scale and depth of the financial sector and in financial intermediation;
- at the same time, the State Bank of Pakistan, the central bank, which had been under the control of the Ministry of Finance, was given a much greater degree of autonomy;
- there has been a parallel and related reform of the regulatory environment, including:
 - improvement in the quality of capital adequacy requirements and prudential regulations;
 - improvements in the corporate governance of banks;
 - the establishment and expansion of credit agencies (with rating being made compulsory for banks).

These reforms of the financial sector are further discussed in section 4.3, below.

3.1.2 The poverty reduction strategy

A consultative process to deal with the persistent problem of poverty was initiated by the GOP in 1999, at around the same time as discussions were launched about the reform of the MF sector and the finance sector environment. The Interim Poverty

Reduction Strategy Paper (I-PRSP,) published in November 2001, is 'a comprehensive strategy, which links social and poverty related expenditures with the attainment of key social and human development outcomes. The I-PRSP is a concerted effort aimed at pooling poverty reduction efforts at the federal, provincial, and district levels, across various ministries, departments, and divisions, to ensure realisation of desired outcomes by focusing on key success drivers.'¹⁶

In the I-PRSP the GOP expressed its view that, 'access to credit is the surest way of empowering the poor and improving their income generating opportunities' and that 'international experience has shown that micro-credit can be an important instrument in improving the income generating capabilities of the poor'.¹⁷ Similarly, the GOP's main partner in developing the Microfinance Sector Development Programme (section 3.2.2 below), the Asian Development Bank, expressed the view in its assessment of the sector in Pakistan, that the 'poverty reduction potential of micro-finance [was] widely recognised at the policy level and among the development community' (ADB, 2000). The Finance Minister of Pakistan, in 2000, stated that MF was a 'critical element' in poverty reduction, a view 'shared by both the Government and ADB'.¹⁸ The Governor of the State Bank of Pakistan in 2003, stated that MF needs to be placed in the 'overall context of the efforts the State Bank in expanding the outreach of financial services and help the goal of poverty alleviation in the country' (State Bank of Pakistan, 2003).

In the last of its four pillars to reduce poverty in Pakistan, 'Targeting the Poor and the Vulnerable', the GOPs PRSP of 2003 sees the expansion of MF facilities as a major goal in this regard. The GOP through its PRSP believes that MF 'is fast emerging as a viable tool to address the question of poverty reduction' (PRSP, 2003).

3.2 Microfinance sector policy

3.2.1 Early developments in the sector

The first generation of MF services in Pakistan, in the late 1980s and 1990s, comprised:

- some small and localised NGOs providing credit to groups of borrowers;
- the Aga Khan Rural Support Programme (AKRSP) in the northern region in the country;
- other Rural Support Programmes (RSPs).

The RSPs, which constituted the main mechanism and approach to MF during the 1980s and part of the 1990s, made a major contribution to the MF sector by accessing lines of

¹⁶ I-PRSP (2001), Foreword.

¹⁷ *Op. cit.*, section 4.3.2.

¹⁸ Development policy letter on MSDP by the Finance Minister to the President of the ADB, 4 November 2001, cited in Khushhali Bank, 2005

credit from commercial banks to provide microcredit to low-income people living in rural areas. Alternatively, the Orangi Pilot Project (OPP) developed an individual lending methodology adapted to urban low-income areas, by targeting entrepreneurs in the Karachi region.

3.2.2 Microfinance Sector Development Programme (MSDP)

In developing the financial sector reforms described in section 3.1.1, above, the GOP recognised that it would also need to take a fresh look at Pakistan's financial sector to find new ways of reaching clients, especially the poor and those involved in the dynamic Small and Medium Enterprise (SME) sector. With the growing privatisation and liberalisation of the financial sector, and with the recognition that the private sector also needs to play a role in Pakistan's Poverty Reduction Strategy (as summarised in section 3.1.2), a set of reforms were developed with the help of private sector banks and non-bank institutions. These reforms were articulated in 2000 in the MSDP, in which the public and the private sector were expected to play important roles independently, as well as in the form of public-private partnerships.

The main aims of the MSDP were to:

- create a conducive policy environment allowing new actors to emerge and to allow greater space to existing actors;
- develop appropriate financial infrastructure;
- promote and strengthen MFIs;
- develop linkages with NGOs and community organisations;
- invest in building social capital;
- mitigate the risks faced by poor households;
- develop institutions which would enhance the capacity and efficiency of those involved in the sector.

3.2.3 Microfinance Institutions Ordinance 2001

As an outcome of the MSDP, a number of interventions have been made in the MF sector over the last 6 years. Perhaps the most important and overriding consequence has been that MF has been given recognition as a separate entity in the financial sector, and a conscious attempt has been made to build an environment in which existing and new players and institutions can move forward.

The Microfinance Institutions Ordinance 2001 was promulgated by the GOP to support the development of the MF sector by introducing the concept of a 'microfinance institution' (MFI), defined as 'a company that accepts deposits from the public for the purpose of providing microfinance services.' (Article 2(j)) Under this ordinance, MFIs were to be created with the necessary amount of capital, to offer MF services, including savings deposits, to the general public (see Box 3.1, below, on MFIs and MFPs).

Box 3.1 Note on terminology: MFIs and MFPs

In many countries, the term 'microfinance institution' is used to designate any institution that provides MF services. Under the Microfinance Institutions Ordinance 2001, however, the term is restricted to 'a company that accepts deposits from the public for the purpose of providing MF services.' The Ordinance prescribes that 'No person other than a licensed MFI shall use with its name the words "Microfinance Bank", "MFB", "Microfinance Institution", "MFI" or derivatives of any words or letters which suggest that it is a microfinance institution.' (Article 5(2)).

For the purposes of this PSIA, therefore, we have distinguished between:

MFI a microfinance institution licensed under the Ordinance

and

MFP a microfinance provider: any institution that provides microfinance services (which includes MFIs)

The Ordinance specifies the functions, capital requirements, ownership structure, and terms and conditions for the establishment, disclosure requirements and winding up procedure for MFIs. In order to regulate the establishment, business and operation of MFIs, the Ordinance allows for the establishment of three types of MFIs according to their operation limits and geographical scale. MFIs are granted licences differentiated on the basis of them being **all-Pakistan**, **provincial** or **district**, with the minimum paid up capital for these three types of institutions being Rs 500 million, Rs 250 million and Rs 100 million, respectively.

The Preamble of the Ordinance, in line with the Government's policies, states that the MFIs will focus on 'financial and infrastructural support to poor persons, particularly poor women, for mitigating poverty and promoting social welfare and economic justice through community building and social mobilisation' (MFIO, 2001, Preamble) The functions and powers of the MFIs in accordance with the State Bank's prudential regulations, are meant to 'render assistance to microenterprises and provide MF services in a sustainable manner to poor persons, preferably poor women, with a view to alleviating poverty.' (MFIO, 2001, Art. 6(1)).

The Ordinance defines a '**poor person**' as follows:

' "poor persons" means persons who have meagre means of subsistence and whose total income or receipts during a year is less than the minimum applicable taxable limit set out in the law relating to income tax' (Article 2(k)).

The rules set for the per-person exposure limit state that while granting any MF facilities to poor persons MF banks must ensure that the total exposure of such a person from the bank and MFI, does not exceed Rs 100,000 in aggregate.

Since the nature and operation of the MF sector and MFIs are considered to be different from the mainstream banking sector, the State Bank of Pakistan (SBP) has issued a separate set of prudential regulations for MFIs under the Ordinance.

3.2.4 Implementation of the policy

In promulgating the Ordinance, the Government has emphasised the need to develop sustainable MFIs that can help create social capital and include risk mitigation as an important instrument to protect against uncertainty. In line with the Government's overall policies applied to other sectors as well, it has continued to encourage private-public partnerships, the most visible manifestation of which is setting up of the **Khushhali Bank**, Pakistan's first licensed MFI, which has taken the lead in retailing MF services across Pakistan. In addition, the government has also encouraged the private sector to set up MF banks, with the result that three MF banks became operational during 2001-04. More recent applications for setting up MF banks have also been received by the SBP and are under process for licensing.

The GOP also restructured a number of Development Finance Institutions (DFIs), closed the Federal Bank of Cooperatives and reorganised the Agricultural Development Bank of Pakistan and re-launched it as the **Zarai Taraqiati Bank**.

Along with the Ministry of Finance, the SBP too, has played a key role in the evolution of MF policy in Pakistan since 1999. A Microfinance Support Division was established at the SBP, in order to improve the environment in which the new and existing MFIs were to function. The SBP has adopted a regulatory regime of a 'facilitator, guide and problem solver' As explained in section 3.2.1 above, the SBP does not prescribe for MFIs the same onerous regulations which prevail for other financial institutions and has 'a light regulatory oversight' and is 'learning together with the practitioners and adapting [itself] to the changing circumstances' (SBP, 2003). It has a Consultative Group drawn from the representatives of stakeholders who guide the State Bank in the development of regulations and prudential norms.

The SBP is also encouraging the provision of credit to small and medium entrepreneurs through a newly set up **SME Bank**, to small farmers through a newly restructured **Zarai Taraqiati Bank** and **Cooperative Banks**, and to women entrepreneurs, individuals and small firms through the **First Women's Bank**. The SBP considers this to be the 'only durable basis through which the poor can benefit from the financial sector of the country' (SBP, 2003). Moreover, it also sees complementarities between MF and other elements of poverty alleviation, such as investment, infrastructure, the social services and capacity building, and feels that these should be built into the overall MF programme. The previous Governor of the Bank argued that 'income generation by the poor cannot take place only through availability of credit if there is no infrastructure, or markets for selling their produce' (SBP, 2003).

Clearly, the focus and emphasis on the development of MF in Pakistan since proactive intervention began in 1999 has been poverty alleviation. Pronouncements by the GOP since 1999 on both subjects reflect this close association, and both are now integrated into annually announced broader economic, growth and poverty alleviation policies. The annual publication of the Ministry of Finance, the *Pakistan Economic Survey* and the SBP's *Annual Report*, both contain views and information about MF (and of course poverty) and show that MF has increasingly become accommodated and mainstreamed into the GOP's overall economic programme and strategy, particularly as a poverty alleviation tool.

3.3 Donors

The Asian Development Bank's support for the MSDP has already been mentioned in section 3.2.2, above. The MF sector in Pakistan has been given support by numerous other multilateral and bilateral donors, as it seen by them to be a means of poverty alleviation and of gender empowerment.

Hence, for example, a Lahore-based NGO, **Kashf**, which has been doing both, has been supported by DFID following a successful 2-year initial pilot phase, where DFID has provided support of £3.2 million over 5 years to the project. While Kashf is seen to be one of the most dynamic and creative, as well financially sustainable, MFIs in Pakistan, this funding from donors is sure to have played a critical role in the organisation achieving noticeable success.

Other donors have also been involved in supporting MF and poverty alleviation programmes related to it. For example, the **Pakistan Poverty Alleviation Fund (PPAF)** was established in 2000 as a not-for-profit private company sponsored by the GOP and funded by the GOP and the World Bank. It was inspired by the success in Bangladesh of Palli Karma-Sahayak Foundation (PKSF), which has a more narrow focus on MF. The PPAF was established to help the poor by enabling them to gain access to resources for their productive self-employment, to encourage them to undertake activities of income generation and poverty alleviation, and for enhancing their quality of life. As an Apex fund, PPAF disburses soft loans to a myriad of MF organisations in Pakistan. It also provides grants on a cost-sharing basis for development of small-scale community infrastructure, and strengthens development and MFIs by supporting their capacity building activities. The resource base of PPAF consists of an endowment from the GOP of Rs 500 million, and a World Bank credit of US\$ 90 million. Half of the World Bank funds are to be used for microcredit and enterprise development.

When it was set up in 2000, Pakistan's first MF bank, **Khushhali Bank** was owned by three public sector banks, 11 private sector and two international banks. The Khushhali Bank received access to a credit line of \$68 million from the Asian Development Bank. The **First Microfinance Bank Limited** was set up after the promulgation of the Microfinance Institutions Ordinance of 2001 and is sponsored by AKRSP, the Aga Khan Fund for Economic Development, Geneva, and the International Finance Corporation.

With the help of donors the GOP also set up four funds during 2001 making more than \$70 million available for sustainable MF services. The **Microfinance Social Development Fund**, worth \$40 million, was set up to finance social mobilisation and to

support communities' capacity building expenses of licensed MFIs. The **Community Investment Fund** totalling \$20 million was created to help community-based organisations to develop projects of 'mutual interest' by providing grants. The **Risk Mitigation Fund (RMF)** and the **Deposit Protection Fund (DPF)** were established to mitigate the risk of indebtedness and loss of deposited money of the poor. The RMF is meant to reduce the fear of indebtedness by protecting poor borrowers in case of failed enterprises or loss of income-generating assets due to unforeseen circumstances; the DMF mitigates the risk of depositors of regulated MFIs as they are to be paid from this fund in the case of the liquidation of any MFI.

In 2003, the Swiss Government and the Swiss Agency for Development Cooperation (SDC) launched the **Financial Sector Strengthening Programme (FSSP)**. The SDC initiative was launched to address problems which accrue due to the lack of adequate human and institutional capacity, the shortage of local expertise and due to weak coordination among the various stakeholders, factors that are seen to inhibit the growth of the MF sector in Pakistan. The **Pakistan Microfinance Network**, a network of organisations engaged in retail MF and dedicated to improving the outreach and sustainability of MF in Pakistan, receives funds for its publications and activities from DFID, the SDC under the FSSP, and the Aga Khan Foundation, Pakistan,

The USAID / Pakistan Economic Growth programme, began in 2003 and while it is national in scope, has a greater focus on the provinces of Balochistan and Sindh. Its current 2003-07 programme provides an estimated \$3.2 million towards **Access to Microfinance**, where the programme component includes the following: expanding MF services to previously neglected areas of Balochistan and Sindh; more than 105,000 loans worth \$18 million have been disbursed with USAID support; the target is to disburse more than 430,000 loans by 2008; and in 2005, the programme was to expand into the Federally Administered Tribal Areas (FATA). In its **Innovation in Microfinance** programme worth an estimated \$3.5 million, USAID was to: provide support to four local MFIs (mostly NGOs) and design and deliver MF products tailored to their communities; expand the availability of micro-leasing in Karachi and Lahore; and, has disbursed more than \$2 million so far with a 100% repayment rate. USAID is supporting Khushhali Bank's expansion into Balochistan and rural Sindh provinces and USAID is helping PPAF diversify into new MF products.

According to the *Year of Microcredit Synthesis Paper* on Pakistan, Pakistan would have borrowed approximately \$500 million from the Asian Development Bank and the World Bank alone for direct investment in the MF sector in the period 1999-2008.

CHAPTER 4: THE EVOLUTION OF MICROFINANCE IN PAKISTAN, 2000–2005

4.1 Introduction

In this chapter and the following chapter we aim to provide the evidence on which we base the conclusions outlined in Chapter 6. Our starting point for this chapter is the premise that in order for MF to play the poverty reduction role outlined for it in the PRSP then the sector will need to grow substantially from its current size, and this growth will largely need to be achieved through financially sustainable organisations that have only limited and discreet reliance on subsidies.

In this chapter we use data analysis from secondary sources to examine the reasons that explain the apparent small size of the sector; we examine the levels of financial and operational sustainability of some of the key MFIs; and we use a series of seven key informant interviews with seven MFIs to understand the structural constraints - if any - for further growth and poverty focus.

In the following chapter (Chapter 5) we use survey evidence and secondary evaluation reports to understand whether existing MF services are firstly, reaching the poor, and secondly, having an impact on the incomes of the beneficiaries.

4.2 The macroeconomic context

In order to understand the size and structure of the MF sector we need first to understand a little of the macro-economic and wider finance sector performance. It is generally more difficult for MF services to grow if either the macro-economy is not performing or the wider finance sector is dysfunctional, or both.

Table 4.1, below, shows the growth performance of key sectors over nearly six decades. Pakistan has had, for the most part, high growth for much of this period, and particularly in the 1960s and 1980s. The decade of the 1990s, however, was Pakistan's worst in many regards, in contrast to the remarkable recovery seen since 2002.

Table 4.1 Growth rates in Pakistan, 1950–2005 (%)

	GDP	Agriculture	Manufacturing	Services
1950s	3.1	1.6	n/a	n/a
1960s	6.8	5.1	9.9	6.7
1970s	4.8	2.4	5.5	6.3
1980s	6.5	5.4	8.2	6.7
1990s	4.6	4.4	5.8	4.6
1999/2000	3.6	0.4	7.0	4.8
2000/01	2.2	-2.7	8.2	4.8
2001/02	3.4	-0.1	5.0	4.1
2002/03	5.1	4.1	7.7	5.3
2003/04	6.4	2.2	14.1	6.0
2004/05	8.4	7.6	12.5	7.9

Source: GOP, *Pakistan Economic Survey*, various issues, Islamabad.

The recovery since 2002 has been characterised by consistent and substantial improvement in each of past three financial years:

- the growth rate for the last financial year, 2004/05, was 8.4%, the highest since 1991/92;
- foreign exchange reserves have risen to their highest levels in recent years and continue to stay high;
- export levels set new records every year, exceeding the targets set by the GOP;
- investment, which had been a poor performer towards the end of the 1990s, has now reached levels comparable with those of the 1980s and early 1990s.

These gains are the result of a number of inter-related factors, including:

- a reform process characterised by increasing liberalisation and openness;
- the privatisation programme;
- better management and more diligent use of resources;
- substantial debt rescheduling after 2001 that has increased the scope for fiscal flexibility;

- recent developments in the financial sector - in terms of greater scrutiny of formal and informal remittances - that have helped foreign reserves to grow to around 10 months of imports, thus helping Pakistan's currency to avoid the volatile depreciations of the 1990s.

4.3 Financial sector and banking reforms

A programme of financial sector reforms was initiated in Pakistan in the 1990s, in order:

'to create a level playing field for financial institutions and markets for instilling competition, strengthening their governance and supervision, and adopting a market-based indirect system of monetary, exchange and credit management for better allocation of financial resources. Reforms covered seven important areas: financial liberalization, institutional strengthening, domestic debt, monetary management, banking law, foreign exchange and capital market' (State Bank of Pakistan, 2002).¹⁹

The banking sector was liberalised by permitting private banks to operate and compete with nationalised commercial banks; the process of privatising public sector banks was initiated; the loan recovery process was streamlined by issuing clear guidelines for loan classification and requiring banks to submit regular reports on recoveries; a number of state-owned banks and Development Finance Institutions were downsized and restructured through golden handshake and branch closure programmes in the latter half of the 1990s. Prudential measures were strengthened to ensure capital adequacy and disclosure of financial data reflecting the true condition of banks. The SBP was also given considerable autonomy in this decade. A summary by the SBP of the reform programme is reproduced in Box 4.1.

¹⁹ Most of this section is drawn from State Bank of Pakistan (2002), subsequent SBP annual *Financial Sector Assessments* and SBP's *Annual Reports*.

Box 4.1 Banking sector reforms in Pakistan

'Since Nationalised Commercial Banks (NCBs) had focused more on increasing their branch network to far-flung areas of the country, their efficiency began to decline with rising cost and oversized workforce. These, together with growing non-performing loans rapidly offset the initial benefits of nationalisation. The more important concern was the increase in intermediation costs that translated into lower returns on deposits and higher lending rates. The resulting stress on their profitability made it clear that without a significant restructuring, these banks would continue to pose systemic risks to the financial system. Keeping this in view, NCBs were asked to prepare restructuring plans to rationalise their work strength and size.

'In September 1997, three NCBs, two specialised banks and two privatised banks introduced various separation schemes for employees besides chalking out plans for branch closure. With the help of golden handshake schemes, in a two-year period, these banks were able to reduce the size of their workforce from 99,954 to 81,079 as on end December 1999. In terms of branch closure program, an earlier criterion, which ensured that no area was rendered un-banked, was changed and banks were allowed to close their branches entirely on commercial considerations. This resulted in a reduction of 718 branches from end June 1997 (8,673 branches) to end June 2000 (7,955 branches).

'Banking sector was liberalised by permitting private banks to operate and compete with nationalised commercial banks. Competition was promoted by privatisation of MCB and ABL. Initially at the start of 1990s, 10 new banks were permitted to operate, of which eight started functioning. A couple of new banks joined later in the private sector. Governance of financial institutions was strengthened by insertion of new sections in Banking Companies Ordinance, 1962. Loan recovery process was streamlined by issuing clear guidelines for loan classification and requiring banks to submit regular reports on recoveries. A number of state-owned banks and Development Finance Institutions (DFIs) were downsized and restructured through golden handshake and branch closure programmes in later half of 1990s. Prudential measures were strengthened at the same time to ensure capital adequacy and disclosure of financial data reflecting true conditions of banks. (p 2)

'During 1990s, a number of amendments were made in the SBP Act, 1956; the Banking Companies Ordinance, 1962; the Banks (Nationalization) Act, 1974; the Banking Companies (Recovery of Loans) Ordinance, 1979 and the Banking Tribunals Ordinance, 1984. The key objectives of these changes were: to pave the way for privatisation of NCBs; to enhance competition by allowing private sector to establish new banks; to increase the autonomy of SBP in formulating and implementing monetary policy; to consolidate its role as regulator of banks and non-bank financial institutions; to strengthen the internal governance of these institutions; and to improve the framework for recovery of loans.'

Source: Bank of Pakistan (2002), pp. 2, 26 and 33.

Domestic debt management also underwent a significant reform processes during the 1990s. A primary market of treasury bills was established through auctions, replacing the earlier tap system. Various monetary management measures were initiated to dismantle the system of financial repression and establish a market-based mechanism

of monetary control. Bank-by-bank credit ceilings were abolished and replaced with a credit deposit ratio that itself was subsequently removed. In addition to this, caps on lending rates of banks and NBFIs were eliminated to pave the way for the implementation of monetary policy indirectly through signals of liquidity and short-term interest rate changes. Banking laws also underwent significant changes during the 1990s in order to provide a supportive legislative framework for the reform process. Important amendments were made in all relevant banking laws.

The main outcomes expected from this set of reforms were:

- greater ownership by the private sector on financial institutions;
- increased financial depth, intermediation and efficiency;
- reduced interest rate spreads and reduced distortion in the term structure of interest rates;
- better management of domestic debt in terms of cost and sustainability;
- reduced segmentation in the government debt market;
- reorientation of monetary policy from direct to indirect controls;
- enhanced efficacy of monetary transmission;
- increased effectiveness of SBP in supervising banks.

The SBP is satisfied that there has been considerable progress in achieving the objectives of the reforms. Through privatisation, deregulation and greater incentives to the private sector, private sector banks have begun to play a greater role in the banking and financial sector of the country. The asset share of public sector banks has fallen from 92.2% in 1990 to less than 40% today. Financial deepening, measured by the ratio of Money M2 to GDP, has risen significantly over the last 25 years, from 37.6% in 1980/81, to 39.2% in 1990/-91 to 42.9% in March 2005 (GOP, 2005). The extent of financial intermediation assessed by the currency to deposit ratio shows that the ratio declined from 51.4% in 1990 to 34.3% in 2000, indicating substantial improvement in intermediation.

In addition to the reforms described above, the banking sector in Pakistan has made increasing use of e-banking and electronic services, with the number of on-line branches growing more than nine-fold, from 322 in 2000 to 2,900 in 2005; similarly the number of ATMs in the country has increased five-fold in the same period, as has the number of credit card holders. Consumer credit specifically, and credit to the private sector more generally, have grown sharply in the last decade or so. For example, the total credit to the private sector in the period 1992-2002 was Rs 580 billion, whereas in the period 2002-05, the private sector was extended credit of Rs 863 billion. As a percentage of GDP, the net private sector credit to GDP ratio increased from 0.5% in 1999/2000 to 5.9% in 2003/04 (GOP, 2005).

The impact of the reform programme was summed up in the 2004 Financial Sector Stability Assessment as follows:

'Major reforms in the financial sector have resulted in a more resilient and efficient financial system that is better placed to absorb significant macroeconomic shocks. ... An important achievement in the last decade has been the transformation of a largely state-owned and weak banking system into a healthier, primarily privately owned system. This has been facilitated by restructuring of major banks, ongoing consolidation, strengthening of regulatory capacity, and improvements in transparency, corporate governance, and credit culture. As a result, quasi-fiscal responsibilities of financial institutions have been reduced sharply. The reform efforts are reflected in improving financial soundness indicators, greater resiliency to credit, market and liquidity risks, and good compliance with international supervisory standards'. (FSSA, 2004)²⁰

4.4 Structure of the microfinance sector in Pakistan

4.4.1 The formal and informal sectors

The classification of formal and informal financial services is discussed in Chapter 2, and the classification used in this paper is shown in Table 2.1. The development of the formal sector in Pakistan is described in Chapter 3. Estimates vary, but there is universal agreement that the formal sector represents only a small proportion of the financial services used by the poor in Pakistan. Household survey data can be a useful entry point to understanding the relative size of the sector, and the following chapter provides us with a limited entry point to this part of the debate.

4.4.2 The formal microfinance sector

So how does the MF sector in Pakistan compare with that of other countries in the region? Comparison is difficult (see Box 4.2, but the regional comparisons in the remainder of this subsection indicate that Pakistan fares much better than many of its critics in Pakistan seem to think. The comparison begins with the largest area of MF - microcredit - comparing Pakistan with other countries first in terms of the reach and shape of microcredit, and then its efficiency and productivity. Finally, the most important other financial service, savings and deposits, is considered.

²⁰ The FSSA also covered the significant reform of the securities market, as well as the status of other parts of the financial sector, including the insurance and pensions industry, where reform is less advanced.

Box 4.2 Access to finance: the problems of international comparison

Rich sources of information exist on access to finance generally and MF in particular, such as the excellent data sets of CGAP, the MIX Market (established by GGAP) and the World Bank Savings Institute. These sources are particularly useful for identifying and analysing specific characteristics of financial service provision in a single country or in a specific institution or set of institutions.

The sources need to be treated with great caution, however, when attempting to make broad comparisons between countries, as demonstrated by just three examples related to the data cited in this PSIA.

As the Note to Table D.1 (Annex D) explains, the CGAP (2004b) access data include figures for the National Savings Centres in Pakistan and the National Savings Branch of the Ministry of Finance in India, even though these institutions cater for relatively well-off, middle-class savers, most of whom already have access to finance also through conventional banking sources.

There are significant differences in the microcredit figures in the MIX Market database (used in Table 4.2) and those published by CGAP in their Occasional Paper (OP) No.8 (CGAP, 2004b). In Pakistan, for example, MIX Market shows 0.45 million borrowers and OP No 8, 0.85 million, but this includes 0.7 million with Sonali Bank. For Nepal, MIX shows 0.16 million borrowers and OP No 8, 0.87 million including the 0.16 million the Agricultural Bank.

As the note to Table 4.2 explains, the MIX Market data on savings can be accessed, in aggregated form, only for specialised MFPs, i.e. those for whom MF represents more than 90% of their business. This excludes multi-purpose institutions like the Rural Support Programmes in Pakistan.

It should also be noted that the institutions covered by MIX Market are self-selecting and quite heterogeneous between countries: for example, some specialist public-purpose bank accounts are included and others are not.

This difficulty is illustrated in the differences between the global microcredit figures for Bangladesh and India. MIX Market shows 13.3 million in **Bangladesh**, and this is very close to the OP No 8 total of 13.8 million once Sonali Bank's 3.5 million loan accounts are taken into account. In **India**, however, MIX shows only 1.6 million MF borrowers while OP No 8 shows 4 million loan accounts at MFIs, plus another 7.8 million via self help groups and another 11.9 million via regional rural development banks. These figures imply very different levels of penetration, and could therefore be misleading if used uncritically in international comparisons. This point is further explored in the discussion of Table 4.2 below.

Finally, in the course of the investigations for this paper, a number of errors have been identified, such as double counting in the OP No 8 data (in, for example, Sri Lanka, Thailand and Mongolia). MIX Market, based on self-reporting, is likely to have fewer such errors, but as explained above, its drawback is that it does not capture the full universe of MF activity.

The problem of comparative data in regard to access to financial services is well recognised. The Advisers Group of the UN International Year of Microcredit, the statement reproduced in Annex C, record that: 'From the start, we have been particularly concerned about the lack of reliable data (except in a few cases) about what financial services are available to poor people, and what services are actually used by them.'

It is recognised that the best source of comparable data is likely to be household surveys (Stone, 2005) and the World Bank are working with DFID and FinScope to produce an agreed standard set of household survey questions (see World Bank, 2005b)

Meanwhile, such aggregate data as are available are used in this paper, but treated with an appropriate level of caution.

4.4.3 Microcredit – reach and shape of the sector

Table 4.2 shows a number of key measurements of the reach of microcredit in Pakistan, Bangladesh, India, Sri Lanka, Indonesia, Afghanistan, Nepal and the Philippines, based on the data in the MIX Market database.

Table 4.2 Microcredit providers: country comparisons

	Pakistan	Bangladesh	India	Sri Lanka	Indonesia	Afghanistan	Nepal	Philippines
Population (million)	152	140	1,080	19	218	29	25	83
Number of MFPs on MIX Market	14	49	32	8	6	9	10	24
Borrowers								
Number of active borrowers	449,044	13,297,973	1,634,103	374,320	3,122,179	83,100	158,218	479,868
<i>Mean no. of active borrowers per MFP</i>	<i>32,075</i>	<i>271,387</i>	<i>51,066</i>	<i>46,790</i>	<i>520,363</i>	<i>9,233</i>	<i>15,822</i>	<i>19,995</i>
Active borrowers as % of population	0.30	9.50	0.15	1.97	1.43	0.29	0.63	0.58
Loans								
Total gross loan portfolio (US\$m)	67.587	958.909	166.503	78.360	1,817.139	9.612	17.199	55.461
<i>Mean gross loan portfolio per MFP (US\$m)</i>	<i>4.828</i>	<i>19.570</i>	<i>5.203</i>	<i>9.795</i>	<i>302.857</i>	<i>1.068</i>	<i>1.720</i>	<i>2.311</i>
Average loan per borrower (US\$)	151	72	102	209	554	116	109	116
Concentration (as % of total)								
Top 5 active borrowers (%)	88	89	64	98	95*	93	90	75
Top 5 loan portfolios (%)	80	91	73	99	99*	94	89	60

* In Indonesia, this represents a single lender: see Note 6 below.

Source: MIX Market database.

See Notes below.

1. **Concentration** measures: active borrowers in top five MFPs in terms of active borrowers as percentage of all active borrowers; gross loan portfolios of five biggest lenders as percentage of total gross loan portfolio of all lenders.

2. **Pakistan:** all figures in the table are for 2004. The two leasing companies, National Leasing Company Limited and Orix leasing, have been excluded from the table, because of the exceptional nature of their business. If they are included then the figures are as follows:²¹

Number of MFPs	16
Number of active borrowers	455,092
Total loan portfolio (US\$m)	77,459
Average loan per borrower (US\$)	170
Concentration: top 5	
Active borrowers (%)	87
Gross loan portfolios (%)	79

3. **Bangladesh:** all figures in the table are for 2004, apart from two MFPs that provide June 2005 figures. Saint NGO is excluded from the table because it does not record the number of borrowers; but its gross loan portfolio is only \$8,286.

4. **India:** all figures in the table are for March 2005, apart from three of the four smallest MFPs, of which two are for 2002 and one is for 2001. Eight MFPs have been excluded from the table as they do not report their gross loan portfolios: they record a total of 46,627 borrowers. Satin Creditcare has also been excluded from the table, because of the exceptional nature of its business. If Silk Creditcare is included then the figures are as follows:

Number of MFPs	33
Number of active borrowers	1,638,550
Total loan portfolio (US\$m)	185,935
Average loan per borrower (US\$)	113
Concentration: top 5	
Active borrowers	64%
Gross loan portfolios	73%

5. **Sri Lanka:** four MFP reports are from 2004 and four from 2005.

6. **Indonesia:** five MFP reports are from 2003 and one from 2002. 95% of loans and 99% of borrowers are concentrated in one single MFI, Bank Rakyat Indonesia

7. **Afghanistan:** five MFP reports are from 2004 and four from 2005. The average loan per borrower varies significantly, between \$594 for ARMP and \$36 for FINCA-AFG (see Table 4.4, below).

8. **Philippines:** one MFP report is for 1998, one for 2002, 10 for 2003, 11 for 2004 and one for 2005.

9. **Nepal:** Nepal Rural Development Organization (NERUDO) has been excluded as the data are not available on MixMarket. All reports are for 2004 apart from the smallest MFP, for which the figures are for 2001.

²¹ NCLC figures are for 2002.

The first point that emerges from Table 4.2 is that despite the fact that the mainstream MF sector in Pakistan is relatively young compared with other countries, it is definitely in the same league as many of them.

In terms of the number of borrowers, the notable exception is Bangladesh, which is more than twice as big as all the other countries in the sample put together (13.3 million borrowers compared with 6.3 million for the rest of the sample). Of the rest, Pakistan has many more borrowers than Afghanistan, Nepal and Sri Lanka, a similar number to the Philippines, though many fewer than India or Indonesia. In terms of borrowers as a percentage of the population, however, Pakistan (0.30%) is ahead of India (0.15%) as well as Afghanistan (0.29%), but well behind the rest.

The need to treat such comparisons with caution is emphasised in Box 4.2, above. This is illustrated by Table 4.3, showing data for microcredit clients collected by the World Bank for a report that is about to be published.

Table 4.3 Microcredit clients in six countries in South Asia

Country	1. Microcredit clients (millions)	2. Comparative figures from Table 4.2
Afghanistan	0.12	0.83
Bangladesh	16.00	13.30
India	15.00	1.63
Nepal	0.50	0.16
Pakistan	0.58	0.50
Sri Lanka	2.50	0.37
South Asia	34.70	23.09

Source: Column 2 - data collected by the World Bank for a forthcoming report.

These differences highlight clearly the difficulties of comparing like with like in MF. The very large difference between column 1 and column 2 for **India** is almost entirely accounted for by over 13 million loans from Self Help Groups (SHGs) supported by the National Bank for Agricultural and Rural Development (NABARD); while in **Sri Lanka**, the difference is largely accounted for by the SANASA Thrift and Credit Co-operative Society (TCCS) network and Community Based Organizations.²² Savings and Credit Co-operative Societies (SACCOs) also appear to account largely for the differences in **Nepal** and **Bangladesh**. The differences in the **Pakistan** and **Afghanistan** figures appear to arise mainly from the different reporting periods covered by the two sources. It is difficult to establish exactly how Pakistan would compare in terms of access to finance if its ROSCAs and other self-help groups were included in the comparison. What Table 4.3 does nevertheless illustrate is that in a like for like comparison of conventional

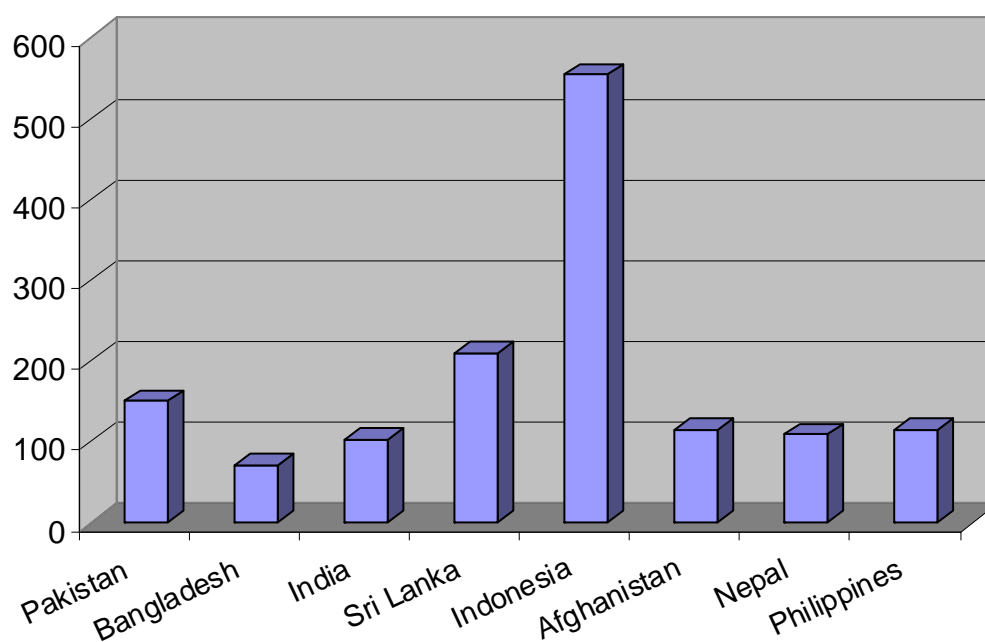
²² For NABARD's work with SHGs, see www.nabard.org, Kropp and Suran (2002) and Harper (2002). For SANASA in Sri Lanka, see Evans (2001) and www.coopscanada.coop.

MFPs, Pakistan is in the same league table as its neighbours (except, of course, for Bangladesh, which is like no other country in this respect).

The NABARD case in India is, of course, more than just statistically interesting. The fact that NABARD has been able to provide a link to the formal banking sector for over 13 million people through SHGs is a matter of great interest. Given the prevalence of ROSCAs in Pakistan, as discussed in Chapter 5 of this paper, it would clearly be useful for Pakistan to study the NABARD case to establish whether there is scope for facilitating a similar linkage between self-help groups and the banking sector, within or outside the MFP structure.

A widely accepted proxy for measuring whether a MF sector is reaching low-income borrowers is the average loan per borrower. As Table 4.2 shows, Pakistan (US\$151) has a much lower average than Indonesia (\$554) or Sri Lanka (\$209), but higher than the rest (which range from \$72 to \$116), implying a lower level of access for poor borrowers. But Pakistan is not far behind the leaders, as illustrated by Figure 4.1. It is in the same league, even if currently in a lower position in the league table.

Figure 4.1 Average loan per borrower of MFPs (US\$)



Source: MIX Market (figures in Table D.3).

MIX Market has recently published a useful survey of MF in the South Asia region (Stephens, Tazi *et al.*, 2006), which indicates that this position has been maintained or, indeed, improved as MF services have expanded in Pakistan. The authors write that, 'Despite the entry of an increasing number of commercial institutions into the microfinance sector, MFIs have continued to serve their initial target group. Over the period studied, overall average loan balance actually declined from 36 percent of local per capita income to 30 percent, indicating that growth in outreach was driven by

rising client numbers rather than a shift towards higher loan sizes.²³ Further comparisons from the MIX Market study are set out in section 4.4.4 below.

Table 4.2 also indicates that the countries in our sample vary considerably in terms of the **shape** or structure of the MF sector.

- The MFPs in Bangladesh and Indonesia have on average hundreds of thousands of borrowers, Pakistan and others have tens of thousands, whereas Afghanistan and Nepal have 9,233 and 15,822, respectively.
- There is a similar variation in the size of the mean gross loan portfolio per MFP ranging from \$302,857 per MFP in Indonesia to \$1,068 in Afghanistan, with Pakistan ranking fifth out of the eight at \$4,828.
- The MF sector is highly concentrated in all countries covered, the highest concentration being in Indonesia where one MFP, Bank Rakyat Indonesia, accounts for 95% of borrowers and 99% of the gross loan portfolio, and the lowest being in India, where the top five MFPs nevertheless account for 64% of borrowers and 73% of the gross loan portfolio. Pakistan is actually less concentrated than most, with the top five accounting for 88% of borrowers and 80% of the loan portfolio.

The differing structures of the MF sectors in relation to credit is brought out in 4.4, which shows the top five MFPs in each country in terms of number of borrowers.

²³ Stephens, Tazi *et al.* (2006), p. 70

Table 4.4 Top five microcredit providers in terms of number of borrowers in selected countries

	Number of borrowers	Gross loan portfolio (\$)	Average (\$)		Number of borrowers	Gross loan portfolio (\$)	Average (\$)
Pakistan				Bangladesh			
Kushhali Bank	168,105	23,541,911	140	BRAC	3,993,525	234,146,287	59
NRSP	88,401	14,298,074	162	Grameen Bank	3,700,000	337,700,855	91
Kashf	67,552	8,068,304	119	ASA	2,772,719	201,102,659	73
PRSP	54,555	6,057,269	111	Proshika	997,090	63,657,960	64
Taraqee	18,194	2,593,057	143	TMSS	372,374	24,652,287	66
Total	396,807	54,558,615		Total	11,835,708	861,260,048	
Mean	79,361	10,911,723	137	Mean	2,367,142	172,252,010	73
India				Sri Lanka			
Spandana	385,996	54,621,671	142	Sabaragamuwa	183,173	23,540,331	129
SHARE	368,996	40,218,274	109	Ruhuna	103,761	25,415,450	245
Sanghamitra	112,029	3,482,305	31	SEEDS	62,660	27,964,390	446
BASIX	89,593	13,009,883	145	WDFH	10,712	467,860	44
Bandhan	82,260	4,629,266	56	Artacharya	6,124	231,703	38
Total	1,038,874	115,961,399		Total	366,430	77,619,734	
Mean	207,775	23,192,280	112	Mean	73,286	15,523,947	212
Indonesia				Afghanistan			
Bank Rakyat Indonesia	3,100,853	1,720,027,773	555	BRAC - AFG	55,572	3,600,533	65
BDB	14,147	94,227,074	6,661	FMFB- Afg.	8,302	2,350,853	283
BPR AK	3,879	876,130	226	FINCA - AFG	7,716	277,890	36
BPR BMMS	1,779	237,945	134	ARMP	3,845	2,284,079	594
BPR PKT	1,263	1,007,785	798	MoFAD	1,978	120,838	61
Total	3,121,921	1,816,376,707	582	Total	77,413	8,634,193	
(Averages not useful here)				Mean	15,483	1,726,839	112

	Number of borrowers	Gross loan portfolio (\$)	Average (\$)		Number of borrowers	Gross loan portfolio (\$)	Average (\$)
Philippines				Nepal			
TSPI	109,629	9,024,521	82	PGBB	36,645	4,611,116	126
KMBI	80,078	4,129,805	52	NGBB	36,242	3,255,864	90
CARD NGO	74,182	6,141,755	83	Nirdhan	36,678	3,587,302	98
NWTF	54,863	5,173,129	94	SBB	26,322	2,588,121	98
TSKI	41,588	1,756,281	42	DD Bank	10,036	1,187,516	118
Total	360,340	26,225,491		Total	145,923	15,229,919	
Mean	72,068	5,245,098	73	Mean	29,185	3,045,984	104

Source: Mix Market database.

This shows just how much the shape of the industry varies within the sample, as follows:

- Indonesia, with a single dominant bank;
- Bangladesh, dominated by a small number of very large providers, providing very small loans; and Afghanistan, with a similar shape, but on a much smaller scale;
- Pakistan, India and Sri Lanka with a wide range of providers, providing a wide range of loan sizes;
- Nepal and the Philippines, with a relatively homogenous class of providers, offering a narrower range of loan sizes.

If one looks more closely at the institutions concerned, it is noticeable that Pakistan and Sri Lanka have a wider range than most not only in numbers of borrowers and sizes of loan, but also in types of institution:

- the top five in Pakistan include an MFI under the Ordinance, two RSPs and two NGOs;
- the top five in Sri Lanka include two banks, two NGOs and a non-bank financial institution (NBFI);
- the top five in India, on the other hand, consist of four NBFIs and one NGO.

4.4.4 Microcredit – the efficiency and productivity of the sector

MIX Market has recently published a useful survey of MF in the South Asia region (Stephens, Tazi *et al.*, 2006) from which Figures 4.2 to 4.6, below, are extracted.

The charts give a good graphical picture of the relative position of Pakistan in the South Asia region, and of the region in the world. The MIX Market paper gives a full

commentary on these comparisons. For the purposes of the PSIA, the following points are highlighted:

- although Pakistan lagged behind its neighbours in terms of borrowers served by profitable MFPs and the number of profitable MFPs (Figure 4.1), the regional comparison indicates that it ranked close to India and Nepal in terms of the percentage of borrower growth from profitable MFPs, and well ahead of Sri Lanka and Afghanistan (Figure 4.2); MIX Market themselves, however, argue that these figures give a distorted picture of developments in Pakistan, as explained at the end of this section;
- in terms of borrowers per staff member, India led the field by very long way, but Pakistan was only slightly behind Sri Lanka, ahead of Nepal and Bangladesh, and well ahead of Afghanistan (Figure 4.3);
- in terms of costs per borrower (also Figure 4.3), however, Pakistan performed significantly less well than any of its neighbours except Afghanistan;
- Pakistan's write-off ratio (Figure 4.4) is rather higher than its neighbours, but the difference is significantly wider in terms of the ratio of loans more than 30 days overdue, where Pakistan's ratio, at 20%, is more than twice as high as any neighbour. MIX Market point out, however, that due account needs to be given to the fact that loans in Pakistan tend to be of longer duration than those in the other countries (apart from Sri Lanka), which mitigates the discrepancy to some extent (a six-month loan that is 30 days overdue, for example, being a less grave matter than a one-month loan that is 30 days overdue);
- finally, and very significantly, in financial performance (measured by the financial revenue ratio), South Asia does not perform as well as the other regions, and Pakistan is the lowest performing country in South Asia (Figure 4.5). The problem is highlighted by the MIX Market survey, which comments: 'the Pakistani [MF] sector posts the region's lowest returns because of a mismatch between revenues and expenses. While cost structures are on par with regional norms, many MFIs in this country charge exceptionally low interest rates that are not in line with the cost of doing business' (Stephens, Tazi *et al.*, 2006, p.11).

It is significant that the figures on which these charts are based are from 2003, at an early stage of the PRSP and of the Microfinance Institutions Ordinance, 2001. The differences between Pakistan and some of its neighbours, particularly India and Bangladesh, are consistent with the view that Pakistan is at an earlier stage in MF development than these countries, i.e. a late starter rather than a laggard. It is particularly encouraging to note that Pakistan ranks third in terms of the percentage of borrower growth coming from profitable institutions, even though the number of such institutions is relatively very small.

Figure 4.1 Sustainability and outreach of microcredit providers

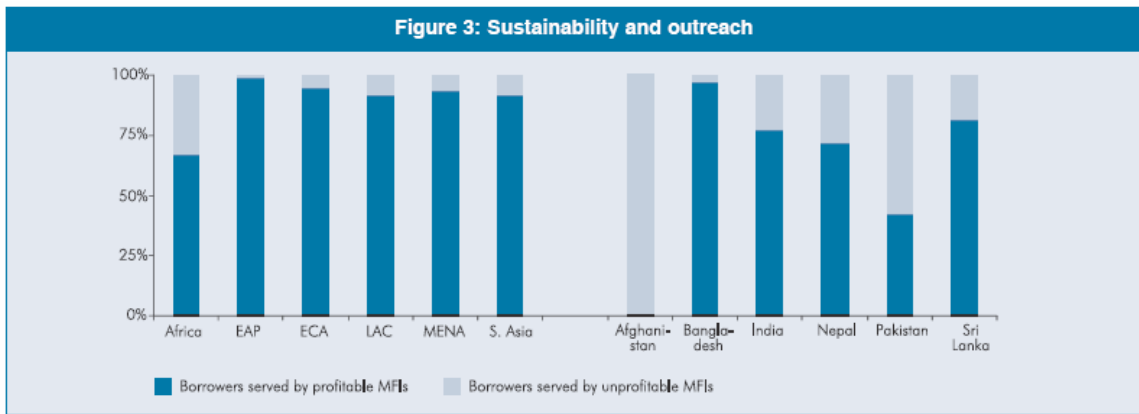


Figure 4.2 Share of borrower growth from sustainable institutions

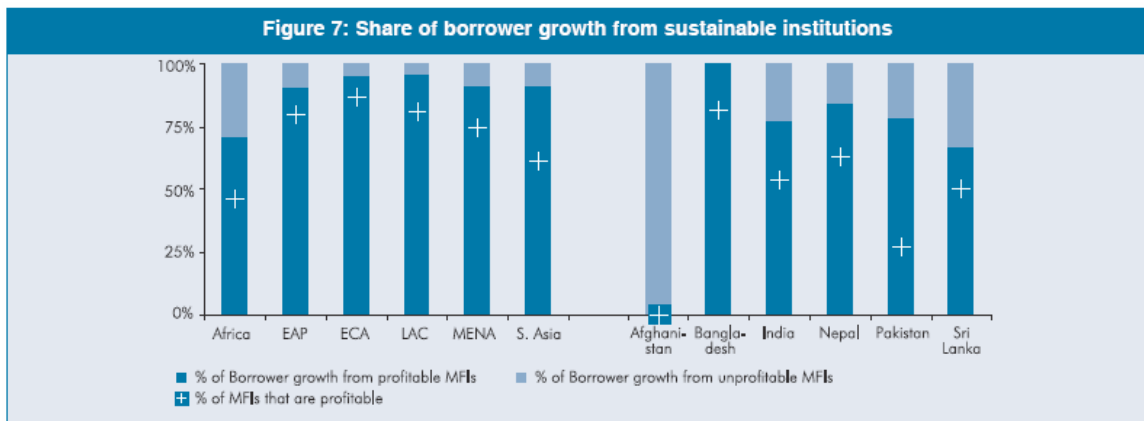


Figure 4.3 Efficiency and productivity

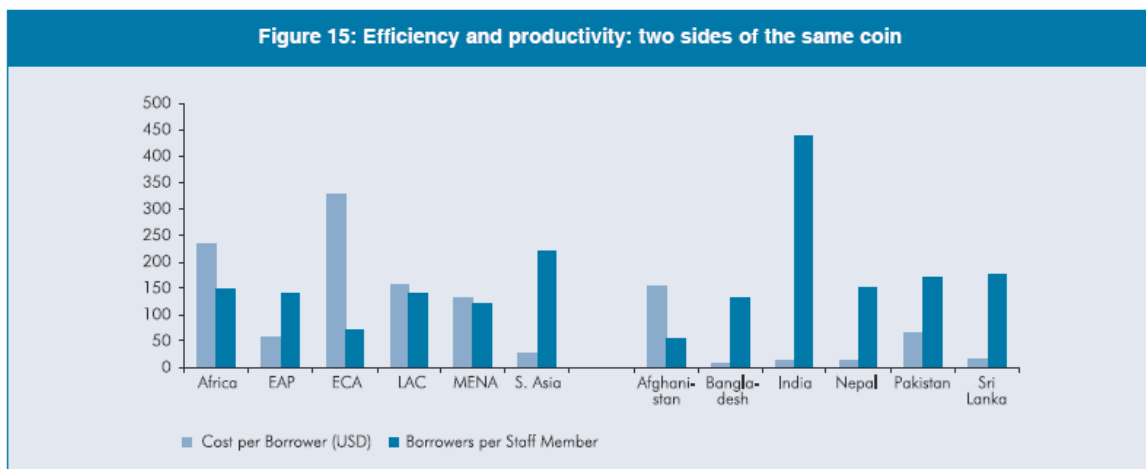
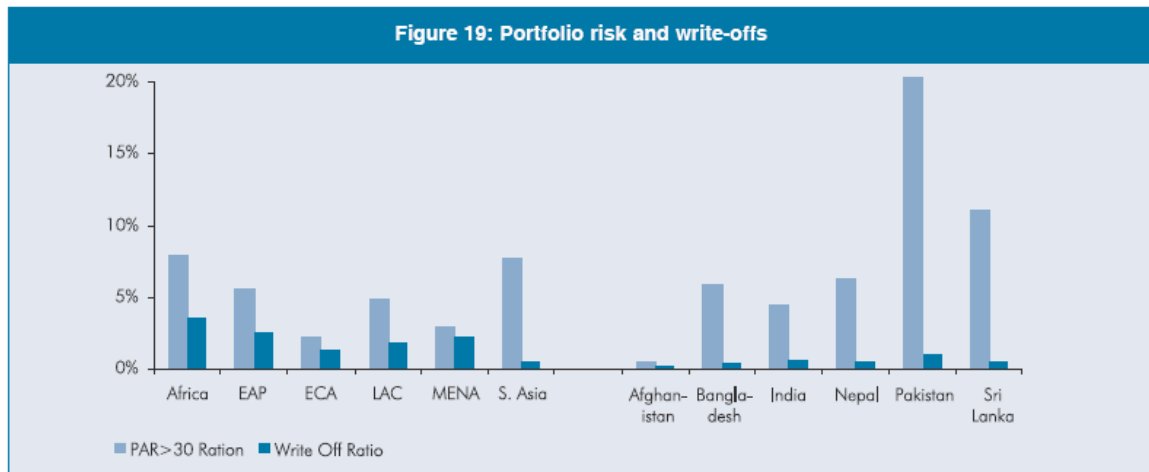
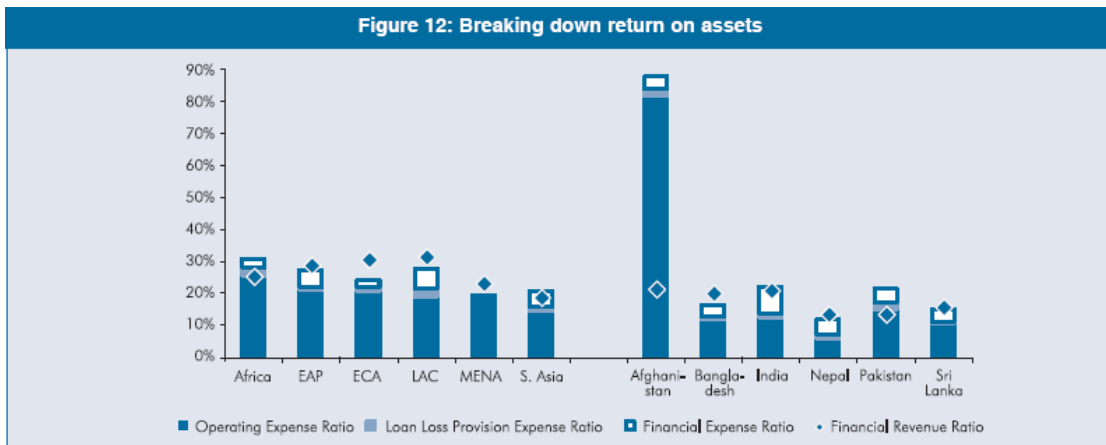


Figure 4.4 Portfolio risk and write-offs



Note: PAR>30 Ratio (not Ratio) is the ratio of the loan portfolio that is more than 30 days overdue.

Figure 4.5 Breaking down return on assets



Figures 4.2 to 4.6: Source, Stephens, Tazi *et al.* (2006): MIX Market 2003 data as of October 21, 2005. Data presented are averages. EAP: East Asia and the Pacific; ECA: Eastern Europe and Central Asia; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; S. Asia: South Asia.

As mentioned above, Mix Market, who generated these figures, argue that Figure 4.3 gives a distorted picture of the position in Pakistan.²⁴ This is because the figures in Figure 4.3 exclude Khushhali Bank and include some MFPs that were on the cusp of sustainability and have since moved from above to below the sustainability line. Indeed, the authors of the MIX Market study argue in the Pakistan country study that, 'One alarming feature of current sector growth is that it is being led by unsustainable institutions that are heavily subsidized. The poor require regular and reliable access to

²⁴ Stephens, Tazi *et al.* (2006), pp.69-71

financial services, but the majority of MFIs are unable to generate sufficient revenues to cover their cost of operations.’²⁵

This supports the report’s conclusions, cited above, about the poor financial performance of that MFIs in Pakistan. The findings of the report on this point conform with the conclusions of this PSIA about the financial performance of the MF sector in Pakistan, and merit quotation at some length (pages 69-73):

‘Future growth, however, is significantly compromised by the sector’s high dependence on subsidized funds to cover costs and maintain operations. To ensure the sustainability of the industry, Pakistani MFIs should build on their exceptionally low cost structures and consider re-pricing their products and services to enhance their financial revenues and become self-sufficient. ...

‘One alarming feature of current sector growth is that it is being led by unsustainable institutions that are heavily subsidized. The poor require regular and reliable access to financial services, but the majority of MFIs are unable to generate sufficient revenues to cover their cost of operations. ...

‘Moreover, the asset side of the balance sheet shows that MFIs are using their assets inefficiently. ... There are several reasons why MFIs do not optimally utilize their resources. Across the country, microfinance is regarded as a charitable activity. Institutions thus charge exceptionally low interest rates and do not regard their credit operations as a significant means to raise revenue. ...

‘The challenge to MFI profitability in Pakistan thus appears to stem from a charitable vision of microfinance that has adverse effects on product pricing, asset allocation and credit risk throughout the sector. MFIs are averse to charging sustainable interest rates since these are perceived as usurious and counter to the movement’s mission of alleviating poverty. Microfinance providers thus wind up on a low cost low yield curve, running heavily subsidized programs.’

4.4.5 Other financial services

Information on other financial services is even more difficult to come by than the information on microcredit set out in the section above (see Box 4.1 on the difficulty of finding comparable data). In Table 4.5 such data as are available on deposits accepted by MFIs are set out for the comparator countries.

As in the case of microcredit, Pakistan appears (on the basis of this, admittedly inadequate, sample) to fare better than many of its critics in Pakistan seem to think.

- The two qualifying institutions in Pakistan recorded on MIX Market, Kashf and First Micro Finance Bank, record between them 72,409 savers, more than the number recorded by qualifying institutions in India, Sri Lanka, Indonesia or Afghanistan.

²⁵ Op. cit., p.70

- The total savings recorded are very similar in volume to India and the Philippines, and are exceeded significantly only by Bangladesh.
- In terms of size of deposits, which, as in the case of loans, is a proxy for measuring whether a MF sector is reaching low-income savers, Pakistan's average, at \$84.13 per depositor, is once again creditable, though capable of improvement: it is less than half the level in India but significantly higher than the rest.

Table 4.5 Specialist MFPs recording information about savings

	Pakistan	Bangladesh	India	Sri Lanka	Indonesia	Afghanistan	Nepal	Philippines
Population (million)	152	140	1,080	19	218	29	25	83
Number of MFPs recording savings	2	18	3	2	1	0	5	8
Savers								
Total number of savers	72,409	3,239,650	34,616	64,439	2,852	0	135,559	138,036
Total savings	6,091,469	367,345,713	6,105,364	988,714	0	0	3,129,390	6,173,753
Average savings balance per saver (US\$)	84.13	12.16	176.37	15.34	N/A	N/A	23.09	44.73

Source: MIX Market (All data collected between 31 August 2004 and 30 June 2005).

Notes to Table 4.5

1. Aggregated data on savings are available on MIX Market only for specialist MFPs, i.e. institutions for which MF represents more than 90% of their business. This excludes, for example, RSPs (though it should be noted that none of the RSPs in Pakistan actually record any savings information in their individual entries in Mix Market). The MFPs excluded from the table are therefore as follows:

Pakistan: Bank of Khyber, DAMEN, NRSP, Orix Leasing, PRSP, SAFWCO, SRSP, Sungi, Taraqee, TRDP

Bangladesh: AF, ASED, ASOD, ASPADA, BASA, BASTOB, BEES, CCDA, COAST Trust, CODEC, DDJ, DESHA, EWF, GJUS, GUP, HEED, NGF, PBK, PMUK, POPI, RIC, RRF, Saint, SBD, SDC, SDS, SSS, ST, TMSS, UDDIPAN, UDPS, VARD, Wave

India: AAMBA, ADARSA, AMMACTS, Asmita, ASSIST, BIRDS, BISWA, Bodhana, BWDA, Janodaya, Kotalipara, KRUSHI, LEAD, Mahasemam, PSS, Sarvodaya Nano Finance, SEVA Microfoundation, SKS, TCT, VCD, VSKSU, VWS

Sri Lanka: ACCDC, Arthacharya, Ruhuna, Sabaragamuwa, SEEDS, Wilgamuwa

Indonesia: BDB

Afghanistan: AMI, BRAC - AFG, MoFAD, Women for Women - AFG

Nepal: MGBB (Nepal), NSSC (Nepal), VYCCU (Nepal)

Philippines: RBTC

2. In Bangladesh, only 4 of the 6 record both the amount of savings and the number of savers (in particular, Grameen Bank, with \$327,944,055 of savings, does not record the number of savers). The average in the last line is only for the four institutions that give both figures.
3. In Indonesia, only one MFP has any record of savings, BPR Kali, which records the number of savers, but not the amount of savings.

4.5 Formal sector case studies

4.5.1 Methodology

As part of the methodology for the PSIA, it was agreed that case studies would be undertaken of a number of MFPs, and of some financial institutions that are not currently players in the MF sector. The purpose of the case studies is to gain an understanding of how such stakeholders or potential stakeholders perceive the sector: their view of the sector as a whole, their perception of their role and their poverty impact, their understanding of government MF policies, and their views about the key issues covered in this assessment.

The case study institutions, chosen to represent a cross-section of different types of institution and areas of geographical focus, were (using the classifications in Table 2.1):²⁶

- **Bank of Khyber** (a full services, broad-spectrum MFP, operating in NWFP);
- **Khushhali Bank** (a full service, specialist MFI, founded with public funds, operating nationally);
- **Tameer Microfinance Bank** (a full service, specialist MFI founded with private funds, operating initially in urban areas);
- **National Rural Support Programme** (a restricted service broad-spectrum MFP, operating nationally);
- **Kashf Foundation** (a restricted service specialist MFP for women, operating in Lahore);
- **Habib Bank** (a large, former state-owned commercial bank that does not undertake MF activities);
- **Union Bank** (a new, 'second generation' commercial bank that does not operate MF strictly defined, though it does have a group lending scheme for farmers, see below).

Interviews were held in Karachi, Peshawar and Islamabad with leading officers of these institutions. The interviews were conducted through open-ended questions and follow-up questions, structured around the Key Principles of Microfinance reproduced in Annex A. In the next section, summary information is given on the case study institutions, and in section 4.5.3 the results of the case study are set out. To protect the confidence of the respondents, the results are reported unattributed, and by theme rather than by institution.

²⁶ As explained in section 2.3.1, the key difference between a 'full service' and a 'restricted service' MFP is that the former are allowed to take deposits from the public, whereas the latter are not.

4.5.2 Case study microfinance providers

4.5.2.1 Bank of Khyber

The Bank of Khyber (BoK) is a commercial bank fully owned by the Government of the North West Frontier Province (NWFP) and is a scheduled / commercial bank which has an MF unit. It has been in the microcredit business for 10 years, though less emphasis is placed on this activity than in the past. It currently has about 9,000 clients, the number of which has not risen substantially in the last few years.

Table 4.6 Bank of Khyber outreach indicators (Microfinance Unit)

	31 December 2004	31 December 2003	31 December 2002
Number of personnel	27	41	43
Number of active borrowers	9,056	8,648	7,761
Average loan balance per borrower (US\$)	481	512	534
Loans below US\$300 (%)	n/a	60.00	60.00
Woman borrowers (%)	9.00	9.60	9.60
Average loan balance per borrower/ <i>per capita</i> (%)	80.23	108.93	127.13
Number of savers	0	0	0

Source: MIX Market.

Table 4.7 Bank of Khyber financial data (US\$)

	31 December 2004	31 December 2003	31 December 2002
Exchange rate used for conversion	59.381 PKR / USD	55.34 PKR / USD	58.309 PKR / USD
Balance sheet			
Gross loan portfolio (US\$)	4,359,404	4,427,350	4,143,800
Total assets (US\$)	4,339,533	4,412,727	4,188,856
Savings (US\$)	0	0	0
Total equity (US\$)	4,339,533	-14,624	145,462
Financing structure			
Capital / Asset Ratio (%)	100.00	n/a	3.47
Debt / Equity Ratio (%)	0.00	n/a	2779.69
Deposits To Loans (%)	0.00	0.00	0.00

	31 December 2004	31 December 2003	31 December 2002
Exchange rate used for conversion	59.381 PKR / USD	55.34 PKR / USD	58.309 PKR / USD
Deposits to Total Assets (%)	0.00	0.00	0.00
Gross Loan Portfolio / Total Assets (%)	100.46	100.33	98.92
Overall financial performance			
Return on assets (%)	-0.27	-3.90	n/a
Return on equity (%)	-0.55	-256.64	n/a
Operational Self-Sufficiency (%)	97.65	76.99	91.70
Revenues			
Financial Revenue Ratio (%)	11.28	13.06	n/a
Profit Margin (%)	-2.41	-29.89	-9.05
Expenses			
Total Expense Ratio (%)	11.55	16.96	n/a
Financial Expense Ratio (%)	3.60	6.29	n/a
Loan Loss Provision Expense Ratio (%)	2.37	2.09	n/a
Operating Expense Ratio (%)	5.58	8.58	n/a
Efficiency			
Operating Expense / Loan Portfolio (%)	5.56	8.61	n/a
Cost Per Borrower	27.6	45	n/a
Productivity			
Borrowers per staff member	335	211	180
Savers per staff member	0	0	0
Risk			
Portfolio at Risk > 30 days ratio (%)	43.88	47.44	39.69
Loan Loss Reserve Ratio (%)	7.81	5.74	3.76
Risk Coverage Ratio (%)	17.80	12.11	9.47
Write Off Ratio (%)	0.00	0.00	n/a

Source: MIX Market.

4.5.2.2 Khushhali Bank

Khushhali Bank is the largest retail MFI licensed under the Microfinance Institutions Ordinance of 2002. It functions and has branches in 65 districts of the country. The Bank was set up in 2001 by the GOP with help and funding from the Asian Development Bank, under the MSDP.

Khushhali Bank is 'mandated to catalyse the environment for the growth of the sector besides undertaking its core responsibility of retailing MF services across Pakistan. Our main challenge is to develop a sustainable and efficient distribution system capable of handling large volume of business across diverse operating environment focusing on our target segment. ... Our mission is to strengthen the economic base of low income populace by improving their accessibility to financial services through the establishment of sustainable, scalable financial services platform with retail delivery capacity.' (Khushhali Bank, *Annual Report*, 2004)

Table 4.8 Khushhali Bank outreach indicators

	31 December 2004	31 December 2003
Number of Personnel	1,171	791
Number of Active Borrowers	168,105	91,532
Average Loan Balance per Borrower (US\$)	140	140
Loans below US\$300 (%)	n/a	n/a
Woman Borrowers (%)	26.60	37.60
Average Loan Balance per Borrower/ GNI <i>per capita</i> (%)	23.34	29.72
Number of savers	0	0

Source: MIX Market.

Table 4.9 Khushhali Bank financial data (US\$)

	31 December 2004	31 December 2003
Exchange rate used for conversion	59.381 PKR / USD	55.34 PKR / USD
Balance sheet		
Gross loan portfolio (US\$)	23,541,911	12,783,977
Total assets (US\$)	75,920,653	58,461,709
Savings (US\$)	0	0
Total equity (US\$)	29,290,888	31,976,710

	31 December 2004	31 December 2003
Exchange rate used for conversion	59.381 PKR / USD	55.34 PKR / USD
Financing structure		
Capital / asset ratio (%)	38.58	54.70
Debt / equity ratio (%)	159.20	82.83
Deposits to loans (%)	0.00	0.00
Deposits to total assets (%)	0.00	0.00
Gross loan portfolio / total assets (%)	31.01	21.87
Overall financial performance		
Return on assets (%)	-4.63%	n/a
Return on equity (%)	-10.16%	n/a
Operational self-sufficiency (%)	52.98	62.07
Revenues		
Financial revenue ratio (%)	5.47	n/a
Profit margin (%)	-88.75	-61.10
Expenses		
Total expense ratio (%)	10.33	n/a
Financial expense ratio (%)	0.57	n/a
Loan loss provision expense ratio (%)	1.56	n/a
Operating expense ratio (%)	8.20	n/a
Efficiency		
Operating expense / loan portfolio (%)	30.32	n/a
Cost per borrower	42.4	n/a
Productivity		
Borrowers per staff member	144	116
Savers per staff member	0	0
Risk		
Portfolio at risk > 30 days ratio (%)	6.39	7.84
Loan loss reserve ratio (%)	4.90	5.03
Risk coverage ratio (%)	76.72	64.21
Write off ratio (%)	2.71	n/a

Source: MIX Market.

4.5.2.3 Tameer Microfinance Bank

Tameer Bank is the most recent entrant in Pakistan to the MF sector, one of the four MFIs set up under the Microfinance Institutions Ordinance (MFIO). It was set up late in 2005 and has two fully functioning branches in Karachi, with four more branches under construction. It is making loans under the MFIO and also taking deposits.

The main sponsors of the project are Emerging Markets Consulting (Pvt) Limited (EMCPL), an investment and management services company. The initial capital of the bank is set at \$10 million. EMCPL will have a 60% stake in Tameer Bank. Two local shareholders, who are businessmen, have subscribed to 30% of the equity. The International Finance Corporation (IFC) has taken 10% of the equity and is expected to provide a partial local currency guarantee or loan of \$3.7 million equivalent as the bank grows.

EMCPL is owned 25% by Cooperative Housing Foundation (CHF), a US-based NGO, and the remainder is owned by a number of Pakistani shareholders, most of whom are experienced bankers. CHF has worked in nearly 100 countries worldwide. It is a pioneer in the small business finance arena and, for the past 20 years, through CHF International, it has been providing a range of financial services to economically disadvantaged groups.

Since its formation, Tameer Bank has deposits worth about Rs 2 million and loans have been advanced worth about Rs 1 million.

Because Tameer is new, outreach and financial data are not yet available.

4.5.2.4 National Rural Support Programme (NRSP)

Established in 1991 by the GOP, NRSP Pakistan's largest multi-sectoral rural development programme. It is a not-for-profit organisation registered under Section 42 of Companies Ordinance 1984.

NRSP is operational in 35 districts and is involved in social mobilisation, infrastructure development and it has a Microfinance and Enterprise Development Programme. The credit programme is fully operational in 25 of these 35 districts. As of 31 December 2005, it had made 609,196 loans since its inception, out of which it currently has 126,086 active borrowers. The cumulative distribution of loans is Rs 7.76 billion, an average loan size of Rs 12,744. NRSP has a recovery rate of 98.3%. NRSP also has 98,000 insurance clients and 31,000 savers saving on average Rs 17,000 - NRSP is not a bank and does not collect these deposits; these are the savings generated by groups. NRSP has an urban microcredit programme called the Urban Poverty Alleviation Programme with 80,589 clients, of which 30,271 are active. This is the largest RSP in the country in terms of outreach, staff and development activities.

'NRSP's mandate is to alleviate poverty by harnessing people's potential and undertake development activities in Pakistan. It has a presence in 32 Districts in all the four Provinces including Azad Jammu and Kashmir through Regional Offices and Field Offices. NRSP is currently working with more than half a million poor households organised into a network of more than 29,000 Community Organizations. With

sustained incremental growth, it is emerging as Pakistan's leading engine for poverty reduction and rural development' (NRSP website).

Table 4.10 NRSP outreach indicators

	30 June 2004	30 June 2003	30 June 2002
Number of personnel	519	483	456
Number of active borrowers	88,401	70,375	50,190
Average loan balance per borrower (US\$)	162	161	
Loans below US\$300 (%)	100.00	100.00	100.00
Woman borrowers (%)	23.00	39.20	n/a
Average loan balance per borrower / GNI <i>per capita</i> (%)	26.96	34.35	n/a
Number of savers	0	0	0
Clients below poverty line (%)	100	n/a	n/a
Clients in households earning less than US\$1/day per household member (%)	100	85	85

Source: MIX Market.

Table 4.11 NRSP financial data (US\$)

	30 June 2004	30 June 2003
Exchange rate used for conversion	58.008	55.679
	PKR / USD	PKR / USD
Balance Sheet		
Gross loan portfolio (US\$)	14,298,074	11,362,468
Total assets (US\$)	22,275,647	17,546,607
Savings (US\$)	0	0
Total equity (US\$)	7,013,243	5,609,555
Financing structure		
Capital / asset ratio (%)	31.48	31.97
Debt / equity ratio (%)	217.62	212.80
Deposits to loans (%)	0.00	0.00
Deposits to total assets (%)	0.00	0.00
Gross loan portfolio / total assets (%)	64.19	64.76

	30 June 2004	30 June 2003
Exchange rate used for conversion	58.008	55.679
	PKR / USD	PKR / USD
Overall financial performance		
Return on assets (%)	0.36	n/a
Return on equity (%)	1.13	n/a
Operational self-sufficiency (%)	102.74	79.52
Revenues		
Financial revenue ratio (%)	13.46	n/a
Profit margin (%)	2.67	-25.75
Expenses		
Total expense ratio (%)	13.10	n/a
Financial expense ratio (%)	2.87	n/a
Loan loss provision expense ratio (%)	1.42	n/a
Operating expense ratio (%)	8.80	n/a
Efficiency		
Operating expense / loan portfolio (%)	13.66	n/a
Cost per borrower	22.1	25.9
Productivity		
Borrowers per staff member	170	146
Savers per staff member	0	0
Risk		
Portfolio at risk > 30 days ratio (%)	6.07	7.59
Loan loss reserve ratio (%)	8.79	11.29
Risk coverage ratio (%)	144.72	148.76
Write off ratio (%)	2.01	n/a

Source: MIX Market.

4.5.2.5 Kashf Foundation

Kashf foundation was founded in 1996 'to provide cost-effective and quality MF services to poor women, by adding value to women's existing economic opportunities in order to enhance their role in economic and social decision-making. At the same time, Kashf aims to contribute to a sustained improvement in clients' incomes in order to enable them to move beyond the poverty trap.' (World Women's Banking website)

Kashf is the largest NGO MFP in Pakistan that works exclusively with women. It operates in five districts in the Punjab and receives funding from DFID and the PPAF, the latter providing credit up to Rs 600 million annually to Kashf on low interest rates, which Kashf on-lends. Kashf currently has 75,000 active clients and a loan portfolio of Rs 700 million. In all, it has disbursed Rs 3 billion. Its average loan size is around Rs 12,000.

Table 4.12 Kashf Foundation outreach indicators

	31 December 2004	31 December 2003	31 December 2002
Number of personnel	326	262	175
Loans			
Number of active borrowers	67,552	59,389	29,655
Average loan balance per borrower (US\$)	119	106	79
Loans below US\$300 (%)	100.00	100.00	100.00
Woman borrowers (%)	100.00	100.00	100.00
Average loan balance per borrower / GNI <i>per capita</i> (%)	19.91	22.47	18.92
Savings			
Number of savers	54,042	57,058	26,791
Average savings balance per saver (US\$)	2	3	4
Average savings balance per saver / GNI <i>per capita</i> (%)	0.38	0.74	0.92
Depth of outreach			
Clients below poverty line (%)	100	100	100
Clients in bottom half of the population below the poverty line (%)	n/a	n/a	n/a
Clients in households earning less than US\$1/day per household member (%)	100	100	100

Source: MIX Market.

Table 4.13 Kashf Foundation financial data (US\$)

	30 June 2004	30 June 2003
Exchange rate used for conversion	58.008 PKR / USD	55.679 PKR / USD
Balance sheet		
Gross loan portfolio (US\$)	14,298,074	11,362,468
Total assets (US\$)	22,275,647	17,546,607
Savings (US\$)	0	0
Total equity (US\$)	7,013,243	5,609,555
Financing structure		
Capital / asset ratio (%)	31.48	31.97
Debt / equity ratio (%)	217.62	212.80
Deposits to loans (%)	0.00	0.00
Deposits to total assets (%)	0.00	0.00
Gross loan portfolio / total assets (%)	64.19	64.76
Overall financial performance		
Return on assets (%)	0.36	n/a
Return on equity (%)	1.13	n/a
Operational self-sufficiency (%)	102.74	79.52
Revenues		
Financial revenue ratio (%)	13.46	n/a
Profit margin (%)	2.67	-25.75
Expenses		
Total expense ratio (%)	13.10	n/a
Financial expense ratio (%)	2.87	n/a
Loan loss provision expense ratio (%)	1.42	n/a
Operating expense ratio (%)	8.80	n/a
Efficiency		
Operating expense / loan portfolio (%)	13.66	n/a
Cost per borrower	22.1	25.9
Productivity		
Borrowers per staff member	170	146
Savers per staff member	0	0

	30 June 2004	30 June 2003
Exchange rate used for conversion	58.008	55.679
	PKR / USD	PKR / USD
Risk		
Portfolio at risk > 30 days ratio (%)	6.07	7.59
Loan loss reserve ratio (%)	8.79	11.29
Risk coverage ratio (%)	144.72	148.76
Write off ratio (%)	2.01	n/a

Source: MIX Market.

4.5.2.6 Habib Bank

Habib Bank Limited is Pakistan's largest commercial / scheduled bank and has 1,425 branches (22% of all Pakistani bank branches) in every province and in every corner of the country. Until 3 years ago, Habib Bank was a wholly state-owned bank and part of the five nationalised commercial banks. It has been partially privatised and bought by the Aga Khan Fund for Economic Development and is now under new, private, management. Habib Bank is not active in the MF sector and there seem to be no indication that it will enter the sector in the future.

4.5.2.7 Union Bank

Union Bank is Pakistan's fastest growing new (second generation) bank. It has not made any plans to enter the MF sector, although it is aware that this is a new and growing sector.

Union Bank does offer small MSME loans, and has started a pilot project in the six districts of the Punjab, where it is issuing a Kissan Card (Farmers Card) to farmers who own less than 30 acres. They have 12-13,000 such customers and the average loan size is Rs 50-60,000. The Kissan card is a credit line through which farmers are allowed to purchase agricultural inputs from specified and dedicated companies, such as Engro and Sengenta, both of which provide fertilisers, seeds and other inputs, and Pakistan State Oils, for diesel requirements. The card is like a credit card except that its use is restricted to specific outlets. No collateral is required in the case of the Kissan Card and groups of 7-8 farmers are set up who offer social / group collateral. The Union Bank is thinking of testing loans to individual clients rather than to groups.

4.5.3 Results of the case studies

As explained in section 4.5.1, to protect the confidence of the respondents, the results of the case study interviews are reported unattributed, by theme rather than by institution.

4.5.3.1 The stage of development of MF in Pakistan

A number of respondents believed that the MF sector in Pakistan was coming to the end of its primary stage and was in a position to take off into significant growth, given the right conditions. Others, however, feared that a lack of strategic thinking by MFPs might hamper that growth.

- One MFP believed that the MF sector is small because Pakistan had 'been slow to get to the take-off stage'. Also, since MF has emerged from a development background, there had not been many specialised institutions doing MF. Now 'specialised institutions are emerging and as long as a handful of them have strong, focused and dedicated leadership, the sector will grow.' The respondent's assessment was that there is an unmet demand for credit from around 15 million potential MF clients in the household and microenterprise sector. The respondent had a very positive outlook about the MF sector, especially as it sees new entrants coming into the sector. It feels that the first phase of urban MF has now come to an end and the sector is set for take-off with new and dynamic institutions entering the market. It feels that as long there are 5 or 6 'serious players' in the sector, the sector will begin to be consolidated. It was argued that 'global experience shows that a MF sector with a handful of players is the trend and within a few years, Pakistan will also be in that position and this will help strengthen the sector.'
- An MFI also saw great growth potential, and its business plan envisaged a million loan clients and 750,000 deposits in the next 5 years, with branches in 35 cities.
- Another MFP, on the other hand, believed that 'most of the teams working in the MF sector do not have a long-term vision, and the sector is expanding annually, more as a matter of fact, rather than as a specific strategy.'
- One of the banks was pessimistic about the involvement of the commercial banking sector in MF, because managers did not perceive the commercial potential of the MF sector.

4.5.3.2 Poverty alleviation versus business objectives

All respondents expressed concern about what they perceived as an excessive focus on the role of MF as a poverty alleviation tool.

- One MFP expressed the view that that the MF sector is small in Pakistan because many of those involved in MF are primarily in the business of poverty alleviation, not the provision of finance. MF is equated with poverty alleviation and this has limited the size of the sector. MF is 'not seen as an independent business but simply as a poverty tool'.
- This was confirmed by another MFP that pointed out that its primary activity is social mobilisation and that MF is just one of the services they provide - it is not a mainstream MFP and regards MF as a 'secondary' activity.
- Another MFP argued that 'a problem with microfinance has been that it has been seen principally as a poverty alleviation tool. It can work as one, but it need not be merely a direct poverty alleviation instrument. It can also be a

means to create employment and meet the needs of those who are poor, though not necessarily the poorest of the poor' The respondent felt that a host of financial services should be available for the poor and that they should be given choices about the sort of services and products they could use.

- One MFI, which regards its mission as poverty alleviation, was nevertheless troubled by the fact that MF is 'overburdened with the widespread idea that it is simply a poverty alleviation tool, and this is a problem since it does not allow microfinance to develop as a sector in its own right. While it can and does address the poverty problems of a number of clients, this is not the only outcome of a microfinance programme, where it can also be instrumental in creating employment and keeping many people out of poverty.'
- Another MFI believes that 'there is a huge market for microfinance in Pakistan and the sector has great prospects for for-profit entrants and entrepreneurs.' The respondent estimated that there was a potential demand nationally for about \$2 billion a year in loans and a similar amount in deposits. The respondent felt that if private sector MF banks can deliver these services in a cost-effective manner, they will remain very profitable. The respondent argued that the MF market is not necessarily for the very poor and that the purpose of the MFI is not to alleviate poverty. It was a commercial for-profit enterprise and if poverty was alleviated as a consequence of providing credit, that would be a very desirable by-product from the MFI's point of view; but that was not the MFI's primary goal.
- A bank not involved in MF maintained that the Government 'had created a segmented market where the poverty alleviation and social aspects of finance would be taken care of by smaller and specialised banks and not by the large commercial banks who would be left to developing the fast-moving and higher end of the overall credit market. In the days when all banks were public sector banks, there was "social pressure" on them as part of government policy. Indeed such lending was mandatory. After privatisation and the presence of and support to specialised MFIs, commercial banks no longer feel the same obligation or need to lend in that segment of the market.'
- Another bank 'had no programme targeted at low income clients / borrowers because it is felt that the costs of transacting and following up on such loans is a cumbersome and high cost activity. The lower limit for most loans from the bank is around Rs 75,000. The costs for transacting any loan tend to be fixed, and if the return is low as it is perceived to be for a microfinance loan, the Bank would prefer not to transact such small loans but to focus on larger commercial loans.'
- Another bank said that it was 'a commercial bank first and foremost, was accountable as a commercial bank to its shareholders, and was profit orientated. It would rather give a loan to one factory of Rs 20 million the cost of which was believed to be low and the outcome quite secure, rather than a few hundred or a few thousand MF loans. ... The long term view and experience of the Bank is that MF should not be part of the commercial banking sector and should be kept separate.' It was felt that the comparative return on an MF loan was lower than on a commercial loan, and that the time-scale of returns in MF was also far longer.

4.5.3.3 *The role of government, donors and subsidies*

MFPs agreed that it was not appropriate for governments to act as MFPs; the appropriate role for them was to lay down policy guidelines and ensure an appropriate enabling environment for MF. There was also agreement that government and donor subsidies were useful at the start-up stage, but needed to be phased out as the industry matures.

- An MFP argued that ‘the role of the government should be one of an enabler rather than a provider since microfinance requires the provider to know one’s client individually, something that government and its institutions are unable to do.’
- An MFI saw the government’s role as providing the policy guidelines and the environment in which the sector can grow, and not to provide subsidies except in the initial start-up phases. Donors similarly ‘play a catalytic role in the sector – a sort of infant industry argument – and had it not been for donor support, there would have been little interest in the sector. Donor support can mitigate the up-front costs, which can be very high.’
- An MFP argued along similar lines: ‘The government should not be involved in the provision of microfinance but should create an environment which is conducive to the growth of the sector. ... Donors can spoil the market and should be careful how and where they provide funds. Donor support is useful for the sector to get it off the ground, but after that donors should be selective and focused in their funding. They should also play a role in building institutions and capability.’
- The same MFP also thought that subsidised credit is a problem in the market, as if an MFI is offering loans below market rates, it causes problems for other providers (see section 4.5.3.4, below, on interest rates).
- Another MFI respondent said that ‘donors played an important role in establishing the market and in allowing the sector to reach “take-off” stage.’ The respondent felt that ‘at some point donor fatigue would set in the sector and donors will shift their focus elsewhere; after that, it will depend on who knows the market best and who operates on a profit-oriented business model.’
- An MFP said that ‘subsidised credit can be a problem in the market. For example, if [a subsidised institution] offers a loan at below market rates, this does cause a problem for other providers.’ The respondent believed, however that a subsidy is important in the earlier phases to get the sector off the ground, but that after about 5-7 years, institutions ought to be financially sustainable.
- Another MFP said that ‘if there was no donor support, microfinance in Pakistan would not have taken off the ground. This support has produced a demonstration effect and the required start-up capital for the sector as a whole, has been provided by donors.’
- A bank respondent was of the opinion the banks that are or were state-owned were in the business of providing small loans mainly because of pressure from

the Government, which regarded 'socioeconomic development' as part of the mandate of banks. Not all managements were enthusiastic about the activity.

4.5.3.4 Microcredit interest rates

All respondents agreed that clients were willing to pay the high interest rates required for sustainable MF, and that what mattered to clients was access to credit rather than its cost.

- An MFI said that 'the interest rate is not at all a problem and that clients can pay more than what we are charging our clients.'
- Another MFI said that high interest rates were not a constraint on the market, since 'formal sources of credit were always below the informal sector rate.' The respondent was charging an annualised rate of 32%, in line with their business plan target to achieve an annual return of around 4-5%. The respondent believed that 'a sustainable business model is viable at 30% rate of interest, while borrowers are willing and able to work with even higher rates if offered services and access to financial services. The question is not one of the cost of credit for the borrower, but the availability and access of different sorts of financial services and products.'
- A bank said that the interest rate for MF loans was 'not a problem even at a 28% rate.' The respondent estimated that small and medium shops and enterprises had a 100% turnover rate with high margins and very quick turnover and they end up making a 'great deal of money' compared with their investment. The respondent said that in their experience 'the mark up has never been a problem' in their area of operation. 'People were desperate for loans and since the rate offered by financial institutions was lower than what prevailed in the informal market, borrowers would come to take loans. While 28% might seem high to some people, the poor would also borrow at 40% as long as they had easy access to finance.' The bank had a policy that they did not require much documentation for a MF loan 'only one piece of paper, not a huge file like a normal commercial bank loan'. They decided to minimise documentation to make it easier for clients to obtain their loans.
- An MFP said that that the interest rate is 'no problem at all' and that people are 'easily willing to pay 30-35% interest rate on small loans.' The respondent argued that there should be no interest rate caps and that wherever MF has grown it has done so without interest rate caps. The respondent believed that 'one reason why the sector has not grown in Pakistan is because of interest rate caps.'
- Another MFP argued that the interest rate cap was a 'social and psychological cap.' That provider was not willing to increase its interest rate because of its 'training', which was highly focused on poverty reduction. 'The literature on interest rates says that it is not a problem for the borrower, but for us there is a social / psychological barrier which we are not able to breach.' The respondent estimated that 'the cost of giving MF loans was 35%, therefore the interest rate had to be higher than that. The effective interest rate being charged by "proper" microfinance providers ... was 40%. Moreover, Pakistan still has the lowest interest rates for microfinance in the region. The interest rate

for some providers like NRSP and Khushhali Bank were the lowest in the sector because they had access to cheap credit.'

4.5.3.5 Regulation and taxation

Respondents agreed that there were problems with the loan limit of Rs 100,000; the taxable income limit for eligible MF clients; the tax rate imposed on MFIs registered under the Ordinance; and the supervision of the MF activities of commercial banks.

- A MFP argued that 'the existing loan limit of Rs 100,000 is too small; if a bank nurtures a client for a few years and builds a relationship with him, the bank loses the client when he wants a bigger loan as his business has expanded on the basis of the previous relationship.' Secondly, the MFP believed that the tax rate on MFIs under the Ordinance was too high and discourages entry of other institutions, including the respondent's. Finally, the respondent feels that the requirement that the prospective client be below the taxable income limit, is also 'not productive since numerous clients who are above the taxable income limit require loans of a small size which commercialised banks are unwilling to provide.'
- A bank not in MF regretted that 'that the regulations on commercial banks for microfinance are the same as they are for commercial credit and there is no distinction made by the State Bank on the type / size of loan. This stops commercial banks from moving downstream towards smaller loans.' The same bank added that that 'the cost of transacting, branch costs and State Bank Prudential Regulations all inhibited commercial banks from making small loans since the Bank was accountable as a commercial bank and not a microfinance bank.' Moreover, the respondent said 'that the legal structure in Pakistan for repossessing and dealing with default was very undeveloped and weak and hence it discouraged small loans.'
- A commercial bank that does provide MF services said nevertheless that 'there was a serious problem with the Prudential Regulations of the State Bank of Pakistan in their case, because the [the bank] was seen as, and is, a commercial / scheduled bank, not a microfinance bank / institution.' They said that they had to follow and answer to a different set of rules, practices, types of documentation, reporting requirements, etc. All this was a hindrance for a commercial bank to venture out into the MF sector. They also felt that 'no bank will want to go to the MF sector since there was too much work involved' and the returns were lower.
- An MFI said that the Rs 100,000 limit and the taxable income limit were 'not conducive to the growth of the sector.' If this rule was followed strictly, then the MFI 'would be able to make an annual loan of only Rs 8,000 or so per client,' while his loans start at Rs 40,000 with the intention to take each client over a cycle where their loan limit is raised by Rs 10,000 each year. The respondent feel that 'the commercially minded microfinance institution should be allowed to decide how large a loan they want to make.' He suggested that perhaps a limit of up to Rs 500,000 would be a good level.'
- The same MFI argued that the tax rate imposed on MF banks was 'too high'. He felt that 'the government should encourage the growth of microfinance banks

and give them a tax break – as for other industries – for the first few years. An upward sliding scale of the tax rate over time should be applied to encourage new entrants to set up microfinance institutions. While there is a mention of some tax relief in the MFIO, the Central Board of Revenue has decided not to give any tax relief to these banks.’

- An MFP argued that ‘a number of measures ought to be taken to improve and expand the sector. There should be no interest rate cap and institutions should be allowed to set their own interest rates; if the rate set is too high, the institution will be pushed out of the market. The formal financial sector needs to integrate with the microfinance sector, where microfinance intuitions / providers should be allowed to borrow from banks. ... Banks do not have information about the microfinance sector and this bridge should be gulfed.’

4.5.3.6 The Bangladesh comparison

Two respondents expressed frustration with constant comparisons with Bangladesh, arguing that Pakistan and Bangladesh were very different environments.

- An MFP challenged ‘the claim made by some people on the basis of the nature of the sector in Bangladesh, that there are, according to the government’s estimates, six million clients for microfinance products in Pakistan. ...There is too much of the ‘Bangladesh influence’ on thinking about microfinance in Pakistan, and there is a need to take a perspective based on Pakistan’s particular specifics.’
- A bank pointed out that its microfinance performance, ‘is said to have failed on the Grameen Bank “criteria” of performance and financial sustainability. But Pakistan is not Bangladesh and that comparisons between the two countries are unfair and unproductive. Rural densities, and political and cultural norms and practices, differ significantly between Bangladesh and [our area of operation].’

4.5.3.7 Miscellaneous points

Respondents also raised issues of skill shortages, the urban / rural distinction, problems of documentation, a ‘default culture’ and the buoyant demand in the conventional credit market.

- An MFI said that feels that the MF sector is hampered by ‘a lack of retailing capacity in the microfinance market in Pakistan.’
- Another MFI also said that ‘one constraint to expansion has been skilled staff for microfinance.’ Through a training unit set up at institution, it is trying to turn sales people into credit assessment officers.
- Another MFI (with a national licence), believes that there is ‘a huge demand for credit in the urban sectors.’ The respondent plans to operate in the urban areas for the first 5 years before it thinks about the rural areas; it is focused on small and medium entrepreneurs.
- A bank not in the MF business argued that ‘a major problem in giving loans to the target segment of the population was that they ‘do not have any

documentation, so it is difficult to for a large commercial bank to give loans.' The respondent believes there is a 'default' culture in the country where people take loans and then avoid paying them back. However, the respondent acknowledged that smaller loans had a lower default rate.

- A commercial bank pointed out that 'commercial banks are unable to meet their existing credit demands in a highly buoyant and expanding credit market, so going downstream was not an immediate consideration.' He felt that it was far simpler to give one loan of Rs 20 million than 1,000 loans of Rs 20,000 each. He also said that by developing the MF banking sector, the GOP and the SBP had taken the 'pressure' off large-scale commercial / scheduled banks to give small, MF banks the opportunity to work in the sector.

CHAPTER 5: ACCESS OF THE POOR TO MICROFINANCE AND ITS IMPACT

5.1 Introduction

To date there is insufficient evidence of a high enough quality to objectively determine whether recent changes in MF provision have changed access of the poor to MF services and whether these changes have improved the standards of living of the poor.²⁷

Clearly, given the centrality of MF to the government's PRSP, it will be important for the appropriate surveys and analysis to be conducted in order to determine changes in the access of the poor to MF services and the impact of MF services on broader social change²⁸; changes in the range, quality and nature of the services provided; and evaluate the impact of these changes on both the incomes of the poor and changes in

²⁷ In 2004/05 the Asian Development Bank financed a survey-based evaluation of the Khushhali Bank operations. The evaluation had three main objectives: (1) assessing whether the microcredit program has a positive impact on the welfare and socioeconomic indicators of participants in the program; (2) assessing whether an eventual positive impact also exists among the poorest of the participants in the program; (3) assessing to what extent participants in the program are poor (below the official poverty line).

The evaluator's conclusions are that the Khushhali bank reaches the poor, that microcredit has a positive impact on participants and especially so for the poorest of the poor.

However, on the basis of the evidence of the published reports there appear to be some serious limitations in the analysis conducted, and a misconception of what is the level of the official poverty line. These limitations do not justify the conclusions that have been drawn.

For example, there is an important misunderstanding of the level of the official poverty line in Pakistan. The evaluation has taken a poverty line of Rs 1000 *per capita* per month for food consumption alone, and an ultra poverty line of Rs 500 *per capita* per month. However, the official poverty line correctly includes amounts for food and non-food expenditure. In fact in the official poverty line food expenditure represents about 50% of the overall consumption expenditure. In June 2005 the official poverty line stood at Rs 834 *per capita* per month.

It appears likely therefore that a great proportion of those classified by the evaluation as poor could not be classified as poor according to the official poverty line.

Secondly, there would appear to have been some important weaknesses in the statistical modelling techniques that were used to determine the impact of microcredit. Although the evaluation design identifies and selects both a treatment (recipients of microcredit) and control group (prospective clients of the Khushhali bank who have not yet started to receive loans), the analysis of the two groups and their differences is very limited: the two groups are analysed together in a set of regression models that assess the significance of the participation in the program after controlling for selected characteristics. However, in a number of models some key control variables appear to have been excluded. The absence of such critical controls could easily affect the modelling results.

Finally, even allowing for the weaknesses of the models used, the results of the regression analyses which are reported do not support the strong and unequivocal conclusions made by the evaluation.

²⁸ For example, more detailed poverty and social impact analysis might be performed when the latest 2004/5 HIES data becomes available and when the Access to Finance survey is undertaken.

the vulnerability of the poor, especially in their ability to manage and cope with risk to their livelihoods.

Against this background the PSIA Steering Committee requested the consultants to undertake two pieces of survey work. The first included a re-analysis of recent Pakistan Integrated Household Survey (PIHS) and Pakistan Socio-Economic Survey (PSES) surveys that were undertaken prior to or at the start of the reforms in MF policy - this would provide some form of baseline analysis. The Steering Committee did however make the point that neither of these two surveys was up to date and that further analysis should be conducted as soon as new and relevant datasets became available.

The second request was for a small mixed-methods survey to be undertaken that covered approximately 100 households and aimed to provide insights into changes in access and their impact.

We now report the results from both of these exercises.

5.2 Analysis from the PIHS and PSES

The team divided the analysis into three parts²⁹:

- the proportion of households that receive credit;
- main characteristics of the credit market;
- poverty and access to credit.

²⁹ Some notes on the datasets:

PIHS: contains basic information on credit, included in a short section of financial assets and liabilities. The household head was asked whether the household receive any loans in the 12 months preceding the interview, their amount and the purpose of the credit (for household expenditure or for other reasons). Questions on credit are unlikely to have received careful attention and probing.

PSES: contains a much more detailed section on credit. Again questions are asked at the household level, but information is collected for each separate loan obtained by the household in the last 12 months. Moreover, there are a set of questions that help in understanding the main characteristics of credit: provider, purpose of credit, etc.

The main limitation of both datasets is that information is collected at the household level rather than for each household member. Moreover, information on credit arrangements could have been asked in more detail, especially when asking how certain durable items (and housing) were acquired. Similarly more investigation could have been done asking about business-related credit in the enterprise modules (agricultural and non-agricultural enterprises).

For these reasons in-kind and trade-related credit might be underestimated, especially in the PIHS. The limitation of the PSES is its relatively small sample size, which does not allow accurate estimates at the province level.

5.2.1 What is the proportion of households receiving credit?

Table 5.1 shows that estimates from the PSES are higher than those from the PIHS, suggesting that the PIHS is likely to underestimate various forms of credit.³⁰ However, PIHS estimates are significant because they can be used to compare changes in credit use over time, and since the questionnaire format did not change between 1998/99 and 2001/02, estimates are internally consistent and comparable. In particular, it is significant to note how the percentage of households who receive credit changed in the four provinces. While credit recipients increased in NWFP and Punjab, they decreased in Sindh and Balochistan. A possible explanation of this could be the drought that hit severely the two southern provinces, affecting both supply and demand of credit. This issue is explored further below.

Table 5.1 Percentage of households receiving credit (12 months preceding the interview)

	Urban	Rural	Overall
PSES 2001-02 % receiving credit	32.6	45.1	41.2
% receiving credit in cash	25.7	33.7	31.2
PIHS 2001-02 % receiving credit	23.2	32.6	29.9
Punjab	23.6	32.3	29.9
Sindh	18.4	26.7	23.2
NWFP	47.6	53.1	52.3
Balochistan	12.5	9.4	9.7
PIHS 1998-99 % receiving credit	20.5	28.8	26.3
Punjab	20.4	26.3	24.6
Sindh	19.1	30.1	25.2
NWFP	33.1	40.7	39.6
Balochistan	11.5	20.8	19.7

Source: Calculations of the authors based on PIHS and PSES.

Note: Please see footnote 29 which highlights important differences between the two datasets. In particular confidence intervals for provincial estimates under the PSES are likely to be larger than for the PIHS.

5.2.2 Main characteristics of the credit market

The PSES can help in understanding about the use of credit, and its main characteristics.

³⁰ In particular, given that the questions on credit were included as part of a section asking about financial assets and liabilities, it is likely that the PIHS estimates largely underestimate credit in-kind.

During the period under observation in the PSES most households who received credit, received only one loan, and 90% of them used the same source or the same credit provider (Table 5.2).

Table 5.2 Number of loans and sources, PSES 2001/02

Number of loans	% of households
None	58.8
One	31.8
Two or more	9.4
Total	100.0
% of hhs using more than one source of credit	4.1

Source: Authors' calculations based on PSES.

The majority of loans are received from friends / relatives and neighbours (more than 60%), followed by shopkeepers, who in most cases provide credit in-kind. Nevertheless when we look at the borrowed amount the formal and semi-formal sector become almost the most important provider (this could be partly due to one very high loan value, if we exclude it, the percentage goes down from 38.8% to 18.1%. Checks made on that single value do not find evidence of errors).

Table 5.3 Credit providers by loans and amounts, PSES 2001/02

Source of loan	% of loans	% of borrowed amount	Median amount
formal/semi-formal	3.3	38.8	36800
trade-related	8.8	6.4	8000
shopkeepers	23.0	7.4	5000
friends/relatives	61.1	45.4	10000
nonclassified	3.9	2.0	5400
Total	100.0	100.0	9000

Source: Authors calculations based on PSES.

Formal and semi-formal include: Agricultural Development Bank of Pakistan, Commercial Banks and cooperatives and NGOs (there were only few observations of loans offered by cooperatives and NGOs).

Trade-related providers include landlords, input suppliers, factory/mill, and money lenders (although the latter should not be consider as trade related they could not stand alone as a separate group)

Although 'friends/neighbours/and relatives' is a very important provider, it is largely uninformative since it would be important to know something more about who they are.

Although PSES estimates are not representative at the provincial level we attempted to breakdown providers by province to determine whether there was a significant difference.

It is important to note the very large difference between the Sindh / Balochistan and Punjab / NWFP. Trade-related credit is much more important in Sindh, where landlords and moneylenders seem to provide an important share of loans. Similarly, shopkeepers are more important in Balochistan and Sindh than in the other two provinces.

The proportion of loans in-kind is much higher in Balochistan and Sindh (respectively 68% and 42%) than in NWFP and Punjab (respectively 28% and 21%).

One possible reason for this different composition of providers is that drought reduces supply from friends / relatives.

Table 5.4 Credit providers by province, PSES 2001–02

Province	Formal / semi-formal	Trade-related	Shopkeepers	Friends / relatives / neighbours	Nonclassified	Total
Punjab	4.5	7.0	17.7	66.9	3.9	100.0
Sindh	1.7	16.3	31.1	46.1	4.8	100.0
NWFP	1.1	1.9	27.8	66.7	2.5	100.0
Balochistan	3.8	9.8	53.4	33.0	0.0	100.0
Overall	3.3	8.8	23.0	61.1	3.9	100.0

Source: Authors calculations based on PSES.

Note: Please see footnote 29 which highlights important features of the PSES. In particular confidence intervals for provincial estimates using the PSES are likely to be largely than for the PIHS.

The main reason for receiving credit is for household expenditure, special circumstances such as marriages, and health problems, though credit related to agricultural production is also very important in rural areas.

Furthermore, the PIHS shows that the main reason for borrowing is to support household expenditure (66%) and this percentage did not change significantly between 1998–99 and 2001–02 even when analysed at the provincial level. This suggests that during drought the demand for credit should have increased rather than decreased.

Table 5.5 Reasons to receive credit, PSES 2001/02

purpose	Urban	Rural	Overall
Agricultural production	2.1	16.4	12.4
Non-agricultural production	8.4	3.2	4.6
Food/clothing	28.9	34.5	32.9
Medical expenses	14.9	9.5	11.0
Marriage/cerimonies	11.6	11.2	11.3
Other hh expenditure	28.4	20.8	23.0
Other	5.9	4.5	4.9
Total	100.0	100.0	100.0

Source: Authors' calculations based on PSES.

Although the PSES questionnaire collects other information about interest rates, length of credit and collateral, such information was not filled in completely. Interest rates are often paid indirectly and the borrower might not be directly aware of their actual levels. Careful questionnaire design and probing techniques in future surveys might reveal the hidden interest rate (for instance 30% of farmers either pay a higher than market price on agricultural inputs or sell their produce at a lower than market price to certain intermediaries because they provided them some credit).

Length of credit is generally short. It appears to be linked to seasonality factors when the loan is taken from shopkeepers and trade-related credit (the median length is only six months), otherwise the loans' length is one year.

5.2.3 Poverty and access to credit

The percentage of households receiving credit is lower in the highest expenditure quintile than in lower quintiles (Table 5.6). The poorest people borrow mainly to support household expenditure, and are more likely to be involved in borrowing in-kind. The formal / semi-formal sector is heavily biased towards the better off (most loans in the formal sectors require collateral).

Table 5.6 Credit characteristics by household's welfare, PSES 2001/02

	quintiles					Overall
	Poorest	2nd	3rd	4th	Richest	
% of hhs receiving loan	40.9	45.9	42.1	43.2	35.5	41.2
Median amount received	8000	8450	10000	14000	23000	12000
Purpose:						
Agricultural production	8.6	11.9	10.5	14.9	14.4	12.4
Non-agricultural production	1.6	2.4	11.2	1.7	5.7	4.6
Food/clothing	42.8	39.7	31.9	31.2	23.7	32.9
Medical expenses	10.8	9.0	9.1	12.4	13.1	11.0
Marriage/cerimonies	10.1	12.9	9.8	10.1	13.0	11.3
Other hh expenditure	20.6	21.8	23.6	24.2	23.7	23.0
Other	5.4	2.4	4.0	5.6	6.6	4.9
Form:						
Cash	62.4	66.2	65.8	76.0	84.1	71.9
In-kind	37.6	33.8	34.2	24.0	16.0	28.1
Provider:						
Formal/semi-formal	1.1	1.0	2.0	3.7	7.1	3.3
Trade-related	8.0	12.5	7.3	11.7	4.8	8.8
Shopkeepers	30.3	29.0	24.5	19.5	15.4	23.0
Friends/relatives	58.0	56.1	56.8	62.5	69.3	61.1
Nonclassified	2.7	1.4	9.3	2.6	3.4	3.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Authors' calculations based on PSES.

Again there are dramatic differences in credit usage between Sindh / Balochistan and Punjab / NWFP. In the southern provinces the percentage of households receiving credit decreases especially among the lowest quintiles. In Punjab and NWFP we find the opposite trend (Table 5.7).

These figures seem to suggest that credit did not insulate household consumption levels from the drought. The reduction of credit seems due mainly to supply problems and the fact that credit providers were also likely not to be insulated from the drought.

A full impact assessment of the impact of credit on household consumption would however require panel data.

Table 5.7 Percentage of households receiving credit by quintile and province, PIHS

Quintile	Punjab	Sindh	NWFP	Balochistan	Overall
1998-99:					
Poorest	27.5	42.8	43.8	19.4	32.6
2nd	27.8	35.1	43.0	20.2	31.3
3rd	24.8	21.2	40.4	19.0	25.6
3th	24.3	24.4	40.6	18.5	25.9
Richest	20.6	16.7	27.5	21.2	20.1
2001-02:					
Poorest	38.0	29.2	58.9	12.8	37.3
2nd	34.8	32.2	56.5	12.7	36.3
3rd	31.8	26.6	55.5	10.1	32.5
3th	28.5	20.8	51.2	7.3	28.1
Richest	22.2	14.6	36.3	5.9	20.7

Source: Authors' calculations based on PIHS.

5.3 Results from a Household Financial Diary Survey

5.3.1 Background and objectives

In recent years a number of studies has been undertaken with the aim of establishing a comprehensive picture of the financial inflows and outflows of poor households by gathering data on income, consumption, savings, lending and investment. Perhaps the most comprehensive of these is the 'South African Financial Diaries' study in which an extremely detailed record of all household transactions was compiled by means of a year-long, fortnightly set of interviews with a sample of 162 poor households.³¹ Two similar financial diaries surveys were carried out in 2002 in Bangladesh and India by Rutherford, and Ruthven and Kumar, respectively.³²

The key insight afforded by these studies was that, even in very poor households, cash portfolios are actively managed using a wide range of formal and informal financial intermediation mechanisms.

Using this insight as a basis, the current survey attempts to build upon some of the techniques developed in these previous studies in order to gain a greater understanding of what financial services, both formal and informal, are available to the poor in Pakistan. Furthermore, since this study forms part of a PSIA of Pakistan's Microfinance Policy, the study has a particular focus on the positive effect that the utilisation of MF services has had on beneficiary households.

³¹ South African Financial Diaries study, Financial Diaries Project, www.financialdiaries.com.

³² See Rutherford (2002), and Ruthven and Kumar (2002).

In summary the study aims to:

- shed more light on how poor households manage their finances and, in particular, how and why they make use of particular formal and informal financial services;
- aid an understanding of the effect of MF services on beneficiary households and how this varies across different MFPs.

5.3.2 Methodology

In order to enable some understanding of variations in the characteristics and impact of MF services across regions and between urban and rural areas, two urban and two rural locations were selected. For each location one MFP was chosen. The locations were therefore chosen carefully so as not only to provide reasonably representative results, but also to facilitate comparison across different types of MFPs. For this reason the following locations were selected:

- Rural North West Frontier Province (NWFP);
- Rural Sindh;
- Urban Lahore;
- Urban Islamabad / Rawalpindi.

The range of MFPs operating in these four locations was intended to enable analysis of two MFIs (Khushhali Bank and the Kashf Foundation), one NGO-administered MFP (Marvi Rural Development Organization) and one RSP offering MF services (Sarhad Rural Support Programme), and thus present a fairly accurate picture of the MF services provided by the full spectrum of MFPs in Pakistan.

The Khushhali Bank recently completed a major evaluation and was therefore substituted with the National Rural Support Programme (NRSP). The selected locations and corresponding MFPs are summarised in Table 5.8.

Table 5.8 Breakdown of surveyed localities by location and MFP

Location	State	MFP	Urban / rural	Locality	No. of respondents
Islamabad / Rawalpindi - Urban	Punjab	1. NRSP*	Urban	1. Ali Pur Farash, District Islamabad 2. Kurri, District Islamabad	25
Lahore - Urban	Punjab	2. Kashf Foundation	Urban	1. Yasin Town, Lahore	25
Sindh - Rural	Sindh	3. MRDO	Rural	1. Kot Diji, District Khairpur	25

NWFP – Rural	NWFP	4. SRSP	Rural	1. Chamkani, District Peshawar	25
				2. Khush Maqam, District Nowshera	
Total number of respondents					100

*NRSP run an urban credit program that operates in the peri-urban areas of Rawalpindi and Islamabad.

For each location / MFP one branch office was selected. At each branch office one locality was then randomly sampled from the all the localities in which the MFP operates programmes that are administered by that particular branch office and which are within 50 km of this office.³³ The survey team then visited the locality and interviewed 15 households that were current or recent users of the MF services offered by the relevant MFP. In order to analyse the relative characteristics of users and non-users, a further 10 non-beneficiary households were interviewed in each locality.

Ideally the selection of branch offices in each location would have been randomised. Unfortunately, however, the MFPs were unwilling to provide the branch listings necessary for this. Instead, with the focus and scale of the study in mind, the credit programme staff of each respective MFP recommended the branch offices from which the localities were selected.

Similarly, it would have been preferable for the household selection also to have been random. However, this would have required a full listing of beneficiary households as a sample frame, something the branch offices were understandably unwilling to provide. Instead a more purposive sampling approach was taken. Since the study aimed to increase understanding of the financial services used by the poor, in all four localities an effort was made to select households from the relatively poorer segments of each group of household types (beneficiaries and non-beneficiaries). This was done with the help of MFP branch office staff who accompanied the field teams in order to identify relatively less well-off beneficiary households.³⁴

The Kashf Foundation, SRSP and NRSP programmes do not target the very poor in the community or those who have a higher probability of defaulting. As a result, during the fieldwork it rapidly became apparent that beneficiary households were not especially poor (i.e. reported income levels well above the official poverty line). Unsurprisingly this meant that the other (non-beneficiary) households living within the same community were not extremely poor either. Therefore standard criteria employed to

³³ In the case of NRSP in Islamabad and SRSP in NWFP some of the localities served by the microfinance programmes were too small to enable the selection of 15 users. Therefore for these two cases two localities were randomly selected, with roughly seven or eight users and 5 non-users interviewed selected from each.

³⁴ It should be noted that there was also a conscious effort by the survey team to consider both male and female beneficiaries in the household selection process. Whilst the Kashf Foundation and MRDO are only working with females, both NRSP and SRSP provide credit to men and women, all with the primary objective of benefiting the entire household.

maximise the probability of selecting genuinely poor households, for example whether or not the household head had completed primary school, proved too restrictive for both beneficiary and non-beneficiary households alike. It was clear during the fieldwork that neither were loans being offered in areas or communities with low average income levels, nor were the households receiving loans amongst the lowest income groups within those communities. Thus an alternative selection procedure - aimed at selecting low income households within the sampled communities - was employed whereby only those households which reported a monthly income of Rs 12,000 (\$200) or less were considered eligible for selection.³⁵ In this way a total of 100 household interviews were sampled: 60 MFP users and 40 non-users.

Previous 'financial diaries' studies have relied upon multiple interviews, using the same panel of households to build up a detailed record of each household's income and expenditure patterns over time. Given the limited scope of this survey, as well as the explicit focus on the impact of MF services, it was decided that, for this study, households should be interviewed using a questionnaire that was a hybrid of a standard questionnaire, composed of closed pre-coded questions focusing in particular upon their current and recent use of formal and informal financial services and mechanisms, complemented by the compilation of a 'financial diary' of the last month. The 'financial diary' component would comprise a detailed record of each household's income, expenditure, savings, lending and investment patterns over the month prior to the interview, with particular attention paid to the formal and informal financial mechanisms used by households in the process of managing their finances.

In summary, the study essentially consists of four (semi-randomly selected) comparative case studies. Each case study focuses on a different MFP (SRSP, NRSP, Kashf Foundation and MRDO) and analyses the usage of formal and informal financial services by the relatively poorer households situated in a locality in which that MFP operates. The particular focus on the MF services available meant that this was done by selecting for interview 15 of the poorest beneficiary households, and 10 of the poorest non-beneficiary households in each of the four sampled localities.

5.4 Brief background of surveyed microfinance programmes

5.4.1 Kashf Foundation

- The Kashf Foundation (described in Chapter 4, above) is a well-established MFP providing small loans to women in low-income rural and urban localities in Punjab. The loans range from Rs 10,000 to 35,000. Credit is provided only for entrepreneur development and not for any personal purposes including emergencies. The service charge for credit is 20% of the loan value.
- The credit process in each community starts with the formation of a 25-member credit committee accompanied by a seven-member subcommittee that checks the credentials and proposals of prospective applicants. There are five

³⁵ The exception to this was the Sindh locality, relatively poorer than the other three, where any household which had a monthly income of no more than Rs 5000 was eligible.

‘group leaders’ who supervise the credit and loan recovery process of their respective group members.

- The credit cycle for all loans is 12 months, with repayments made twice in a month, and there is a strict adherence to the recovery amount. The Kashf Foundation prefers to extend loans to already trusted beneficiaries and their reported loan recovery rate is over 98%.
- Savings are a part of the credit schemes, but it is flexible and all beneficiaries can put aside money in the saving account of the committee if they so desire.

5.4.2 National Rural Support Programme (NRSP)

- The National Rural Support Programme (described in detail in section 4.5.2.4, above, has been working for the development of poor rural communities since 1995. However, they also provide some assistance in the urban areas.
- Microcredit is a major component of NRSP focusing on improving livelihoods. It is reported to be the largest credit programme in the country after the Agriculture Development Bank, having so far disbursed Rs 7 billion in loans.
- Loans are provided to both men and women for entrepreneurial business projects or for other income generation activities, such as investment in livestock.
- The credit process begins with an initial instalment of Rs 10,000, followed by two further instalments of Rs 5,000. Total credit therefore does not exceed Rs 20,000. Interest rate is 10--11% over the 12-month credit cycle. However, after the inclusion of the processing fees, this rises to 21%. The recovery rate is claimed to be 100%.
- In the urban areas, in contrast to rural areas, NRSP provides loans through community groups of 5-7 members so as to maintain pressure on individual borrowers not to default.

5.4.3 Sarhad Rural Support Programme (SRSP)

- SRSP follows the same development model as NRSP, including a similar credit program, the only exception being that its area of operation is NWFP.
- SRSP also claims a 100% recovery rate.

5.4.4 Marvi Rural Development Organisation (MRDO)

- MRDO is a rural development women-focused NGO working in the Khairpur and Sukkur districts of Sindh. MRDO operates in approximately 120 villages in the area.
- The MRDO credit programme initially started on a small scale through the conventional committee system for women as an introduction to the concept of

savings. It gradually expanded with financial assistance from Catholic Relief Services and Orangi Pilot Project Credit programme and is now also supported by Pakistan Poverty Alleviation Fund (PPAF).

- MRDO only provides credit to females for entrepreneurial business projects or for other income generation activities, such as investment in livestock.
- The loans they offer these women range from Rs 5,000 to 10,000, with an interest rate of 18% recovered in 12 months.
- Their loan recovery rate is reported to be 98%.

5.5 Study findings

5.5.1 Household income

There are some significant variations in the sources of livelihood and the income levels, not only between the rural and urban areas, but also within each locality. In the Lahore locality self-employment in small- to medium-scale business ventures was the main source of income for most households, while in the Islamabad localities the main source of income included service sector and salary class employment.

In rural Sindh most of the respondent households were dependent on members working as daily labourers or running small businesses such as village shops. In a number of cases female household members helped supplement household income, engaging in domestic home-spun entrepreneurial activities. The frontier villages appeared to have multiple employment opportunities, probably due to their accessibility to the main road and large urban centres such as Peshawar and Nowshera, with around half of those interviewed having at least two sources of income, generally non-agricultural self-employment and wage employment.

Overall, households that were beneficiaries of MFP services were more likely to be engaged in non-agricultural self-employment, in contrast to non-beneficiaries who tended to be reliant on wage employment. Only 15 households reported agricultural self-employment as a source of income, reflected in the fact that very few households in all four areas had any significant land holdings or large quantities of livestock.

The average reported monthly household income was around Rs 8,000, working out as at roughly Rs 1,000 per household member. While these estimates are based on reported incomes, and therefore need to be interpreted with some care, the variation in average *per capita* income levels did correspond with the interview team's perception of the relative prosperity of the four localities, with the Lahore locality the best-off, followed by Islamabad and NWFP. Income levels in the Sindh localities were both perceived and reported as being by far the lowest for beneficiaries and non-beneficiaries alike.

The survey also collected information relating to certain household characteristics that are closely related to socioeconomic status. The variations in these indicators, shown in Table 5.9, are broadly consistent with the regional variations in household income described above. The differences in the relative income levels of beneficiaries and

non-beneficiaries are also reflected in the table below, although perhaps not to the extent expected (given the differences in average reported incomes), indicating that the beneficiaries are generally better off than the non-beneficiaries.

Table 5.9 Variations in socioeconomic status: proportion of households with each of the following characteristics (%)

Household characteristic	Region				Beneficiary	Non-beneficiary	Overall
	NWFP	Islamabad	Lahore	Sindh			
Brick / cement walls	12	16	20	0	15	8	12
Concrete / cement roof	52	88	100	4	60	63	61
Concrete / cement floor	32	80	100	13	59	53	57
Piped / tubewell drinking water	16	84	89	8	47	53	49
Flush latrine	44	96	100	95	82	84	83
Electricity connection (official or unofficial)	96	100	100	84	95	95	95
Gas connection (official or unofficial)	20	48	100	8	48	38	44
Telephone connection (official or unofficial)	12	16	20	0	15	8	12
Own a radio	20	32	36	21	33	18	27
Own a camera / camcorder	12	16	20	0	13	10	12
Own a bicycle	44	36	44	4	33	31	32
Own a refrigerator / freezer	36	48	64	0	37	38	37
Own a television	48	60	84	17	58	44	53
Own a wristwatch	56	76	72	17	65	41	56
Own a motorcycle	4	12	16	4	12	5	9
Own a car	4	4	5	0	4	3	3
Own a mobile telephone	28	56	56	0	38	31	35

5.5.2 Household demand for financial intermediation

All households, regardless of their income levels, at some points will desire to transfer the ability to purchase goods and services across time and / or space. This transferral of purchasing ability may be facilitated using either formal financial services or via other informal mechanisms. For example, any household making or receiving remittances is effectively transferring purchasing ability from 'here' to 'there' or vice versa. This transfer may be effected through formal methods, e.g. a money transfer service, or informally, e.g. carried by hand to the recipient.

Similarly, a household may want to transfer spending across time, for example to deal with an emergency or take advantage of an investment opportunity, shifting financial resources from 'now' to 'then' or vice versa. It can do so using either formal saving or saving services offered by banks or MFPs or use informal methods such as participating in a committee or taking a loan from family or friends.

In general the survey found that most households were managing their finances using a wide variety of informal and formal mechanisms. Surprisingly, however, 16 of the households appeared not to have used any financial mechanisms in the past year, either formal or informal. In fact, with the exception of Lahore half of the non-beneficiaries in each of the other three localities were 'financially inactive'.

Of the 100 interviewed households, 38 were currently saving, whilst 59 of the respondents had taken out at least one loan in last 12 months.³⁶ Most of the households that were currently saving did so on a regularly monthly basis, with the average monthly deposit roughly Rs 1,000. This is a large amount when considered in relation to the average monthly incomes. In fact, for these households, savings deposits amounted to roughly one-tenth of monthly income on average.

Table 5.10 Number of households currently saving and number that have taken at least one loan in the last 12 months

	Reason		Overall
	Consumption smoothing	Investment	
Currently saving	37	10	38
Taken a loan in last 12 months	26	40	59

5.5.3 Borrowing and saving for investment

Households were asked whether they had ever invested in items or activities that contributed to household income, and the types of financial activities they had

³⁶ The reason the number of households that reported taking out a loan in the last 12 months is less than 60, the number of MPF beneficiaries, is that in some cases beneficiaries were still repaying a debt taken out more than a year ago.

engaged in order to facilitate this. There was a clear distinction between beneficiary and non-beneficiary households, with just four non-beneficiary households reported ever having made any sort of investment. Similarly, of the 40 households that had had to borrow money for investment purposes in the past year, just one was a non-beneficiary. The average value of the loan required for each investment was roughly Rs 15,000, with households reporting a monthly profit of around Rs 5,500 on average. In all 40 cases the loan was provided by an MFP.

Table 5.10 reveals only 10 households, of which three were non-beneficiaries, were saving money with the specific intention of making some sort of investment at some point in the future. Furthermore, the investments planned were generally rather small-scale, for example buying the raw materials required for stitching school shirts for a clothes retailer. Most of these households were using a committee as their main method of saving, although two of the beneficiaries were using their MFP savings account.³⁷

5.5.4 Borrowing and saving in order to smooth consumption over time

Economic theory highlights the importance of consumption smoothing as a motive for financial intermediation. Borrowing and saving can allow households to respond to negative income shocks or positive expenditure shocks, either by withdrawing previous savings or taking a loan out against future earnings, and thereby reduce the impact of these shocks on household consumption. The economic literature in this area makes a clear distinction between these shocks on the basis of their predictability: unpredictable 'emergency' events and predictable 'life-cycle' events. Stuart Rutherford's description of these distinctions is summarised in section 2.2.4.1 and Box 2.1, above.

'Emergency' events are unexpected, unpredictable events that adversely affect household income and / or expenditure. The household does not know whether or not these events are going to occur. If they suspect that there is a fair chance that such an event could occur they may choose to insure themselves against this risk, either directly through insurance policies or indirectly via savings. Alternatively they may have to take out loans to cover unexpected expenditure or loss of income. Examples of 'emergency' events include: a relative falling seriously ill or suffering a serious injury; loss of household income (e.g. unemployment or famine); natural disasters; unexpected household repairs.

'Life-cycle' events are expected, predictable events that the household knows are going to occur with certainty - although the timing of the event may be uncertain. Examples of 'life-cycle' events include: weddings; funerals; childbirth; children's education; expected household repairs; expected medical expenditure (e.g. relative is known to be seriously ill); procurement of particularly expensive items bought for general use or as presents (e.g. mobile telephone, television).

³⁷ A committee, also known as a Bisi or Kistunas, is the common name for a ROSCA in Pakistan. Further details regarding committees are provided in section 5.4.3.2.

Using suitable examples, the households were asked about the emergency and life-cycle events that they faced, and their responses to them in terms of their usage of financial intermediation mechanisms. 36 households reported having to take out at least one loan in the past year in response to such events. In 18 cases these loans were in response to emergency events, mostly illness and accidents, of which 12 were beneficiaries and six non-beneficiaries.

In a number of cases valuable assets such as jewellery or livestock were sold to meet emergency expenses. Around half of these households would have preferred to have taken a loan instead. Twelve households had borrowed money for life-cycle events, especially for weddings, of which seven were beneficiaries and six non-beneficiaries. In a further 10 cases it was not possible to determine whether the non-investment loans had been taken out for emergency or life-cycle purposes. All but four emergency or life-cycle loans were provided by friends or family.

Over half of households currently saving were doing so with multiple motives in mind. All but one of those households saving for some future investment were also saving for consumption smoothing purposes. Similarly, of the 25 households saving for life-cycle events, the most common of which was again family weddings, 12 were also saving against emergency events. Committees were by far the most frequent method of saving for both beneficiaries and non-beneficiaries. Some beneficiaries were also using their MFP accounts to save, though the amounts deposited were small.

5.5.5 Financial intermediation mechanisms

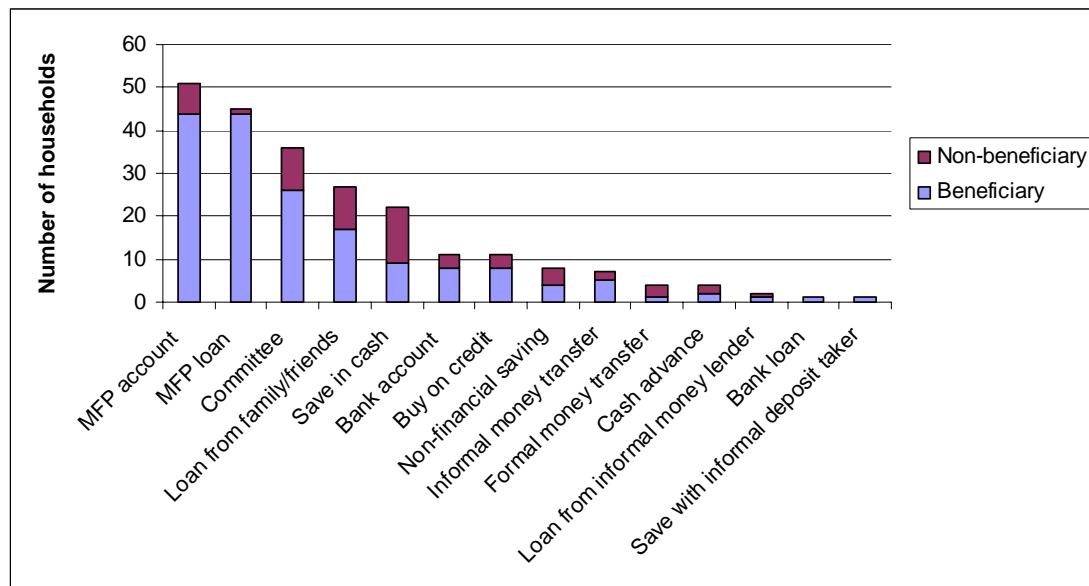
Households have at their disposal a large number of financial intermediation mechanisms, i.e. methods by which households can transfer purchasing ability across time and / or space. Even where formal financial services are limited, households can and will take informal out loans, save informally (either with commercial deposit takers, committee or even simply by holding cash), or transfer money using informal arrangements. Accordingly, the results of this survey indicate that financial intermediation mechanisms are widely used even by relatively poor households.

Of those households that have utilised financial intermediation mechanisms, 65 have used at least one formal mechanism in the last year and 65 have used at least one informal mechanism, with 46 households reporting use of both. The numbers reporting using formal services are clearly skewed by the explicit focus on beneficiaries of MFP programmes, and in fact only 14 households have used formal financial services other than those provided by the MFPs under study. Most respondents felt that the only formal financial services available to them were those provided by MFPs. Respondents appeared to be hesitant in approaching banks and other more formal financial services. A general perception was that banks were for the 'educated' and 'well-off' and thus it was not appropriate for low-income groups to utilise them since they offered no services that would be of benefit to them.

Figure 5.1, below, shows the range of formal and informal financial intermediation mechanisms that respondents reported having utilised in the last 12 months. Unsurprisingly skewed by the focus on MFP beneficiaries, MFP savings accounts and MFP loans are the most frequently used mechanisms. The number of households who took

an MFP loan in the last year is less than 60, the number of beneficiaries is small, because in some cases beneficiaries are still repaying a debt taken out more than 1 year ago.³⁸ More interestingly, committees and borrowing from family or friends appear to be widely used by the interviewed households, both beneficiaries and non-beneficiaries alike. Household usage of these mechanisms is discussed in detail in various subsections of this chapter.

Figure 5.1 Formal and informal financial mechanisms used by households in the last year



Many households also reported saving in cash, storing money in their dwellings. This was particularly prevalent for non-beneficiaries, with over a quarter reporting saving in this manner. It is perhaps a surprising finding that not one respondent from the rural Sindh locality reported saving in cash.

Practically all of the few households holding bank accounts did so because it was obligatory for salary deposits rather than for saving purposes and therefore 9 out of 11 were from the urban localities. In fact the questions regarding bank accounts, or any other relationship with a bank, were generally laughed away cynically by most respondents. Many respondents, especially men, were aware of banking schemes for investment purposes, but were afraid of the collateral requirements and high interest rates, which they felt would create further financial burden.

Of the 11 households that reported having bought something on credit in the past year, three items bought were for investment purposes.

³⁸ The reason that the MFP loan figure appears to be inconsistent with the number of households who took out a loan for investment purposes shown in Table 5.10, is that there are some cases of MFP loan misuse whereby MFP loans were used for non-investment purposes.

There are also non-financial methods of saving. Jewellery and livestock are often sold in order to raise money as and when it is required. In fact, eight households report buying valuable items such as these specifically for saving purposes. This is likely to understate the true extent of non-financial saving, since these items are often bought with several purposes in mind, of which saving might just be one motivation. This is consistent with the finding that only three of these eight households would have preferred to have used a formal method of saving instead of a non-financial method of saving.

Just 11 households report receiving remittances. No other households receive or make any other types of money transfers. Of these, only four use formal money transfer services. In two of the four cases, cash advances represented significant loans (more than Rs 20,000). Neither of these two respondents would have preferred to receive this money from another source, although one of the other two recipients did state such a preference.

5.5.6 Microfinance services

Figure 5.1 reveals that a number of non-beneficiaries report using MFP services, MFP savings accounts in particular (presumably from other MFPs). In fact in all four sampled localities most households were aware of at least one other MFP currently operating there.

With regard to the four MFPs under analysis, beneficiary households generally report utilising the relevant MFP services in a manner in line with the official regulations and conditions set out by each, as outlined in Chapter 4. The main exceptions to this are the value of NRSP MFP loans taken out by beneficiaries in the Islamabad locality, some evidence of substantial, possibly unofficial, fees being charged for making deposits with SRSP in NWFP, and, most importantly, the misuse of MFP loans.

With the exception of the NWFP locality, where none was reported, loan misuse appears to be a very significant issue. In fact, 9 of the 45 MFP beneficiaries from Lahore, Islamabad and Sindh localities report using their most recent MFP loan for non-investment purposes rather than the investment project for which it was intended.

Surprisingly, there was not a single respondent who mentioned any incident when he or she was unable to make a loan repayment on time. It appears that beneficiaries plan ahead and keep their repayment money separate from their other expenses.

5.5.6.1 Kashf Foundation

The most recent loans received by beneficiaries of the Kashf Foundation in the Lahore locality were all between Rs 10,000 and Rs 28,000, with an average value of around Rs 20,000. No households were required to pledge collateral in order to secure this loan. All respondents reported paying the official interest rate of 20%. Three households admitted to not using their most recent MFP loan for the investment project for which it was intended.

In the past year, 11 of the beneficiary households deposited savings in the account provided as part of the Kashf Foundation credit scheme. All report receiving zero interest on their savings. None of these households were required to pay a fee in order to make a deposit.

5.5.6.2 NRSP

The most recent loans received by beneficiaries of NRSP in the Islamabad locality were all between Rs 10,000 and Rs 15,000, with an average value of around Rs 11,000. In order to secure the loan one respondent was required to pledge collateral of equal value to that of the loan. All the respondents reported paying an interest rate of 20%. One household admitted to not using their most recent MFP loan for the investment project for which it was intended.

In the past year, nine of the beneficiary households deposited savings with NRSP. All report receiving zero interest on their savings. One of these households was required to pay an official fee in order to make a deposit.

5.5.6.3 SRSP

The most recent loans received by beneficiaries of NRSP in the Islamabad locality were all between Rs 1,000 and Rs 20,000, with an average value of around Rs 8,500. In order to secure the loan five respondents was required to pledge collateral, in one case of value equal to that of the loan. The respondents reported paying an interest rate of 12%. No household reported using their most recent MFP loan for any purpose other than the investment project for which it was intended.

In the past year, all of the beneficiary households deposited savings with SRSP. All report receiving zero interest on their savings. Three of these households had to pay a fee of Rs 150 and one had to pay Rs 900 in order to make this deposit. In three of the four cases this fee was said to be unofficial.

5.5.6.4 MRDO

The most recent loans received by beneficiaries of NRSP in the Islamabad locality were all between Rs 500 and Rs 15,000, with an average value of around Rs 8,500. In order to secure the loan three respondents were required to pledge collateral of equal value to that of the loan. The respondents reported paying an interest rate of 18%. Five households admitted to not using their most recent MFP loan for the investment project for which it was intended.

In the past year, all of the beneficiary households deposited savings with MRDO. Respondents report receiving 8% interest on their savings. All but one of these households had to pay an official fee of Rs 5 in order to make this deposit.

5.5.7 Committees

Figure 5.1 shows that 36 households have participated in at least one committee in the last year, while Table 5.11, below, reveals how committee usage breaks down across

beneficiaries and non-beneficiaries and across the four sampled localities. Beneficiaries appear to be more likely to be in a committee than non-beneficiaries. In the rural Sindh locality just one household had participated in a committee in the past year. In the other three localities participating in multiple committees is fairly common. Fourteen households have used more than one committee in the past year, while 12 are currently using more than one.

Table 5.11 Number of households that have participated in at least one committee in the past year

	Beneficiary	Non-beneficiary	Overall
Rural NWFP (SRSP)	8	3	11
Islamabad (NRSP)	8	2	10
Lahore (Kashf Foundation)	9	5	14
Rural Sindh (MRDO)	1	0	1
Overall	26	10	36

Households were asked to give details of the committee they had participated in most recently.³⁹ These committees all operated according to the standard ROSCA system.⁴⁰ Committee members generally all contribute the same amount of money each month, around Rs 900 on average, and each month the combined contributions are allocated to one of the members. In the vast majority of cases the order of the allocations was determined randomly using a 'chit' or lottery system. In a few other committees the order was decided by the committee organiser. The average committee had 18 rounds, i.e. spanned 18 months. The highest committee payout recorded was Rs 77,000, for a committee with 35 members and a cycle of 35 months.

³⁹ If the household was currently participating in more than one committee, then the respondent was asked to give details of the one that required the highest contribution.

⁴⁰ Whilst piloting the questionnaire, the survey team came across a more complicated committee system that is effectively providing an insurance function for its members, described in Hurrell (2006). Like a standard committee the members all make the same contribution each month, and similarly each member receives a payout just once over the committee cycle. However in this low-bid 'insurance committee', the recipient of each month's payout is determined via an auction in which the individual willing to accept the lowest amount received this as their payout. The balance between the payout and the total contributions is then divided up and subtracted from the next month's contribution.

In this way the majority of committee members end up paying more in contributions than they will receive as their payout, effectively paying a substantial insurance premium. The exception to this is the recipient of first payout, invariably the committee organiser, who receives the full value of the monthly contribution, but will, over the course of the committee cycle, inevitably contribute much less than this amount. The same applies to the few members, lucky enough not to require their payouts earlier, who get the final few payouts which will be equal to, or just under, the full value of a month's contributions, and thus are receiving a substantial return on their investment in the committee. Surprisingly, no other variants of the standard committee system were encountered during the fieldwork.

In 25 cases, some committee members shared rounds, e.g. three people might each put in Rs 300 for a combined Rs 900 contribution. In this way a committee can have more members than rounds. The fact that these committee groups are formed on mutual trust facilitates further flexibility. For example, although there were very few reports of such incidents, if anyone were unable to pay their monthly contribution other group members would normally cover for that person so the main cycle would not be affected. In some cases respondents reported swapping payout positions, such as in the case of an emergency when one member needed that month's payout particularly urgently, another example of how committee members can accommodate for one another's needs.

Interestingly, in some cases households actually want to use committees as a means of borrowing money, with seven respondents wanting the first payout. However, the random allocation of payouts somewhat undermines the borrowing motive for participating in a committee. Having said this, often the individual who initiates a committee, and takes responsibility for its running, will be rewarded by receiving the first payment. This was actually the case for 21 of the committees. Thus individuals can set up a committee in order to get an interest-free loan. In fact the most recent committee participated in by one respondent had been started by them for this very reason.

5.5.8 Borrowing from family and friends

Previous sections have highlighted the importance of loans from family and friends, often in response to emergency events such as illness or accident. In fact Figure 5.1 reveals that 27 households borrowed from friends and relations in the past year. Table 5.12 shows how these loans vary across locality and between beneficiaries and non-beneficiaries. Most striking is the surprising finding that only one of the households from the rural Sindh locality has taken out such a loan.

Table 5.12 Number of households that have borrowed from family or friends in the last year

	Beneficiary	Non-beneficiary	Overall
Rural NWFP (SRSP)	5	3	8
Islamabad (NRSP)	8	4	12
Lahore (Kashf Foundation)	4	2	6
Rural Sindh (MRDO)	0	1	1
Overall	17	10	27

The amounts borrowed from friends and family range from Rs 500 to Rs 60,000, with an average value of around Rs 11,000. The average loan values do not vary significantly across localities, but are slightly lower in NWFP.

Interestingly, just seven of the interviewed households report having made loans to family or friends, five of whom were beneficiaries. None came from the relatively poorer rural Sindh locality. Therefore perhaps this is an indication that loans are generally made by relatively better-off members of a community rather than simply a household's closest relations.

5.5.9 Impact of microfinance services

There was a general consensus among all the MFP beneficiaries that MFP programmes enabled them to take advantage of income-generating activities, business expansion, and other investment opportunities, thereby increasing livelihoods. As mentioned above, 39 beneficiary households made an investment using an MFP loan in the past year. The average reported monthly profit yielded by these investments is around Rs 5,500, so, unsurprisingly, all these households reported feeling better off as a result of taking out this loan. Community-based MFPs were especially appreciated by female beneficiaries, who through these programmes got an opportunity to participate in credit and saving schemes in their own interests and for their own economic empowerment.

Of the 44 beneficiaries that have used an MFP account in the past year, 42 reported feeling better off because they were able to save money in this way. However, it should be noted that in the majority of cases the amount deposited as savings was so small that it was rarely used for any significant purpose. Despite this, some respondents said that although it was a small amount they still felt more secure knowing that that it was there.

In spite of these positive perceptions of MFP services, some reservations were expressed by some of the beneficiaries regarding certain services. Beneficiary households were asked whether they felt that their MFP currently offered them all the financial services that they required. Table 5.13 indicates that nearly two-thirds of beneficiaries were in some way dissatisfied with the MFP services being offered to them.

Table 5.13 Number of beneficiary households who feel their MFP currently does not offer them all the financial services they require

	Number of households
Rural NWFP (SRSP)	9
Islamabad (NRSP)	10
Lahore (Kashf Foundation)	6
Rural Sindh (MRDO)	13
Overall	38

In general, a point expressed by a significant number of beneficiaries in all areas, but especially those from the urban localities in Lahore and Islamabad, was that the loan

amount should be increased in order to facilitate more meaningful support for business establishment or expansion. Two respondents said that, if MFP services were to bring about real economic improvement in their lives, a thorough assessment of clients' needs should be made and the loan amount should be disbursed accordingly.

Households were asked about which specific services an MFP needed to offer in order to best meet their borrowing and saving requirements. The number of households from each locality desiring the certain MF service characteristics is shown in Table 5.14.

Table 5.14 MF services characteristics desired by MFP beneficiary households, by locality (number of households)

Service characteristic	NWFP	Islamabad	Lahore	Sindh	Overall
Fixed regular deposits (i.e. saving discipline)	0	7	8	0	15
Variable deposits (i.e. saving flexibility)	3	2	6	13	24
Personalised door-to-door service	2	4	3	14	23
Fixed withdrawal rules (i.e. withdraw savings at certain times only)	0	0	4	0	4
Flexible withdrawal rules (i.e. withdraw savings at any time)	2	4	7	13	26
Interest on savings deposits	2	11	4	11	28
Low collateral requirements	1	6	1	0	8
Low interest rates on loans	6	11	4	13	34
Insurance services	1	10	7	6	24

Although many felt that it would be ideal if the interest rates on loans were lower, no respondents mentioned it as a particular concern. Interestingly, nearly all the respondents from the Sindh locality thought flexibility in savings deposits and withdrawals were desirable characteristics; perhaps helping to explain why so few respondents from this locality participated in committees.

A major component of the surveyed MFPs is community mobilisation. Door-to-door mobilisation is carried out on a regular basis and credit officers have a personal rapport with their clients and also, in case of the RSPs and MRDO programmes, with a team of social organisers who are also providing other community development services. This door-to-door mobilisation strengthens people's trust in the programmes and the organisations. This service is clearly valued by a large number of respondents, particularly in the Sindh locality.

Overall, it is obvious that households are benefiting substantially from using MFP services, primarily through the increased income resulting from the investment projects facilitated by MFP loans. However, there appears to be scope for improvement. Respondents have highlighted a number of areas where they feel

services could be modified, and as a result the benefits increased. Similarly, it is not obvious why MFPs have not modified their services so as to encourage more beneficiaries to deposit savings in MFP savings accounts, rather than continuing to use committees, particularly if MFPs could pay some interest on savings, while many beneficiaries appear to desire savings schemes which involve flexible savings deposits and withdrawals, something most committee systems cannot provide.

5.6 Conclusions

The conclusions that can be drawn for the reanalysis of the PIHS and PSES are that in 2000 the poor had very little access to formal and semi-formal credit markets; the vast majority of loans were used for consumption rather than investment; large loans were provided by formal and semi-formal credit providers; and finally, the availability of credit may have played a significant role in reducing the poverty impact of the drought in NWFP and Punjab. However, in Sindh and Balochistan, covariate risks (i.e. suppliers of credit were unable to supply when the users of credit needed it most) may have severely reduced the role that credit might have played in maintaining consumption levels.

The conclusions that can be drawn from the 'financial diaries' study are clearly constrained by its methodological limitations. The study essentially comprises four comparative case studies. Each case study focuses on a different MFP (SRSP, NRSP, Kashf Foundation and MRDO) and analyses the usage of formal and informal financial services by the relatively poorer households situated in a locality in which that MFP operates. There was some randomness involved in the selection of the surveyed localities, but none at all in the sampling of households to be interviewed. Therefore the results are in no way representative.

For this reason this study is perhaps best regarded as a pilot, highlighting the main issues and particular difficulties involved in assessing the impact of MF services. In any case, and in spite of these concerns, the study did produce some interesting findings:

- While most of the sampled households used a wide range of financial intermediation mechanisms to manage their resources, in each of the Sindh, Islamabad and NWFP localities half of non-beneficiaries interviewed reported neither having used any method of saving nor having borrowed any money in the last year. This seems a rather dubious finding and highlights the desirability of using full-blown 'financial diary' methodology, whereby extremely detailed and ongoing logging of a household's finances provides a far more reliable technique of establishing whether or not a household is using any financial mechanisms. Unfortunately, such an approach, requiring a series of interviews over a substantial period of time, was clearly beyond the scope of this study.
- The households interviewed were just as likely to use informal financial mechanisms as they were to use formal financial services. However, this finding was skewed by the focus on MF beneficiaries. In fact very few households used formal financial services other than those provided by MFPs.
- Participation in committees was by far the most common method of saving, even for those beneficiaries with MFP savings accounts. Clearly not all

households could afford to save, but those who could were frequently saving for life-cycle events, such as weddings. Having said that, saving was often undertaken with multiple motivations in mind, e.g. a household may be saving for a wedding knowing that in a real emergency these savings could be used for another purpose.

- Almost all borrowing fell into one of the following distinct categories: MFP loans, used for investment purposes; and borrowing from family and friends, most frequently in response to an emergency event, particularly illness or accidents. This highlights the importance of MFP loans as basically the sole source of funding available to facilitate investment.
- There is some evidence of MFP loan misuse with 9 out of the 60 beneficiary households interviewed admitting to not using their most recent MFP loan for the investment project for which it was intended.
- With monthly reported profits on MFP loan financed investments averaging around Rs 5,500, MFP beneficiaries clearly benefit substantially from MFP services. However, whilst clearly satisfied in general with these services, many beneficiaries identified areas for improvement, which could potentially increase these benefits further. It is unclear why MFPs do not make more effort to persuade beneficiaries to divert their savings away from committees and into MFP savings accounts, which could in principle pay interest, since the many beneficiaries appear to desire savings schemes which involve flexible savings deposits and withdrawals, something most committee systems cannot provide.
- MF beneficiaries appear to be relatively better off than non-beneficiaries in all four of the localities sampled for this study. Therefore one obvious possibility for increasing impact of MF services would be to extend MFP services to poorer non-beneficiaries. This would be in conflict with most MFPs' current policy of focusing on those members of a community who have a lower chance of defaulting on loan repayments, and who are therefore generally better off. Although many felt that it would be ideal if the interest rates on loans were lower, no respondents mentioned it as a particular concern. Thus, it may be that interest rates could be raised sufficiently to cover the increased costs associated with lending to those with relatively greater chance of defaulting, whilst still being below the seemingly very high rates of return on potential investment opportunities.
- Even if MFP services can be extended they will still not be reaching those in extreme poverty. However, the study highlighted the importance of those relatively better-off members of a community lending to those in need, particularly in response to an emergency. Therefore, to the extent that MFP services increase household incomes, by strengthening these informal support mechanisms the extension of MFP services may have further indirect positive effects.

CHAPTER 6: CONCLUSIONS

The MF sector in Pakistan, while a late starter, is less far behind the sector in other countries in South and South-East Asia than might be apparent at first glance. Indeed, despite the fact that the mainstream MF sector in Pakistan is relatively young compared with those of other countries in the region, it is definitely in the same league as many of them in terms of key measurements, such as the number of beneficiaries and the average size of loans.

In some areas, such as the range of types of service providers, Pakistan is actually ahead of many comparable countries. There are still some serious issues to be addressed, in areas such as access, sustainability and efficiency. Perhaps the most urgent and difficult area to address is that of financial sustainability. Also, and of particular relevance to this PSIA, the MF sector has yet to demonstrate its potential in terms of its social and poverty impact.

These issues, however, are characteristic of an early-stage MF sector. The PSIA supports the view that the MF sector in Pakistan is now in a position to consolidate the gains it has made during the years since the passing of the MF Ordinance in 2001, and is ready to embark on a major expansion in size and scope, given the right conditions.

In terms of size, our analysis confirms the views of the providers covered in the case studies, that there is scope for a major expansion in the number of beneficiaries in the next decade, from hundreds of thousands to millions.

In terms of scope of services, the case studies and the surveys demonstrate that providers and users share similar aspirations – for example, for more access to savings and insurance products, and for more flexibility in microcredit.

So what will ‘the right conditions’ be? How can MF policies be maintained or adapted to provide the conditions for expansion of the MF sector and to maximise its social and poverty impact?

The broad conditions required for this expansion, at the highest level, are obviously macroeconomic stability, and continued development of the banking sector.

At the MF sector level, the analysis supports the consensus of the current providers that the sector is ready for take-off, that the GOP’s catalytic role in the ‘start-up’ phase has been a success, and that it is now time for the GOP to step back and let the MF industry evolve under its own momentum. The GOP no longer needs to be a provider of MF services, nor the main financier of those services, nor does it need to take an interventionist approach to the scope and nature of the services provided by NGOs, MFIs and banks. The time has also come when the role of subsidies needs to be changed to ensure that any future subsidies are used to build the efficiency and financial sustainability of the institutions. The key role of MF policies at this stage of the development of the sector is to provide an enabling environment in which the sector can grow.

It would therefore be appropriate for consideration to be given to a number of policy options aimed at liberalising regulations and restrictions that were useful in the early stages of MF development, but that are now in danger of creating an artificial segmentation of the sector that might inhibit its growth. Particular consideration might be given to the following issues:

Regulating by function or institution?

Currently, MF providers are regulated, or not regulated, according to what kind of institution they are (bank, MFI, NGO etc). Consideration might be given to regulating MFPs according to the kind of service provided (MF loans, deposits, transfers etc). This would mean, for example, that the regulation of MF services provided by MFIs under the Ordinance would be the same as, or comparable to, the regulation of the same services provided by commercial banks.

This principle applies particularly to prudential regulation, i.e. regulation that governs the financial soundness of licensed intermediaries' businesses, in order to prevent financial-system instability and losses to small, unsophisticated depositors. The key arguments in this area are explored in the comprehensive CGAP *Guiding Principles on Regulation and Supervision of Microfinance* (2003), the conclusion of which is that 'As much as possible, prudential regulation should be focused on the type of transaction being conducted rather than the type of institution conducting it.' The Guidelines also set out as 'an important general principle' the need 'to avoid using burdensome prudential regulation for non-prudential purposes—that is, purposes other than protecting depositors' safety and the soundness of the financial sector as a whole.'

Tax structures

Currently, an NGO would be penalised by becoming a deposit taking MFI under the ordinance, as it would have to pay corporation tax; this would also have a detrimental effect on the interest rates that NGOs would need to charge. A very crude calculation on the basis of the Kashf Foundation 2004 audited accounts, for example, would indicate that if Kashf became an MFI and was subject to 40% tax on surplus (after loan provisions), then it would have to increase its interest rate by about one third to maintain the level of surplus transferred to reserves to ensure financial sustainability. That would mean, for example, that in cases where they were charging 20% interest, they would need to increase the charge to around 27% to cover the incidence of tax

Tax is a complex area, and there are many exogenous factors to be taken into account that are outside the scope of this PSIA. On the one hand, as the CGAP Guidelines cited above point out,

'It can reasonably be argued that not-for-profit NGO MFIs ought to be treated the same as all other public-benefit NGOs when the tax in question is a tax on net profits. The reason for exemption from profits tax is the principle that the NGO is rendering a recognized public benefit and does not distribute its net

surpluses into the pockets of private shareholders or other insiders. Rather, it reinvests any surplus to finance more socially-beneficial work.⁴¹

On the other hand, favourable fiscal treatment to NGO MFPs could cut across the norms of fiscal policy in Pakistan, undermine the principle of regulation according to function rather than institution and prevent MF services being offered on a level playing field.

This is, as stated above, a complex issue, but it certainly merits further consideration by GOP.

The use of subsidies

It is argued in this paper that subsidies have played a useful part in initial stages of the development of MF in the Pakistan. It is also argued, however, that the start-up phase is now drawing to a close and that the sector is ready for take-off. It is a necessary condition for rapid growth in the next stage of development that microfinance services will be provided by institutions that are fully financially sustainable, or can become fully sustainable in a very short time. That requirement is undermined by subsidies that are passed straight to the borrower in the form of lower interest rates, and/or by subsidies that are used by MFIs to avoid the need to leverage lending services in order to build adequate capital. Any subsidies planned for the next few years, therefore, need to be very carefully designed to ensure that they are used purely for capacity building, or for building the MF infrastructure at the macro- and meso- level, and not used to maintain non-sustainable services and institutions.

Restrictions on loan size

After five years of experience, the loan limit of Rs 100,000 on MF credit under the Ordinance needs to be re-examined. The MFPs argue that it is a disincentive to lending to MF entrepreneurs, and in particular that it prevents an MFI from developing a relationship with a growing enterprise: as a microenterprise grows and requires larger loans, it moves outside the scope of MFIs, but its borrowing requirements are not yet large enough to interest normal commercial banks. If that is indeed the case, it would represent a significance constraint on the Micro, Small and Medium Enterprise (MSME) sector in Pakistan.

Poverty monitoring and evaluation

The recent literature suggests that MF providers that make poverty reduction an explicit goal and make poverty reduction a part of their organisational culture are far more effective at reaching poor households than those providers that do not. The same literature also suggests that MF institutions underspend on monitoring and

⁴¹ CGAP (2003), p. 14

evaluation and this failure while cutting costs in the short-run does so at the expense of long-term social and economic goals.⁴²

The definition of eligible borrowers

The same re-examination is advisable in relation to the MFIO definition of eligible borrowers as 'poor persons', defined as 'persons who have meagre means of subsistence and whose total income or receipt during a year is less than the minimum taxable limit set out in the law relating to income-tax.'

The poverty line defined in the PRSP is significantly lower than the MFIO's poverty line. This leads MFIs to believe they are more poverty focused than they are in practice.

Interest rates

Throughout this PSIA, evidence has been cited from around the world as well as from Pakistan that demonstrates that people on low incomes continue to take out loans either from the informal or formal sector even at interest rates that, in different circumstances, might be regarded as very high. The large increases in output that result from investment at low levels of capital intensity generate the large increases in revenue that in turn can help repay investment loans at high interest rates. Access to credit is therefore usually much more important to people on low incomes than the costs of credit.

Given the need - also demonstrated in this PSIA - for MFPs to become financially sustainable, it would be advisable to consider allowing the market to determine interest rates by removing explicit or implicit caps on interest rates.

Linking to ROSCAs - using the example of NABARD?

Given the prevalence of ROSCAs in Pakistan, there is merit in considering ways in which the formal financial sector can better serve the informal. Indeed, as the case of NABARD in India demonstrates, such mechanisms can, in the right circumstances, support very rapid expansion of MF services. It would be useful for Pakistan to study the NABARD case to establish whether there is scope for facilitating a similar linkage between self-help groups and the banking sector, within or outside the MFP structure.

⁴² Morduch and Haley, op.cit..

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ANNEX A: TERMS OF REFERENCE

Government of Pakistan

Terms of Reference

for

A study on the potential social and poverty impacts of microfinance policies in Pakistan

Introduction

1 The GOP has decided to conduct a Poverty and Social Impact Analysis (PSIA) of its microfinance policies. The topic was identified at a PSIA workshop organised by the Ministry of Finance in Islamabad in March 2003. This will be the first PSIA conducted by the GOP.

2 Poverty in Pakistan is widespread and increased slightly over the 1990s. In 2001 a third of the country's population lived below the national poverty line. The GOP has developed a national Poverty Reduction Strategy to address the problem, which includes special measures to generate employment and incomes and to target the poor and vulnerable. The expansion of the microfinance sector is a key component of this strategy.

3 Over the last 5 years, the Government has initiated a wide-ranging series of policies designed to encourage the development of the microfinance sector. These include:

- Enacting ordinances making it possible to establish microfinance banks in the country (e.g. the Khushali Bank and First Microfinance Bank).
- Developing a legal and regulatory framework to encourage the establishment of licensed private sector microfinance institutions
- Promoting and supporting the growth on NGOs and other microfinance organisations focusing on the needs of the poor (e.g. through the Pakistan Poverty Alleviation Fund).

- Restructuring of existing banks and microfinance institutions (e.g. ZTBI Ltd).
 - Promoting an environment conducive to the growth of the microfinance sector through the State Bank of Pakistan.
4. The Government's efforts have been supported by a number of donors including the World Bank, which supports the PPAF; the Asian Development Bank, which supports the Khushali Bank and Rural Finance Sector Development Programme; and DFID, which supports the Pakistan Microfinance Network (PMN) and Kashf.
5. Despite these important developments, the microfinance sector meets only approximately 5% of demand. There is a huge scope to expand coverage to poor households throughout Pakistan and to develop new policies and approaches to address the needs of the very poor, both directly and indirectly, by supporting the growth of micro- and small-scale enterprises.
6. The GOP places a high priority on expanding and developing the microfinance sector as part of its Poverty Reduction Strategy. It is therefore timely to review the impacts of the microfinance sector on poverty in Pakistan and to identify lessons that may be used in making the policy framework more effective in promoting rapid development of the sector and poverty reduction.

Objective

7. The general **aims** of the study are to:
- Review the social and poverty impacts of microfinance policies and advise the GOP on ways to improve the effectiveness of its policies. (To analyse the impact of microfinance from different angles).
 - Explore the value of PSIA in analysing policy choices in Pakistan, and to help establish an efficient process for conducting future PSIAs.
8. The specific **research questions** to be addressed in the study will be identified during the first 'scoping' phase of this study. The broad questions to be addressed are:
- What microfinance services are currently provided by the main microfinance banks, institutions and other providers (including an assessment of their coverage, products and services, costs of borrowing, recovery rates and overall financial viability). How have these changed since the introduction of the new microfinance policies over the last 5 years?
 - What is the capacity of microfinance institutions (MFIs) to reach the poor?
 - What is likely to be the impact of the government's microfinance policies (once fully implemented) on different groups of the population?

- How will the policies affect the assets, incomes, employment prospects, stability and empowerment of different socioeconomic groups, especially the poor?
 - Which groups of people are likely to benefit the most from microfinance development and which are likely to be excluded or disadvantaged (e.g. women, the extreme poor, specific ethnic groups)?
- How effective have microfinance policies been in encouraging the development and expansion of effective and financially sustainable microfinance banks, institutions and other providers, and how able are these organisations to scale-up to meet the demand for microfinance services in the country?
 - What new policies, or changes in existing policies and approaches, will be needed if microfinance banks, institutions and other providers are to: address the needs of the very poor and other excluded groups, and scale up rapidly to meet the needs of poor and very poor households throughout the country?
 - Are there any significant differences in the scope and effectiveness of microfinance policies in urban and rural contexts?)

Approach

9. The study will be implemented in two stages. Stage 1 will be a scoping exercise, with the full study being undertaken in Stage 2. In Stage 1 it is anticipated the team will consist of three international and two local team members working for approx 10 days each (total 50 working days).

10. In Stage 1:

- define the scope the study, in consultation with the main stakeholders (GOP, microfinance organisations, poor people with and without access to microfinance services);
- review existing literature, data and analyses on the entire microfinance sector in Pakistan, identify information gaps and clarify the research questions to be addressed;
- develop a detailed proposal for the full study to be undertaken in Stage 2.

11. It is anticipated that the full study in Stage 2 will be undertaken by two international and two local consultants working for approximately 25 days each (total 100 working days). Stage 2 should include social, economic and institutional analysis and a plan to disseminate the results of the study. It is expected that the final report will include:

- a review of current microfinance services provided by the main microfinance banks, institutions and other providers, including an assessment of their coverage, product range, costs of borrowing, recovery rates and overall financial viability;
- an analysis of social and economic characteristics of current beneficiaries and the impact that microfinance services have had on their incomes and well-being, with a special focus on the poor;
- an analysis of the role and interests of the main stakeholders in designing and implementing policies for microfinance. These will include the Ministry of Finance, the State Bank of Pakistan, the Pakistan Microfinance Network and its member MFIs, the business community (in particular small-scale enterprises), community organisations, and the bilateral donors and multilaterals providing support to the sector;
- an assessment of the impact of policy changes in the last 5 years on the expansion of the sector and a discussion of key issues (e.g. the problem of high client attrition rates; the need for common reporting standards to allow comparative analysis of microfinance organisations; the extent and justification of subsidies to the microfinance sector);
- a qualitative analysis of the need for microfinance and the strengths and weaknesses of current microfinance policy from the viewpoint of beneficiaries and non-beneficiaries (i.e. potential beneficiaries);
- a proposal for a continued process for identifying and conducting future PSIAs (i.e. the role of the steering committee, the institutional home, how these would be funded in future).

12. The work will be carried out through an analysis of existing studies and data, and interviews, workshops and focus group discussions with key stakeholders, organisations and members of the community. Large-scale data collection exercises are not expected to be required.

13. During the study, the consultants will adopt a participatory approach and will ensure the main stakeholders in the process of strengthening the microfinance system in Pakistan are fully engaged in the study and 'own' the main conclusions.

14. The work should result in concrete recommendations for improving the policy. It should also identify the actions needed to implement these recommendations, which would take in to account capacity, political and social factors. It should also highlight whether any additional analysis or data collection would be useful.

Process

15. The study will be managed by the PSIA Steering Committee. This includes members from the Ministries of Finance and Planning, the Federal Bureau of Statistics, DFID and civil society. The Steering Committee will brief the consultants,

comment on interim reports, approve the final methodology and report, and support dissemination.

16. The work will be undertaken by a multi-disciplinary team consisting of both national and international consultants. DFID will contract the international consultancy and it is expected that they would subcontract the national consultants. The team would contain an appropriate gender mix and include expertise in the following areas:

- microfinance;
- enterprise and private sector development;
- governance / institutional analysis;
- social development;
- sustainable livelihoods;
- economics;
- research design and implementation.

17. The consultancy team will be familiar with current conditions in Pakistan and other countries in the region. Team members should have previous experience of carrying out impact analysis and be familiar with the relevant PSIA tools and methods. Some consultants should have at least 10 years of relevant experience. The team will be competent in English and Urdu. It is expected that at least one member (most likely a local consultant) will have knowledge of the microfinance sector in Pakistan.

Outputs and timetable

18. The outputs will be as follows:

Stage 1

- A detailed proposal for the study to be undertaken in Stage 2, for discussion with the Steering Committee. To be completed by end of December 2005

Stage 2

- A draft of the final report of the study, including a short summary of the main conclusions and recommendations, which will be presented at a workshop with the Steering Committee and other key stakeholders.
- The final report, which will be made available in both English and Urdu languages. A supplementary report recommending a general approach to conducting future PSIAs based on the experiences of this pilot.

- A proposal for a continued process for identifying and conducting future PSIAs (i.e. the role of the steering committee, the institutional home, how these would be funded in future).
- Stage 2 to be completed within 3 months of approval of proposal.

Timetable

The first phase of the work will be undertaken by end of December the second phase during January and February, and the first draft of the final report completed by the end of February. The report should be finalised by the end of March.

List of key reports and background documents

To be provided.

October, 2005

ANNEX B: KEY PRINCIPLES OF MICROFINANCE

These **Key Principles of Microfinance** were developed and endorsed by CGAP and its 31 member donors, and further endorsed by the Group of Eight leaders at the G8 Summit at Sea Island on 10 June 2004.

1. **Poor people need a variety of financial services, not just loans.** Like everyone else, the poor need a range of financial services that are convenient, flexible, and affordable. Depending on circumstances, they want not only loans, but also savings, insurance, and cash transfer services.
2. **Microfinance is a powerful tool to fight poverty.** When poor people have access to financial services, they can earn more, build their assets, and cushion themselves against external shocks. Poor households use microfinance to move from everyday survival to planning for the future: they invest in better nutrition, housing, health, and education.
3. **Microfinance means building financial systems that serve the poor.** In most developing countries, poor people are the majority of the population, yet they are the least likely to be served by banks. Microfinance is often seen as a marginal sector – a 'development' activity that donors, governments, or social investors might care about, but not as part of the country's mainstream financial system. However, microfinance will reach the maximum number of poor clients only when it is integrated into the financial sector.
4. **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people.** Most poor people cannot get good financial services that meet their needs because there are not enough strong institutions that provide such services. Strong institutions need to charge enough to cover their costs. Cost recovery is not an end in itself. Rather, it is the only way to reach scale and impact beyond the limited levels that donors can fund. A financially sustainable institution can continue and expand its services over the long term. Achieving sustainability means lowering transaction costs, offering services that are more useful to the clients, and finding new ways to reach more of the unbanked poor.
5. **Microfinance is about building permanent local financial institutions.** Finance for the poor requires sound domestic financial institutions that provide services on a permanent basis. These institutions need to attract domestic savings, recycle those savings into loans, and provide other services. As local institutions and capital markets mature, there will be less dependence on funding from donors and governments, including government development banks.
6. **Microcredit is not always the answer. Microcredit is not the best tool for everyone or every situation.** Destitute and hungry people with no income or means of repayment need other kinds of support before they can make good use of loans. In many cases, other tools will alleviate poverty better – for instance, small grants, employment and training programmes, or

infrastructure improvements. Where possible, such services should be coupled with building savings.

7. **Interest rate ceilings hurt poor people by making it harder for them to get credit.** It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs. Their growth will be limited by the scarce and uncertain supply soft money from donors or governments. When governments regulate interest rates, they usually set them at levels so low that microcredit cannot cover its costs, so such regulation should be avoided. At the same time, a microlender should not use high interest rates to make borrowers cover the cost of its own inefficiency.
8. **The role of government is to enable financial services, not to provide them directly.** National governments should set policies that stimulate financial services for poor people at the same time as protecting deposits. Governments need to maintain macroeconomic stability, avoid interest rate caps, and refrain from distorting markets with subsidised, high-default loan programmes that cannot be sustained. They should also clamp down on corruption and improve the environment for micro-businesses, including access to markets and infrastructure. In special cases where other funds are unavailable, government funding may be warranted for sound and independent microfinance institutions.
9. **Donor funds should complement private capital, not compete with it.** Donors provide grants, loans, and equity for microfinance. Such support should be temporary. It should be used to build the capacity of microfinance providers; to develop supporting infrastructure like rating agencies, credit bureaus, and audit capacity; and to support experimentation. In some cases, serving sparse or difficult-to-reach populations can require longer-term donor support. Donors should try to integrate microfinance with the rest of the financial system. They should use experts with a track record of success when designing and implementing projects. They should set clear performance targets that must be met before funding is continued. Every project should have a realistic plan for reaching a point where the donor's support is no longer needed.
10. **The key bottleneck is the shortage of strong institutions and managers.** microfinance is a specialised field that combines banking with social goals. Skills and systems need to be built at all levels: managers and information systems of microfinance institutions, central banks that regulate microfinance, other government agencies, and donors. Public and private investments in microfinance should focus on building this capacity, not just moving money.
11. **Microfinance works best when it measures—and discloses—its performance.** Accurate, standardised performance information is imperative, both financial information (e.g. interest rates, loan repayment, and cost recovery) and social information (e.g. number of clients reached and their poverty level). Donors, investors, banking supervisors, and customers need this information to judge their cost, risk, and return.

ANNEX C: STATEMENT OF THE ADVISORS GROUP TO THE UN INTERNATIONAL YEAR OF MICROCREDIT, 2005



Statement of the Advisors Group to the United Nations International Year of Microcredit 2005

**United Nations Forum to Build Inclusive Financial Sectors
United Nations Headquarters, New York
8 November 2005**

Endorsed by:

- Stanley Fischer, Chairman of the Advisors Group, Formerly IMF
- Fouad Abelmoumni, Executive Director, Association Al Amana
- Rene Azokli, CEO, PADME
- Ajay Banga, Chairman & Chief Executive Officer, Citigroup Global Consumer Group and Global Consumer Group International
- Charles Konan Banny, Governor, Central Bank of West African States
- Matthew Bishop, Business Editor, *The Economist*
- Gregory Casagrande, President, South Pacific Business Development Foundation
- In Channy, General Manager, ACLEDA Bank
- Marilou van Golstein Brouwers, Senior Fund Manager, Triodos Bank
- Fazle Hasan Abed, Chairperson, BRAC
- Enrique Iglesias, President, Inter-American Development Bank
- Diederik Laman Trip, Chairman, ING Netherlands
- Marge Wagner, Independent Advisor

- Princess Maxima, The Hague, Netherlands
- Diana Medman, Director, AO Bioprocess
- Leonor Melo de Velasco, President, Fundacion Mundo Mujer-Popayan
- Raghuram G. Rajan, Economic Counsellor and Director, Research Department, International Monetary Fund
- Christopher Rodrigues, President and Chief Executive Officer, Visa International
- Hernando de Soto, Director, Institute for Liberty and Democracy
- Washington Sycip, Founder, The SGV Group

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1. The United Nations International Year of Microcredit has exceeded even our expectations as the Advisors Group to the Year. The UN Year has raised the profile of microcredit and of microfinance in general. It has generated a great deal of enthusiasm, among microfinance users and providers, suppliers of capital, commercial businesses and the public of many nations, developed and developing: a record number of national committees – most of which are impressively diverse and actively engaged – have been formed to promote the goals of the UN Year. The critical role that access for poor people to financial services plays in reducing poverty is now much better understood by policymakers. Promoting greater access has become a key part of the international development agenda, including achieving the Millennium Development Goals.
 2. As an Advisors Group, we are confident that, although microfinance remains very far from its potential, significant progress can be made in overcoming the remaining obstacles to the spread of financial services that can meet the needs of poor people. We have seen encouraging evidence that microfinance works. We applaud the efforts of thousands of people who have brought it this far. In this note, we make a number of key observations arising from the UN Year, and set out our recommendations for further action. This note contains the collective view of the 20 members of the Advisors Group alone, the result of our meetings and other conversations during the UN Year. It is intended to complement other important work produced as part of the UN Year, such as the 'Blue Book' on 'Building Inclusive Financial Sectors for Development'.
 3. The focus of the UN Year quickly expanded from microcredit to the whole of microfinance, including services such as savings, insurance and money transfer, as well as lending. With good reason, the main message of the UN Year became: there is a vital, pressing need to build inclusive financial sectors in which the billions of poor people around the world have access to affordable financial services.
 4. At its launch last November, we said that the overarching goal of the UN Year was to 'secure a global commitment to develop inclusive financial sectors in which all people have access to the financial services they need to make the best possible use of their human potential'. Specifically, we agreed that the

UN Year would be a success if it achieved three goals. First, if it increased awareness of microfinance and the conditions in which it can flourish. Second, if it contributed to filling the information gaps about who has access to what financial services, at what cost, what impact this access has, and why access is currently limited. Third, if it secured the commitment of governments to ensure that their fiscal, macroeconomic, regulatory and supervisory policies support rather than stunt the availability of microfinance, and of multilaterals, donors, NGOs and private-sector institutions to treat microfinance as a serious part of the financial sector and as a business concern, not an act of charity.

5. Given these demanding goals, our aim as an Advisors Group has not been to cheerlead but to focus attention on the many difficult questions that arise regarding financial access for poor people. From the start, we have been particularly concerned about the lack of reliable data (except in a few cases) about what financial services are available to poor people, and what services are actually used by them. This lack of data has made it hard to move beyond a general observation that, in sharp contrast to rich countries, a large majority of the populations of poor countries is essentially ignored by the mainstream financial sector. In our view, the lack of good data has made it hard for governments and others to make well-designed policy, hard for potential providers of financial services to poor people to accurately judge the need / opportunity, hard for multilaterals and donors to judge if their actions are helping or hindering the financial sectors in which they intervene, hard for investors to assess the market opportunities, and hard even to reach empirically sound conclusions about the relationship between financial access, poverty and economic growth.
6. The generation of good data has therefore been one of our priorities during the UN Year. Specifically, the Advisors Group has brought together central bankers, leading economists and statisticians, including from the UN, World Bank, IMF, Britain's Department for International Development (DFID), the Central Bank of West Africa (BCEAO) and the private and non-government sectors, to develop common measures of financial sector inclusion and to answer the central question of how many poor people have access to what kinds of financial services and what is the quality and impact of those services.
7. In September, the International Monetary and Financial Committee of the Board of Governors of the IMF observed in the official communiqué at its annual meeting that '2005 is the International Year of Microcredit. The Committee notes the IMF's role in improving data availability on microcredit and in addressing microcredit issues in the Financial Sector Assessment Program'. Following on this, we urge the IMF and the World Bank to include more of an analysis of the financial services targeted at poor people in the various statistics it collects. We expect that financial access will increasingly be recognised as a key indicator of the efficiency of a country's financial sector.

8. Although much work remains to be done, we are delighted that the process of gathering good data about the access of poor people to financial services has begun. Already it has yielded two notable achievements. The first is a window into the current state of microfinance. The second is that it has provided a foundation on which multi-year comparisons between nations can be built. We strongly recommend that this work continue, so that inadequate data will soon cease to be a factor slowing the spread of microfinance.
9. We are particularly hopeful that countries will soon employ common measures of financial inclusion developed during the UN Year by the World Bank and DFID as an indicator of progress in reducing poverty. We recommend that national governments (and their regulators and supervisory institutions) adopt common indicators and methodologies and work with the IMF, the World Bank and others in using these data to assess the breadth, depth and inclusiveness of their financial sectors. We also recommend that multilaterals and other donors support governments in this effort and help them to strengthen their statistical collection systems and that the UNDP Human Development Reports, amongst other publications, include this data.
10. We note recent empirical analysis by the World Bank, which for the first time shows that increased access to finance helps to reduce poverty (rather than, as is sometimes argued, that greater financial access is merely a consequence of reductions in poverty). The results support the view that building an inclusive financial sector should be considered a driving force of economic development and poverty reduction, and we hope that the increased availability of data about microfinance will encourage further research into its potential role.
11. The World Bank analysis is noteworthy in two other respects. First, it confirms that access to financial services remains extremely limited in most poor countries. Although throughout the UN Year we have been encouraged by numerous examples of how microfinance can transform the lives of poor people, it is clear that the biggest challenge for the next few years is to provide microfinance on a significantly greater scale than anything we see in poor countries today. A particular challenge is in rural areas that can be especially costly to reach.
12. Second, the World Bank analysis also finds that government ownership of the financial sector is inversely correlated with access. This underlines a crucial lesson for policymakers as they consider how to 'scale up' microfinance: the private sector will play a critical role in enabling poor people to receive financial services.
13. This does not mean that governments should ignore microfinance. On the contrary, we believe that governments have a crucial enabling role to play in increasing access to financial services.
14. In general, financial services are more likely to be available to poor people in countries which are essentially well-governed: with sensible macroeconomic policies aimed at keeping inflation and interest rates low, a competitive

economy with strong antitrust laws, limited red tape, clear enforceable property rights (for poor people as well as rich, for men as well as women) and effective law enforcement, including against corruption.

15. In addition, there are several crucial areas of government policy that specifically relate to microfinance. One common temptation is for governments to impose ceilings (caps) on the rate of interest that can be charged on micro-loans. Such ceilings have a simplistic political appeal, by appearing to ensure cheap credit for poor people, but in practice interest-rate ceilings tend to reduce the supply of credit, especially to the poorest would-be borrowers, who are driven instead to borrow from illegal money-lenders whose rates are not capped, and whose collection methods are notorious. Interest-rate ceilings can also reduce the transparency of the cost of credit to borrowers, as lenders seek to evade the caps by adding various service charges and application fees. We strongly recommend that governments do not impose interest-rate ceilings on micro-lenders. The evidence shows that a far more effective way for governments to ensure that interest rates are not excessive is to foster healthy competition within the financial sector.
16. Government regulations on the collection of deposits often prevent, or impose a significant cost on, micro-lenders providing other financial services, in particular savings accounts. These regulations are often intended to protect savers from bank failure, which is clearly a desirable goal. However, they raise the cost of capital to micro-lenders, which are prevented from operating as normal banks that lend money that has been deposited with them. Moreover, these regulations can mean that poor people are denied access to savings accounts, and thus have to save by methods that involve far greater risks than that of bank failure. We recommend that financial sector authorities should devise prudent and appropriate means to make it possible for microfinance providers to qualify to accept deposits.
17. Finding the appropriate balance between consumer protection and a light regulatory burden is not easy, but getting it right should be a priority for governments everywhere, and particularly in poor countries. We believe that too often well-run microfinance institutions are being overly constrained by regulations (particularly with regard to restrictions on what services they can provide) as they look to increase the scale and scope of their operations. We recommend that governments, assisted by the relevant multilaterals, urgently review their regulations to ensure that they encourage prudent and sound provision of financial services to poor people. We also recommend that priority is given to training competent bank regulators, accountants and auditors, lawyers and credit-raters, who are often in short supply in poor countries. This may be a fruitful area for international assistance, from multilaterals and national governments, and from private donors. We commend the Bank for International Settlements, the Federal Reserve Bank of New York, the Banking Superintendent of New York, Citigroup and the Central Bank of West Africa (BCEAO), leading trainers of central bankers and other regulators and supervisors in developing countries, for including issues pertaining to microfinance in their training programmes. We recommend that others follow their example.

18. Regarding consumer protection, there are at least three areas in which government can play a helpful, enabling role. First, we recommend that lenders be required to inform borrowers clearly of the full cost of their borrowing, including interest rates and any other fees. Such a requirement ought not to impose significant costs on either lenders or regulators.
19. Secondly, we are concerned that, in some countries, laws to protect privacy are preventing the emergence of credit bureaus. Such credit bureaus can greatly reduce the cost of lending – and thus increase the overall supply of loans – by giving lenders better information about the creditworthiness of borrowers. Some rich countries have managed to combine strong, effective privacy protection with sufficient freedom to share financial information to enable viable credit bureaus, and we recommend that poor countries follow their example and take measures to facilitate and encourage the establishment of credit bureaus. Furthermore, we encourage efforts to help microfinance providers improve their information systems, not least so that these bureaus can receive relevant information.
20. Third, deposit protection is often woefully inadequate in poor countries. Although deposit protection schemes, such as insurance, can have some downsides, including a heavy regulatory burden and the creation of a moral hazard that can make savers careless of who they entrust with their money, combined with effective but light regulation such schemes can greatly increase consumer confidence in the financial system. A lack of such confidence is often – and not unreasonably – a serious constraint on the growth of financial systems. We recommend that governments explore whether they can sensibly and cost-effectively introduce deposit insurance or other protection scheme for savings accounts provided to poor people.
21. A difficult issue for suppliers of capital for microfinance is how or if they should subsidise the provision of financial services to poor people. Here there is no simple answer. We observe that even at current levels of subsidy, many microfinance institutions find themselves constrained by a lack of funds. Increasingly, they are looking to find other sources of capital, not least by focusing more on generating profits from their activities, which in turn makes them attractive to private-sector investors. We welcome this increasingly commercial approach to serving poor people, not least because we believe that only the private sector will have the ability to provide the organisation, expertise and capital that can drive a rapid increase in access to financial services.
22. Whether it would even be desirable for more subsidised capital to be made available is debatable. In practice, government or other donor subsidy of microfinance has often gone hand-in-hand with a lack of transparency, significant corruption and general inefficiency, which in turn has distorted the provision of financial services in ways that have hindered their long-run development. Whilst there may be poor people to whom it will never be commercially viable to provide financial services – in which specific circumstances, a case can arguably be made for subsidy (but perhaps a better case for social safety nets) – we believe that the best hope for a rapid

increase in access to financial services lies in the provision of these services to poor people becoming more commercially-driven. We therefore recommend that governments and others are restrained in their provision of subsidised capital to microfinance, and aim to deploy it in ways that encourage, not discourage, commercially-driven capital into the sector. For instance, governments and other donors might more usefully invest in the development of the regulatory infrastructure within which microfinance can thrive, in seeding new microfinance institutions and new technologies that speed the increase in financial access, and in providing relevant education and training to users and providers of microfinance.

23. We also welcome the increasing enthusiasm of many providers of microfinance – old and new – for delivering financial services to poor people on a commercially sustainable basis. Though many established microfinance institutions are rightly proud of their charitable roots, a growing number of them are willing to talk about possible partnerships with established commercial financial institutions, about scrutinising loan portfolios, retailing insurance policies underwritten by commercial insurers, and even of making profits and perhaps becoming listed public companies. Some of the best institutions are now reducing their dependence on donor financing, exposing their operations to critical ratings agencies, and hunting out private capital. We also welcome the growing interest of commercial financial institutions in serving poor people, who until recently they often avoided as customers. Encouraging examples of commercial institutions entering microfinance include large banks in Latin America, Asia and Eastern Europe, and some of the major international banks based in rich areas of the world including America, Western Europe, and Australia.
24. Nevertheless, rhetoric is certainly running ahead of action. Although a growing number of institutions and governments talk about treating people who are poor as clients and not beneficiaries, they often continue to ghettoise microfinance within the philanthropic arms of their organisations, where resources and accountability are typically limited, or otherwise evaluate them in non-commercial ways. A culture change is still required in many of the established institutions that provide financial services to poor people. In particular, we recommend that providers of microfinance become more transparent, especially about their loan problems and about the degree to which they depend on subsidised capital, and we recommend that they subject their performance data and accounts to independent audit. Likewise, whilst we wholeheartedly welcome the growing interest in microfinance of established mainstream national and international financial institutions and even some industrial firms, we urge them to back up their rhetoric with more substantial action.
25. We note with some concern the fact that much of the commercial capital available to microfinance providers is foreign, and therefore carries significant exchange-rate risk. This risk has been sufficiently large to bankrupt some microfinance providers in the past. We recommend that foreign suppliers of capital to microfinance institutions develop ways of providing such funding in

local currency. We further recommend that governments examine whether their own policies are constraining the supply of local capital to microfinance.

26. We are also concerned about those multilaterals and other donors who, through their actions, appear wedded to microfinance remaining an activity subsidised directly through cash contributions or indirectly through technical assistance and subsidised financing. We recommend that multilateral institutions and other donors give serious thought to how they can use their resources more effectively to develop commercially sustainable microfinance.
27. We have been greatly encouraged by the growing interest in microfinance of a new generation of philanthropists, many of whom made their fortunes as entrepreneurs during the recent wave of technological innovation. We recommend that they bring that entrepreneurial mindset to microfinance, not least so that they avoid replicating existing subsidy-based microfinance.
28. We are also greatly encouraged by various attempts now underway to use technology such as mobile telephony to dramatically lower the cost of providing financial services to poor people. This may offer large economies of scale and reduce the need to deploy traditional high-cost bank branch networks. We recommend that donors do what they can to spur this technological innovation in the early stages where it may not be able to generate an economic return. We also recommend that regulators have an open mind to such technological innovation, which may challenge traditional approaches to providing, and regulating, financial services.
29. Throughout the UN Year, we have been greatly encouraged by the active role played by clients, and aspiring clients, of microfinance institutions. It is their demand, more than anything, that is driving the growth of microfinance, and their insights have been invaluable. We recommend that providers of microfinance continue to actively consult and otherwise involve microfinance clients to ensure that the financial services they offer truly meet their needs.
30. With the International Year of Microcredit, the UN has exemplified its role as a neutral broker, bringing together disparate parties to address an issue of critical importance. We commend the UN for the seriousness with which it has undertaken this task. In the light of this, we note that much of our work as an Advisors Group has been to initiate activities that will not be completed until after the end of the UN Year. Although our role concludes with the UN Year, and we do not wish to extend our mandate, we recommend that the UN should appoint a group of experts, for a limited period not exceeding two years, to see the work we have begun through to completion.
31. All that remains is to congratulate the UN for dedicating this year to such an important subject, and to thank all the many people involved in making the UN International Year of Microcredit such a success.

ANNEX D: COMPARATIVE DATA

D.1 Introduction

In order to put the Pakistan PSIA in context, a comparison has been made in this Annex between Pakistan and other countries, particularly in South and South-East Asia, and particularly Muslim countries.

The conclusion of this review is that Pakistan still has some way to go compared with most of its neighbours in terms of the depth of the financial sector as a whole and the reach of the banking sector, especially in relation to access by low-income households and microenterprises. On the MF side, however, Pakistan, while a late starter, is less far behind the other countries in South and South-East Asia than might be apparent at first glance. The comparisons in this Annex support the argument in Chapter 4 of the main report that the MF sector in Pakistan has the characteristics of a late starter rather than a laggard, and may be well placed for rapid expansion, given a favourable enabling environment.

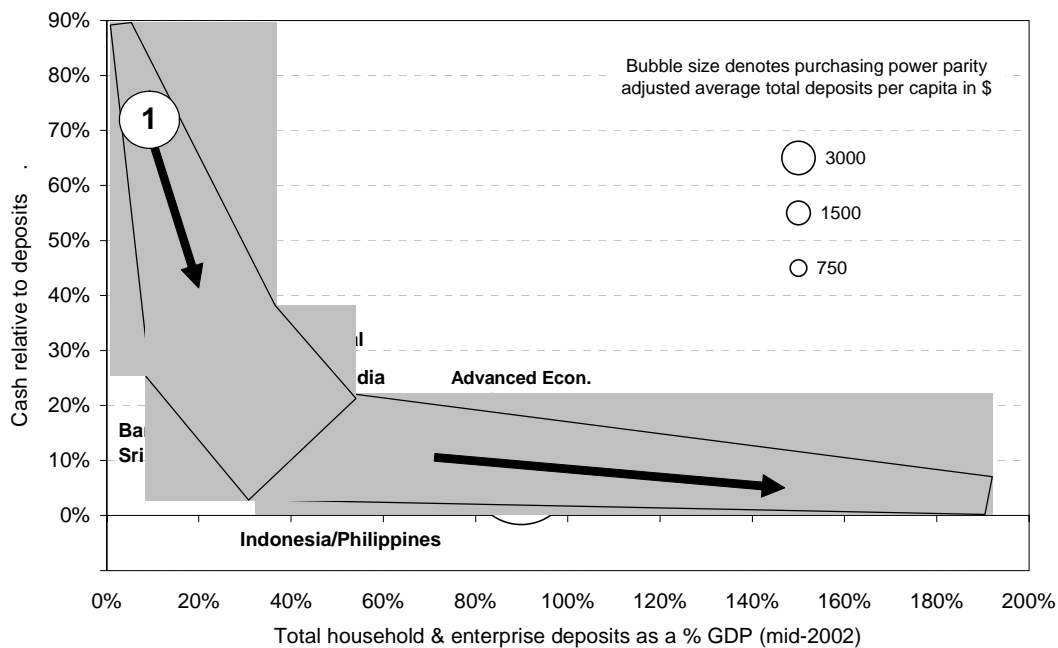
D.2 The financial sector

MF is of course a part of the financial sector as a whole, and its breadth and depth needs to be judged in the context of that sector. In this section, therefore consideration is given to how Pakistan compares with other countries in terms of financial sector depth, access to finance and the banking sector.

D.2.1 Financial sector depth

The ratio of bank deposits to GDP ('monetisation') is widely accepted as a key indicator of financial sector depth in an economy. There is also correlation between financial sector depth so defined and access to financial services, as clearly illustrated by Peachey and Roe (2006). Figure D.1 shows the relationship between the two in a range of countries, the most relevant of which are identified.

Figure D.1 Monetisation indicators



Source: Stephen Peachey, based on data used in Peachey and Roe (2006).

Peachey and Roe argue that as the financial sector in a country develops, it tends to move from the top left to the bottom right of the Figure through three Zones:

- Zone 1 contains countries where high reliance on cash and low deposit to GDP ratios indicate repressed access, such that less than one in five adults has a bank account;
- Zone 2 contains countries where reducing reliance on cash and growing deposit to GDP ratios indicate access at an intermediate level, such that between one in four and one in three adults has a bank account;
- Zone 3 contains countries where low reliance on cash and deposit to GDP ratios rising towards 100% indicate moving towards full access, such that at least every second adult and ultimately almost every adult has a bank account.

As the Figure shows, in mid-2002 Pakistan lay just inside Zone 2, level with Bangladesh and Sri Lanka in terms of deposits to GDP, and with Nepal in terms of cash to deposits, but generally behind its neighbours in terms of the combined measurement. For obvious reasons, this placed Pakistan in a less favourable position than many of its neighbours when it came to developing access to finance. Although Pakistan does indeed lag in terms of access to finance, however (section D.2.2, below), the banking sector appears to be making significant advances (see section D.2.3).

D.2.2 Access to finance

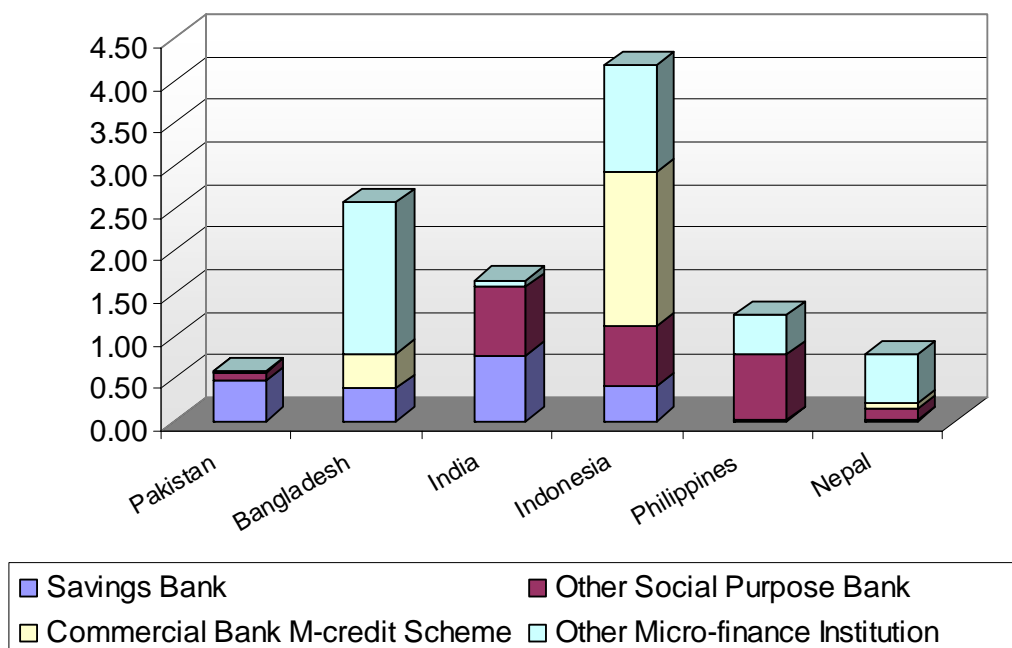
It is indeed the case that access to finance in Pakistan is relatively repressed compared with many countries in South and South-East Asia, as Table D.1 and Figure D.2 show.

Table D.1 Accessible accounts as percentage of adults

	Savings bank	Other social purpose bank	Commercial bank microcredit scheme	Other MFI	Total accessible accounts per adult
Pakistan	0.48	0.09	0.00	0.02	0.59
Bangladesh	0.39	0.00	0.40	1.78	2.57
India	0.77	0.80	0.00	0.08	1.66
Sri Lanka	9.37	6.04	0.10	1.54	17.06
Indonesia	0.41	0.70	1.81	1.26	4.18
Philippines	0.01	0.77	0.01	0.46	1.24
Nepal	0.01	0.13	0.07	0.57	0.78

Source: Peachey and Roe (2006), based on data in CGAP (2004b).

Note: Accounts through the National Savings Centres (NSCs) at Pakistan's Central Directorate National Savings have been excluded from the table because the NSCs target those who are relatively well-off, and have very high average balances relative to *per capita* GDP - about 800%. The National Savings Branch of the Indian Ministry of Finance is a similar kind of institution and has also been excluded, though it probably does more than NSS to reach the mass market. The 0.48% of adults having access through Savings Banks in Pakistan therefore consists mainly of those who save through Post Office savings accounts.

Figure D.2 Accessible accounts as percentage of adults

Source: Peachey and Roe (2006), based on figures in CGAP (2004a).

Note: Sri Lanka has been omitted from Figure D.2 as it would distort the scale, having an access ratio of 17.06%

Although access to finance in Pakistan is relatively limited, however, the evidence presented in this Annex and in the main report indicates that policies put in place at the turn of the century are beginning to bear fruit, and that conditions are favourable for a significant improvement in the coming years in the performance of the financial sector in general and in access to finance in particular, given appropriate policies for the sector.

D.2.3 The banking sector

The monetisation indicators cited in section D.2.1, above, are from mid-2002. As described in Section 4.3 of the main report, however, a major banking reform programme was launched in Pakistan in 1999, and by mid-2002 the programme had only just begun to gain momentum. Beck, Demirgüç-Kunt and Martinez Peria (2005) examined the results of a survey of bank regulators and central banks conducted by the World Bank in 2005. Table D.2, based on the data from that study, shows the penetration and use of banking services in Pakistan (December 2004), Bangladesh, India, Sri Lanka, Malaysia and Iran.

Table D.2 Penetration and use of banking services in selected countries

	Pakistan	Bangladesh	India	Sri Lanka	MALAYSIA	Iran
GDP <i>per capita</i> (US\$ PPP)	464	376	563	965	4,164	2,061
Demographic branch penetration						
Score	4.73	4.47	6.30	6.87	9.80	8.3
Rank (of 98 countries)	65	67	59	57	41	50
Demographic ATM penetration						
Score	0.53	0.06	n/a	3.67	16.44	1.25
Rank (of 89 countries)	85	89	n/a	71	47	79
Loan accounts <i>per capita</i>						
Score	21.93	54.73	n/a	n/a	328/97	48.19
Rank (of 44 countries)	40	31	n/a	n/a	10	36
Loan-income ratio						
Score	14.26	5.22	n/a	n/a	2.95	2.91
Rank (of 44 countries)	5	16	n/a	n/a	26	37
Deposit accounts <i>per capita</i>						
Score	191.84	228.75	n/a	n/a	1,250	2,249
Rank (of 54 countries)	45	43	n/a	n/a	17	6
Deposit-income ratio						
Score	2.63	1.6	n/a	n/a	0.92	0.04
Rank (of 54 countries)	10	16	n/a	n/a	23	54
Currency of data	Dec 04	Dec 03	Jun 04	Dec 03	Dec 03	Dec 04

Demographic branch penetration Number of branches per 100,000 people.

Demographic ATM penetration Number of Automated Teller Machines per 100,000 people.

Loan accounts per capita Number of loans per 1,000 people.

Loan income ratio Average size of loans per GDP *per capita*.

Deposit accounts per capita Number of deposits per 1,000 people.

Deposit income ratio Average size of deposits per GDP *per capita*.

Source: Beck, Demirgüç-Kunt and Martinez Peria (2005).

Pakistan is clearly making significant progress in banking reform, but there is still some way to go in deepening and widening the reach of the sector. Summarising some of the features of Table D.2:

- Pakistan ranks ahead of Bangladesh but well behind the other countries in demographic branch and ATM penetration;
- Pakistan ranks very low in terms of loan accounts *per capita* and deposit accounts *per capita*, but very high in terms of loan–income ratio and deposit–income ratio;
- that means that, compared with the other countries, Pakistan is making a relatively small number of relatively large loans, and accepting a relatively small number of relatively large deposits.

So Pakistan still needs to make further progress with its banking reform if it is to catch up with its neighbours in terms of services to smaller customers, but it is making progress in this direction. Meanwhile, the burden of providing access to finance for low-income households and microenterprises lies with the MF sector.