Pakistan

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Summary

Despite having a population of 132 million, Pakistan has only a very small microfinance sector. And while the State Bank of Pakistan (SBP) has administered a range of directed credit requirements and interest rate controls for broader "developmental" objectives, it has not undertaken either developmental or promotional activities specifically in support of microfinance. For SBP to regulate microfinance institutions would be premature at present, given the small size of the sector and the host of prior financial sector issues confronting the central bank.

However, there are some opportunities for it to contribute to the development of microfinance through well-targeted promotional activities and by encouraging bankers to set interest rates to cover transaction costs and take account of risk. It would also be appropriate for SBP to review a number of restrictive banking regulations which discourage licensed banks from engaging in microfinance.

Pakistan

Currency Equivalent

Currency Unit – Pakistan rupee/s (Pre/PR)
US$1 = PR50.1 (at mid-1999)

Abbreviations

ADB	Asian Development Bank
ADBP	Agricultural Development Bank of Pakistan
AKRSP	Aga Khan Rural Support Programme
BOK	Bank of Khyber
BOP	Bank of Punjab
BRSP	Balochistan Rural Support Programme
CBO	community-based organization
D&B	Dun & Bradstreet
FANA	Frontier and Northern Areas
FBC	Federal Bank for Cooperatives
FWB	First Women Bank
GDP	gross domestic product
GNP	gross national product
MFI	microfinance institution
NBP	National Bank of Pakistan
NGO	nongovernment organization
NRSP	National Rural Support Programme
NWFP	North West Frontier Province
OPP	Orangi Pilot Project
PPAF	Pakistan Poverty Alleviation Fund
PRSC	Punjab Rural Support Corporation
ROSCA	rotating savings and credit association
RSP	rural support program
SBFC	Small Business Finance Corporation
SBP	State Bank of Pakistan
SES	Self-employment Scheme
SRSC	Sarhad Rural Support Corporation
UNDP	United Nations Development Programme

Note

In this report, “$” refers to US dollars.

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1 Introduction and Background

1.1 Key Demographic and Economic Data

Pakistan has a population of 130.6 million people (ADB 1999b).[1] Its average annual population growth rate of 2.6 percent[2] during the period 1980–1997 has been the highest of all of the Asia-Pacific countries included in this study (World Bank 1999b). Pakistan's gross national product (GNP) per capita of $500 is higher than that of its South Asian neighbors, India and Nepal. From 1987 to 1997, gross domestic product (GDP) growth averaged 4.7 percent but has remained relatively stagnant since 1994. GNP per capita growth averaged 1.2 percent but per capita income actually fell in dollar terms from 1995 to 1998.

Women in Pakistan are extremely disadvantaged, suffering marked gender disparities in access to health care, education, and income

The United Nations Development Programme's (UNDP) Human Development Index score of 0.508 for Pakistan results in an international ranking of 138th out of 174 countries included (UNDP 1999a). This ranking puts Pakistan close to the cut-off point for the "low human development" classification. The score reflects an adult literacy rate of just 40.9 percent, but this summary measure masks the particularly high gender disparity in Pakistan. The adult literacy rate for women is only 25.9 percent and the women's labor force participation rate only 7.6 percent, as compared to a male literacy rate of 55.2 percent and labor participation rate of 27.5 percent.

UNDP's Human Poverty Index for developing countries for Pakistan is calculated at 42.1 percent, suggesting that 42.1 percent of the population is affected by poverty. When this is disaggregated by gender, it shows that women's poverty is increasing. Pakistan is unique in the world in that, when compared to 1975 statistics, women are poorer, less healthy, and less educated relative to men. UNDP's ranking places Pakistan 72nd out of the 92 developing countries included in the index. Pakistan's Gini index[3] for income distribution of 31.2 is, by international standards, comparatively low (that is to say, more even) if compared with, say, China at 41.5 and Indonesia at 36.5. The income share of the highest 20 percent of the population is approximately 4.4 times that of the lowest 20 percent of the population.

2 Development of Microfinance

Poverty affects more than 40 percent of the population, or some 52 million people

As noted, approximately 42 percent of the 130.6 million population in Pakistan are affected by poverty. As in many Asian countries, there are not yet any compelling examples of microfinance institutions (MFIs), be they nongovernment organization (NGO) or bank, that have developed a product and methodology that has proven to

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1 This number is based on results of the fifth population census in July 1998.

2 The 1998 Asian Development Bank (ADB) Country Economic Review (ADB 1998b) stated the annual population growth to be 3.1 percent during the 1990s.

3 The Gini index appears in the literature, for example, World Bank (1999) and UNDP (1999), with a value between 0 and 100. This indicator is essentially the same as the Gini coefficient, with a value between 0 and 1.

be fully financially sustainable and capable of reaching significant numbers of microentrepreneurs. However, there is nonetheless an interesting range of models and products, and the industry is young and still experimenting; the future of the sector in Pakistan will be keenly observed.

2.1 NGOs in Microfinance

According to the Microfinance Pakistan Report (SEBCON 1999), NGOs[4] working in microfinance can be grouped into three tiers.[5]

MFIs can be grouped in three tiers

The top tier includes the large regional rural support programs (RSPs). The original NGO is the Aga Khan Rural Support Programme (AKRSP) that is located in the Frontier and Northern Areas (FANA). AKRSP is an independent NGO and partly due to its success the Government created rural support programs that followed this model. The largest of these government-sponsored "NGOs"[6] is the National Rural Support Programme (NRSP) that operates in all provinces. NRSP and the Punjab Rural Support Corporation (PRSC) have been endowed with PR500 million by the Government of Pakistan, which generates income to cover the cost of its operations. The Sarhad Rural Support Corporation (SRSC) focuses on the North West Frontier Province (NWFP) and the Balochistan Rural Support Programme (BRSP) is unlikely to expand beyond its regional mandate. All these RSPs operate by establishing village- or community-based organizations (CBOs) of 20 to 40 people that are the distribution channels for a wide range of economic and social development programs.[7]

For lending, RSPs follow a variant of a group lending methodology. Within the CBO, smaller groups develop for lending. Each group is required to save for some time before applying for a loan but not necessarily to continue saving thereafter. The "NGOs" are not licensed to take deposits so the individual's or CBO's savings are kept in a local bank in their names, not in the name of the NGO. However, saving has proved to be a popular service for clients, particularly when positive real rates of interest are paid.

The next tier consists of those working in several districts of one province. They include the Orangi Pilot Project (OPP) working in the slums of Karachi and Kashf Foundation based in Lahore. OPP is the only major NGO in Pakistan which does not require savings by its group borrowers. OPP's borrowers use their discretionary income to build up capital in the projects (UNDP 1999b). Kashf started as a replicator of the Grameen methodology in Pakistan, but is now adapting that methodology to meet the needs of its clients better. Kashf, together with AKRSP, is known for its commitment to building a financially viable MFI.

Then there are thousands of village-level development NGOs with little knowledge of microfinance other than that their beneficiaries need access to credit.

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4 Most NGOs involved in microfinance are registered under either the Societies Registration Act, 1860 or the Voluntary Social Welfare Agencies (Registration and Control) Ordinance, 1961. For more information on the regulation of NGOs, see Section 5.

5 For a more detailed description of the activities of each of the individual institutions, see the ADB Pakistan Rural Microfinance Project Interim Report (1999b) as well as Thapa (1999) and McGuire et al. (1998). A summary of the informal sector lending that outlines the moneylenders, commission lenders, and village rotating savings and credit associations (ROSCAs) is found in SEBCON (1999) and ADB (1999b).

6 "As these NGOs have been sponsored by the Government and the latter appears to have some influence on board appointments, it is somewhat of a contradiction in terms to call them NGOs" (UNDP 1999b, 24–25).

7 Like any cross-section of MFIs, some of these RSPs are not without management and financial problems.

Three Tiers of MFIs

NGOs active in microfinance can be classified in three tiers:

- large regional or national-level programs — the various "rural support programs" such as the Aga Khan Rural Support Programme and the Sarhad Rural Support Corporation
- those working in several districts of one province — for example, Orangi Pilot Program, Kashf Foundation
- village-level development NGOs — of which there are thousands.

Most of these NGOs undertake real development work while a few are "scoundrels" who use microfinance for their own ends and have generated a bad reputation for NGOs with government officials. However, there are probably currently only 50 NGOs that have potential for reaching scale (ADB 1999b).

Loan sizes for these NGOs are all below PR50,000 and typically below PR25,000 for loans of six to 20 months. NRSP's average loan size is PR15,000 and Kashf's is PR4,500. The estimated number of clients outstanding for all these NGOs together was 800,000 as at June 1998 (Thapa 1999). No more recent official estimate was available.[8]

2.2 Banks in Microfinance

There are at least seven banks that are currently providing financial services to microentrepreneurs in some form. They are Habib Bank, First Women Bank, First Investment Bank, Agricultural Development Bank of Pakistan as well as the National Bank of Pakistan, Bank of Khyber, and Bank of Punjab. Under the State Bank of Pakistan's (SBP) prudential regulations, banks are able to make uncollateralized or "clean" loans below PR100,000, so the usual barrier of collateral requirements for microentrepreneurs' access to bank finance is not present.

Habib Bank, a government-owned commercial bank undergoing partial privatization, has opened a fully secured PR2.2 billion credit line for NRSP, and one for PR0.3 billion to PRSC, to onlend. It is charging them interest of 14 percent per annum.

First Women Bank is one of seven banks engaging in some microcredit, but the only one focused on women

First Women Bank (FWB) is currently a government-owned commercial bank with the status of a development financial institution (although its final ownership status is still under review by the Government). "Its major exposure is in financing of women business enterprises of small medium size both in urban and rural areas" (UNDP 1999b, 17). However, FWB is only profitable because of its investing activities; in its June 1998 annual report there was a net negative cashflow from operations of PR17.8 million. In 1992 the Department of Women's Development provided a grant of PR48 million to FWB to establish a lending program for women microentrepreneurs. FWB continues this program now, accessing a government concessional credit line and using three distribution channels to reach its clients, primarily in urban areas:

(i) Directly to women with a household income of less than PR2000 per month, streamlining complex borrowing procedures and conditionalities.

(ii) NGOs as financial intermediaries that onlend to women borrowers and, in some cases, the NGOs themselves use smaller CBOs as nonfinancial intermediaries. However, FWB has difficulty finding NGOs that have the "financial discipline" to be able to work as the partner of a commercial bank.

8 Unfortunately, the SEBCON (1999) report did not provide numbers of loans outstanding.

(iii) NGOs as nonfinancial intermediaries, which identify and train borrowers for the loans (Goodwin-Groen 1998).

FWB will be expanding these services through UNDP's Women in Urban Credit Project and also providing training in design, marketing, quality, etc. for women who have had no business experience, so that they can be good bank clients (UNDP 1998).

The Agricultural Development Bank of Pakistan (ADBP) is a government-owned development bank that is mandated to provide loans to the agriculture sector and especially to low income clients through its 349 branches and mobile credit officers. It is making a serious effort to focus on loans below PR50,000 but its clients are required to have collateral or a guarantor. Clients who can show title to their land can get access to loans on the same day. Because of this collateral requirement there is some debate about classification of ADBP loans as microfinance. Even with the collateral requirement, it has extreme loan recovery problems. In 1999 it had an improved recovery rate of only 65 percent, and its June 1998 annual report showed a net negative cashflow from operations of PR7.8 billion. These problems are symptomatic of the whole financial sector, as described in Section 4.2.

Most banks see microfinance as a social obligation rather than a business opportunity

The Bank of Khyber (BOK) and the Bank of Punjab (BOP) are provincial banks. BOK has already established a special window for making loans of PR25,000–100,000 with less documentation required, and it plans to increase services to female borrowers and savers. BOP has initiated a pilot project of rural microfinance in one Punjab district and, based on a positive experience with that pilot effort, wants to expand its program to additional areas (ADB 1999a).

The National Bank of Pakistan (NBP) is a national commercial bank. NBP wants to revamp its rural lending program to cover micro-enterprises in addition to agricultural lending. This would include milk production, tube wells, etc. Its competitive advantage is that it has 1,445 branches nationwide. As of June 1998, it was managing its operations to breakeven.

Unfortunately, most of these banks "still see [microfinance] primarily as a social obligation rather than as a business opportunity" (ADB 1999b, VI). It will take more exposure (especially internationally) for Pakistani bankers to understand the nature and opportunities of microfinance.

2.3 Leasing Companies in Microfinance

There are two leasing companies in Pakistan that reach the microfinance market; both are listed on the stock exchange. Orix is larger with a net cash flow from operations of PR134.5 million at June 1998 and a net profit of PR103.9 million. It also serves medium-size businesses. Network Leasing Corporation is smaller and focuses only on the micro and small market with net cash flow from operations of PR5.9 million at June 1998 and a net profit of PR8.1 million. Network Leasing Corporation is proud of its 10 percent dividend paid to shareholders as it maintains its small focus. These companies usually lease lathes, fax machines, sewing machines, and refrigerators to microentrepreneurs, with a value of around PR11,000–40,000 for three years. Specifically, as of June 1999, Network Leasing Corporation's average lease size was PR181,000 and 22 percent of the portfolio was leased to women.

Orix Leasing has researched its database extensively by sector, size of business, etc. and found that the larger the lease the more risky it is. Conversely, the low end is much less risky. This is because the microentrepreneurs are dependent on the asset for their livelihood. If the asset is repossessed, their means of earning an income for their families has gone too. Microentrepreneurs also generate a lot of repeat business, thereby reducing Orix's administrative and operational costs. Therefore, considering the risk and return on their portfolio of leases, Orix needs the smaller loans to reduce the overall risk through portfolio diversification.

Some leasing companies succeed in financing micro-enterprise investments profitably

PPAF was established as a wholesaling or "second tier" institution, but has been slow to get started

2.4 Wholesale Institutions for Microfinance

The Government of Pakistan, under a $100 million World Bank project, established the Pakistan Poverty Alleviation Fund (PPAF) in 1997. Its purpose is to enable the poor (assetless) to gain access to resources for productive self-employment. It will achieve this primarily by lending to microfinance NGOs and banks and enhancing their capacity and financial sustainability. (The concept for PPAF was inspired by the microfinance wholesale institution in Bangladesh.) As of late 1999 it had not disbursed any funds. PPAF will be lending to NGOs for onlending to individuals or groups that meet PPAF's eligibility criteria. Those NGOs to which PPAF will be lending will be required to lend at rates that cover all the costs of lending including administrative costs, cost of funds, and loan losses. PPAF will also require NGOs to report to them on both their clients' and their own financial performance. (SBP is not directly involved in PPAF.)

It should be noted that the Federal Bank for Cooperatives (FBC) was not studied in this research even though it is also a wholesaling institution. This is because the cooperatives' reputation for fictitious societies, bogus loans, and inadequate accounting procedures (ADB 1999b) means that any comments about their performance would lack credibility.

2.5 Financial Sustainability of Microfinance

Data on sustainability of leading MFIs are hard to obtain, reflecting lack of attention to accounting and reporting

ADB's Microfinance Development Strategy (2000, 16) states that "only viable financial institutions involved in microfinance can ensure permanency of services to an increasing number of the poor and contribute significantly to poverty reduction." The World Bank's PPAF project document (World Bank 1999a) has noted that sustainability of NGOs in Pakistan is a serious concern. However, there is a shortage of national data available about the sustainability of the microfinance industry in Pakistan. A report on microfinance in Pakistan (SEBCON 1999, 9) had no numbers to report on either sustainability or outreach, stating only that "NGOs in Pakistan ... have been completely reliant on external funding sources." Not surprisingly, the report also states that this "complete dependency … has had a debilitating effect on … the viability of NGOs in Pakistan." An example of this lack of concern about financial viability is that even one of the large government-supported NGOs in its annual report included data on its clients and some disbursements but did not include a balance sheet (or standard indicators of financial performance).

Pricing of loans is one of the biggest issues in improving the sustainability of microfinance in Pakistan. The majority of NGOs work in isolated rural communities and provide a range of services. Typically, they do not separate out the direct and allocated indirect costs of the credit program, nor assess the actual financial sustainability of their institutions. This means that they either do not or are not able to calculate the interest rate they need to cover their costs. This becomes more problematic when interest rates or mark-up are a political issue rather than a business issue. Many NGOs and banks feel political pressure not to charge more for micro-loans than the "market" rate of 16–18 percent per annum[9] (that is, the same as the corporate sector). But they do not typically have the ability to assess what they need to charge to be sustainable, how to structure it, or how to communicate the idea to national decision makers.

9 ADBP's lending rate is capped at 14 percent per annum.

2.6 Demand for Microfinance

According to the interim report of the Pakistan Rural Microfinance Project (ADB 1999b), the net new "demand" for microcredit (based on requests from institutions received by PPAF in its first round of solicitations) is PR481 billion ($9.6 billion), of which PR476 billion is requested by NRSP, leaving a PR5 billion demand from the remaining institutions. There is no way to tell whether these are realistic numbers or not. It is in no sense an estimate of market demand.

Again, according to UNDP's study on women's credit needs in Rawalpindi and Karachi (Hussain et al. 1997):

(i) 87 percent of women said they wanted credit;
(ii) 50 percent of them wanted PR25,000–50,000;
(iii) 53 percent wanted loan terms of 2–5 years;
(iv) 75 percent said they had a physical asset as collateral; and
(v) in most cases, the authors decided, the credit would not be used effectively without technical support and training.

This information is purely indicative; it suggests there was a "need" for credit but in the analysis this need was not in any way related to capacity to pay nor to any price, or range of prices, for the credit requested.

For this reason Von Pischke (1991) contends that "credit need" is a bankrupt approach. Even more important than "demand," according to him, is "debt capacity."[10] The debt capacity perspective emphasizes improvements in the operations of the financial markets. It requires financial intermediaries that are financially viable, precisely because they understand the repayment capacity of their clients and the risk involved. Any approach to meeting credit needs with subsidized funds from a financially unsustainable institution will not be addressing a client's actual debt capacity. Rather, the demand for credit in a market sense will be addressed by efficient MFIs which are themselves acting in accord with market principles.

Of course women "need" credit in Pakistan, but does adequate "debt capacity" exist?

On the demand for access to savings services, a 1996 rural financial markets study, quoted in ADB (1999b), found that a typical rural household saved over 23 percent of annual household income, and that every village had a committee system that collects savings and lends to members of the committees. This suggests that the ready availability of institutional savings services would be a facility valued by Pakistanis.[11]

3 Role of the Central Bank

3.1 Mandate of the State Bank of Pakistan

SBP was set up in 1956 with a mandate to "secure monetary stability and soundness of the financial system" (State Bank Act 1956, 7) (excerpts from the Act that describe its mandate are provided in Appendix 1). The State Bank Act requires SBP to focus on agriculture by setting up a specific agricultural credit department and to coordinate

10 For a detailed description of how to calculate debt capacity and for methods to increase a client's debt capacity, see Chapter 12 of Von Pischke (1991).

11 More in-depth studies and additional perspectives on microfinance in Pakistan can be found in ADB (1999b) and McGuire et al. (1998).

SBP is concerned with monetary stability and the soundness of the financial system

"any other organizations engaged in the business of agricultural credit." This could be broadly interpreted as including those MFIs that lend for agriculture, but in practice this is not applied. As part of this focus, SBP has traditionally subsidized credit to agriculture along with other special schemes. However since 1991–1992, SBP has "begun to move towards a market based system of rates of return on rural loans" with financial sector liberalization (ADB 1999b, V–4). This does not mean that subsidized lending has been entirely discontinued, but at least some of the "developmental" activities, which can also include directed credit programs of central banks (Chandavarkar 1996) are being phased out.

SBP's pursuit of this goal of monetary stability and a sound financial system is its most important role in support of the development of a financially viable microfinance sector. Macroeconomic stability and serious financial sector reform have set the stage for the emergence of a robust commercial microfinance sector (and the associated increases in income generation) in countries such as Indonesia, Bolivia, Chile, Paraguay, and Uganda (Rhyne and Christen 1999). This is particularly important at this time when there are severe challenges to the soundness for the financial system, particularly the massive arrears problems (see Section 4.2).

Consistent with its mandate, SBP has taken no direct action in the development of sustainable microfinance in Pakistan. There is no threat to the stability of the financial system from current microfinance activities and there are no commercial MFIs that it has to supervise. However, SBP's pursuit of a sound financial system is of paramount importance to the advent of a commercial microfinance market. It means SBP needs to create a supportive financial system and economic environment that will permit commercial institutions to enter the microfinance market freely.

3.2 SBP and Directed Credit

SBP still instructs banks to lend to agriculture, including small farmers

Even with progress in financial sector reform, SBP continues to provide credit through ADBP and to direct credit of the three state-owned commercial banks, the two privatized commercial banks, and the Federal Bank of Cooperatives. Each of these banks is given a quota of loans to provide for agricultural financing to ensure that there is lending to this sector.[12] The chairman of the Task Force on Agricultural Finance estimated that the amount of directed credit was only about "25 percent of the agriculture sector's needs."[13] There are no explicit interest rate restrictions but the bankers feel they are under pressure not to lend at much more than the minimum rate of 14 percent per annum. Within this allocation they must lend at least 50 percent of disbursements to small farmers. For a variety of reasons, this and other programs have been "hijacked by the influential" (World Bank 1999a, 4) so it is unlikely that poor farmers have benefited much from this allocation.[14] Furthermore, loan delinquency is a major problem and directed credit is seen as one contributing factor to the national loan arrears problem (see Section 4.2).

Experience in the Asian region shows that, other things being equal, directed credit schemes which target the poor will cause banks to lend more to poorer borrowers than would otherwise be the case. But they have failed in terms of reaching

12 McGuire et al. (1998) and ADB (1999b) both provide a description of how the National Credit Consultative Council's complex quota system works. The definition of agriculture lending is given in the State Bank Act (1956) as "agricultural operations" which includes improvement of land, procurement of agricultural inputs, agricultural machinery, and other requirements of agriculture. It does not include off-farm and non-agricultural activities in rural areas.

13 Refer to the discussion of credit needs under Section 2.6.

14 Small farmers are defined on the basis of their landholdings, whether as owners or tenants.

significant numbers of low income borrowers and failed in terms of financial viability (especially given the low portfolio quality) (Goodwin-Groen 1998). This directed credit is one of the reasons cited in the ADB rural microfinance project interim report (ADB 1999b) that the banking and legislative systems are not yet fully effective in discouraging loan default. The ADB microfinance development strategy (2000) also notes that mandatory credit schemes operated by state-owned banks, interest rate subsidies, and other restrictive policies still prevail in many countries, and continue to undermine microfinance development.

Among poverty lending programs, the central bank is directly involved only with directed credit and the Self-employment Scheme — neither of these is microcredit

3.3 SBP and Government Microfinance Programs

There is no government microfinance program with which SBP is directly involved. The most direct form of involvement by the Government that involves SBP was the establishment and ongoing support of ADBP and FWB. However, there are many government programs that seek to alleviate poverty and thus build up micro-entrepreneurs, including PPAF, as well as the rural support programs, NRSP, PRSC, SRSC, and BRSP, all of which have received government support. The only ones that SBP considers itself to be directly involved with are the directed credit programs described above and the Prime Minister's Self-employment Scheme (SES). Thus, SBP is not involved directly with any genuine microfinance activity.

SES is a special program with the aim of helping the unemployed start their own businesses through access to credit. However, the loan sizes ranging up to PR5 million for seven years, with a grace period of 2–6 months, indicate that the program is not targeted to those in poverty. There is a smaller loan size bracket from PR10,000 to PR500,000 but even at that size only the smallest loans would be considered microfinance loans.

The Small Business Finance Corporation (SBFC) has more than 100 branches and has been the main agency spearheading the SES program. SBFC's typical clients are people who have had 10–12 years of education, have PR40,000–50,000 of their own equity to put into a business, are urban based, and need a loan of about PR200,000–250,000. This is an important market since these new businesses would not be considered creditworthy by the banks. However, the size of the equity base and the loan size means that SBFC is not undertaking microfinance. As of June 1998 SBFC had disbursed PR12 billion to 1,157,162 unemployed people. This was said to have resulted in 397,129 additional jobs (ADB 1999b). Unfortunately, there have also been loan losses of 35 percent. Under the SES scheme, SBFC has disbursed PR1.8 billion. Commercial banks have also been involved in the national Self-employment Scheme and SBP has been involved, in terms of tracking results under this scheme, as illustrated in the table.

Statement of Loans Disbursed by Participating Banks under the Prime Minister's Self-employment Scheme (1 September 1998 – 30 April 1999)

Participating Banks	Amount Disbursed (PR '000)	Percentage of Total Disbursed
National Bank of Pakistan	999,868	20.6
Allied Bank of Pakistan Ltd	879,242	18.1
United Bank Ltd	143,917	3.0
Habib Bank Ltd	673,123	13.9
Muslim Commercial Bank Ltd	85,068	1.6
Bank of Punjab	221,393	4.6
Bank of Kyber	95,550	2.0
Small Business Finance Corporation	1,761,660	36.2
Total	**4,859,821**	**100.0**

Source: State Bank of Pakistan (1999).

SBP's financial sector responsibilities should include persuading citizens of the binding contractual nature of loan agreements

There is one final area where the Government directly affects the microfinance sector and in which SBP has, or ought to have, a role. That is in protecting the principle of the bank-client relationship as being a contractual one for which there are legal consequences if broken. Historically, in Pakistan some leaders have intervened in the bank-client relationship, particularly of the rural poor. There have been times when principal as well as interest has been waived. But these actions undermine the clients' perception that loans have to be paid back. Rather, they lead to the perception that clients will eventually be bailed out if they do not pay. Therefore, if this sector is ever going to be able to expand, it is important for SBP to reinforce the message consistently that the bank-client relationship is a contractual one where there are legal consequences for nonpayment. This applies to all aspects of that contract, including payment terms and conditions.

3.4 Perceptions of SBP about Microfinance

Bankers interviewed in all parts of Asia tend not to be well informed about the development of the microfinance industry. Little is written about microfinance in banking literature so it does not come to their attention. In the case of the bankers in SBP in Pakistan, their perception of the sector and how it might be regulated in the future is based on a combination of international awareness, gained through some exposure to the literature and attendance at meetings overseas, and local knowledge.

Within the central bank there is a range of views on microfinance but there is no official SBP "view"

The following is a summary of the perceptions of individuals within SBP about SBP's role with respect to key issues facing the microfinance sector. These perceptions do not represent the official position of SBP but since they are the perceptions of significant individuals at SBP they are instructive in regard to the issues addressed.

(i) The view was expressed that the purpose of microfinance is to support the Government's goals of:
   (a) employment;
   (b) transitioning micro-businesses to the formal sector (that is, so they can pay taxes); and
   (c) growing the economy.

(ii) It was claimed that microfinance is not best done by the commercial banks, since banks are too expensive, and do not know these clients and how to assess and monitor these loans. It was thought that this leaves NGOs (in practice, large reputable NGOs to which banks lend) as the best avenue for microfinance development.

(iii) It was also observed that in the past several government-sponsored schemes for self-employment achieved only limited results, largely because the operational aspects of such schemes — the economics of a proposal, its feasibility, stake of the borrower, collateral, implementation, and monitoring — were not given due attention by the banks. With regard to current government microfinance programs, it was suggested that, if the banks are not to make the same mistakes again, they needed to learn from the successful NGOs how to lend to micro-entrepreneurs or, alternatively, to identify financially robust NGOs in order to lend to them.

Banks could learn about micro-financing from the better NGOs

(iv) Another view was that it is SBP's role to regulate and supervise banks, not NGOs. Banks are free to make commercial lending decisions when it comes to lending to NGOs for microfinance. At present the regulations require that NGOs provide some form of collateral, the assumption being that if it were a reputable NGO (like NRSP), it would have some fixed asset or endowment to pledge. Otherwise, it might not be a good bank client.

   However, it was claimed, if an NGO does not have that collateral and a bank still wanted to lend to it, there are ways to address this issue. For example, the bank might designate the NGO to become an agent of the bank, in which case it would not need collateral. SBP can be flexible when there are sound business decisions, as long as it is informed and part of the process. (This has been the experience of BOK: in the writer's view, if the banker wants to make a microfinance loan, it can be done! For example, BOK has found community guarantors are acceptable security, and that by registering a peer group it becomes a legal entity.) The regulation requiring collateral or security for a bank loan to an MFI is not the main problem. The main problem is that most NGOs are not creditworthy so no bank wants to lend to them.

There are ways of getting around the collateral problem

(v) In cases where interest costs are small in relation to a producer's total costs, it was suggested that the level of interest rates is a relatively minor consideration. For example, it has been estimated that, currently, interest payments are only around 7 percent of a farmer's total annual cotton production costs. The situation has changed radically for farmers since the days of interest rate subsidies. Now they are selling at international prices, there are no foreclosure laws, there are passbooks that establish land ownership, there is technical assistance, and if there are floods the Government steps in to help. These are the reasons that the interest regime was, and continues to be, liberalized. The interest rate should be part of the bank-client relationship; thus, the farmer should pay for the service he receives.

(vi) Regarding the creation of a new type of financial institution for the rural poor, it was thought that the key constraints to rural financial sector development needed to be understood before a decision was made about a new type of financial institution. Is the number of financial institutions one of those constraints? It would seem not, because 400 unprofitable bank branches were closed last year. According to this view, there are already too many banks for the country. There cannot be viable institutions until the economy is vibrant so perhaps the constraint is health, education, or infrastructure.

3.5 Future Role of SBP

SBP has no specific plans for its involvement in the microfinance sector, as is consistent with its mandate. However, the National Task Force on Poverty Eradication has recommended, amongst other things, a national program for microcredit to the poor in rural and urban areas. It is proposed that the provincial governments should set up a network of RSPs. This will provide an "enabling environment" in which communities, NGOs, and government departments can work (ADB 1999a). Also, the new government has proposed the establishment of a national microfinance bank. This concept is being driven by the Ministry of Finance and is still evolving at the time of writing. While SBP has been involved in the discussions, it is not within SBP's mandate to become directly involved in such an initiative, and it has major challenges in managing its current mandate without its being expanded. However, there may be some opportunities for SBP to contribute positively to the building of sustainable microfinance, which are within its mandate. They do not directly relate to SBP's bank supervision role, but they could be classified as "promotional" activities (Chandavarkar 1996) that could contribute to the development of a sound financial system serving the majority of the economically active population. Potential initiatives include the following.

SBP is not directly involved in plans for a national microfinance bank, and sees such initiatives as incompatible with its role

Potential SBP Initiatives for Building Sustainable Microfinance

(1) Document and disseminate national and international examples of profitable microfinance.

Leasing companies are one example of national profitable microfinance. Microfinance may not compete with the highest financial returns but it achieves goals that all financial institutions want to reach, namely: a consistently performing product that contributes positively to the bank's bottom line, that diversifies the portfolio to diversify their risk, and that maximizes the performance of their branch network. Leases are structured over three years (which is the minimum lease period by law but could be reduced if legally permitted). The client has to make a 10 percent deposit at the beginning, and there is a 2 percent fee for insurance in addition to the mark-up, which will depend on the type of asset and its resale value (ranging from 24 to 32 percent).

There is much the banks could learn from leasing companies about profitably operating in the micro and small business market, for the following reasons:

(i) Leasing companies have loyal and dedicated sales staff who are prepared to work hard in non-air-conditioned environments as they get to know their clients. The analysis of the business includes creation of financial statements for clients. In addition, they help clients to open a bank account if needed.

(ii) These staff are trusted and given decision-making authority with minimal oversight (there is a separate recovery department for clients in default).

(iii) They have an excellent management information system that tracks all the following factors: the average rate earned, the total amount of business, the number of contracts, and the amount of *new* business in both PRs and number of accounts, as well as all the direct and indirect costs.

(iv) They undertake a careful analysis of risk and return, focusing on businesses that have been in operation for more than two years. As noted above, they diversify their risk to ensure a good return for their shareholders.

Activities such as documentation of good microfinance practice, including Pakistan's own leasing companies, would be appropriate for SBP

Another common feature of leasing agreements is affordable client life insurance or loan protection that pays back the loan/lease in the event of accident, ill health, death, or other contingencies, and which enables the client's family to keep the asset that was purchased. The MFI or financial institution charges a fixed fee or raises the interest rate slightly to pay for the protection. There are also many examples internationally (Schwartz et al. 1999). In addition to life insurance an "all risk insurance cover" is included in the price of the lease to ensure that all the assets leased are insured.

(2) Facilitate a private credit bureau.

One particular area that could support the entry of commercial institutions into microfinance is the creation of a private credit bureau (Rhyne and Christen 1999). As long as the database included the smallest businesses and all institutions providing micro-lending services participated, the facilitation of such an innovation could encourage financially sustainable microfinance by giving banks and MFIs the credit history of their clients. While there would be practical difficulties, one of the biggest challenges facing the financial sector is nonpayment of loans. Successful implementation of such a database would help counteract that problem. (Apparently, Dun & Bradstreet's global business development team has already discussed the need for a credit bureau in Pakistan with the heads of major local and foreign banks including the governor of SBP and has been well received.)

4 Regulation and Supervision of Banks

4.1 Review of the Banking System

The Banking Companies Ordinance, 1962, is the applicable law with respect to commercial banks in Pakistan. The Ordinance states that "[n]o individual or association of individuals, not being a company, shall carry on banking business in Pakistan (and) no company shall carry on banking business in Pakistan unless it holds a license issued in this behalf by the State Bank" (as quoted in UNDP 1999b, 21). The banking sector in Pakistan that relates to the microfinance sector includes two specialized banks: ADBP and the Federal Bank for Cooperatives (FBC). Commercial banks consist of six nationalized commercial banks, 15 private commercial banks, and 20 foreign banks.[15] The State Bank of Pakistan supervises all of these institutions, together with the investment banks.[16] The activities of the seven banks that undertake microfinance in some form are described in Section 2. 2.

Bank Involvement with Microfinance

Banks engaged in microfinance or with potential to do so include:

- two specialized banks, ADBP and FBC
- six nationalized and 15 private commercial banks, and 20 foreign banks.

However, only ADBP and six commercial banks serve microentrepreneurs to any real extent.

4.2 Prudential Regulation and Supervision and a Sound Financial Sector

One of the key roles of SBP as it pursues the goal of a sound financial system is the regulation and supervision of banks. This role relates to microfinance in that SBP ensures that the regulatory framework and supervisory apparatus governing the financial sector encourages commercial provision of financial services to the majority of the population. The biggest challenge for SBP in achieving this has been in the area of loans in default.

Overdue loans cripple the banking system and impede SBP's efforts to strengthen it through regulation and supervision

A unique Banking Companies Act had to be passed in 1997 to set up special courts to hear the backlog of cases where banks are trying to recover their money. It is estimated that PR160 billion remains in overdue loans, that is, 7 percent of GDP. This is truly a massive problem (ADB 1999b). It is partly due to a loan provisioning system that does not require formal classification of any loan until it is over 90 days late; loans from 180 to 360 days late are all classified as sub-standard with only 25 percent provisions required. According to one Pakistani banker, the bad loans that have crippled the country's banks are also due to the accumulation of decades of patronage. This directly affects the provision of microfinance because financial institutions are much more risk averse and reluctant to embrace new markets, and because microentrepreneurs have little access to patronage.

15 Among banks described as "commercial" here is First Women Bank, founded in 1989 under a special ordinance with a mandate to serve women's financial requirements.

16 Chapter V of the ADB (1999b) study gives a detailed description of the legal and regulatory framework for formal financial institutions.

ADBP needs reform on a scale similar to that achieved by Bank Rakyat in Indonesia

The loan loss problem as it directly relates to SBP's oversight of the banks is focused on ADBP. Many institutions in the region like ADBP are seeking a revitalizing formula that will give them a mission that can be pursued with profit. This is particularly so in Pakistan where the limited tax base and rampant evasion have pushed the Government close to bankruptcy. One of the options successfully undertaken in Indonesia was to transform the rural network of the state-owned development bank, the Bank Rakyat Indonesia unit system, into a highly profitable micro-banking division within the bank. This micro-banking division prices its loans to cover the full cost of operations and make a profit. Before the Indonesian crisis, it charged a flat rate of 2 percent per month with a six-monthly rebate of 0.5 percent per month (if there is on-time payment) on a twelve-month loan. That is an effective interest rate of 40 percent or more per annum. Even with this rate there is no shortage of clients and, equally important, there is no need for government subsidy. This is not a panacea for all such institutions but gives hope for reform.

4.3 Minimum Capital Requirements

The minimum capital requirement to register as a private commercial bank is PR500 million ($14.2 million), although it has been suggested that this may be increased to PR1,000 million ($28.5 million). It is also necessary to establish a branch in each of the four provinces of Pakistan and the disputed territory of Kashmir, and to be a publicly listed company with public shareholders to the extent of at least 50 percent. Given that small banks are much more likely than large banks to provide services to poor borrowers in remote locations, the restrictions on establishing banks reduce the likelihood that banks will engage in microfinance. They also make it extremely difficult for MFIs to establish banks so that they can accept deposits and offer a wider range of services (McGuire et al. 1998).

4.4 Interest Rate Regulation

Interest rates for both lending and saving have been fully liberalized except that there is still a minimum rate of 14 percent per annum. To date, however, this liberalization has had little effect on the behavior of the formal financial system with respect to rural microfinance (ADB 1999b). This is because, despite the official liberalization, there is still a lack of clarity about the Government's position on the rate of interest allowed. Even though there is now officially no cap on the maximum rate that banks can charge, the minimum rate acts as a brake on the system, effectively discouraging banks from going much higher. As explained in Section 2, there is no way that microfinance can be profitably undertaken even at 18 percent per annum.

Regulatory Hurdles to Microfinance

Regulatory hurdles to microfinance include:

- high minimum capital and locational requirements preventing formation of small local banks which might be more agile in micro-financing
- lingering uncertainty of bankers concerning permissible interest rates
- collateral requirements and inability to offer receivables as collateral
- limitations on lending to "unstructured" entities without audited accounts
- uncertainty over use of mobile or part-time banking facilities.

SBP needs to make it very clear to all the banks it supervises that interest rates are not an issue for SBP regulation or for government intervention. Interest rates are part of the contractual relationship between the financial institution and its client, and they are set to ensure both the competitiveness and the financial viability of the financial institution. Such a clarification would benefit, in addition to banks, all those involved in pricing credit including leasing companies, NGOs, and PPAF.

4.5 Issues for Microfinance in Prudential Regulation and Supervision

The limit of PR100,000 on lending to an unstructured entity such as a self-help group, or a village organization, inhibits bank financing of microcredit

NBP and other banks interviewed identified three regulatory barriers to developing microfinance as a major business segment for banks (in addition to the confusion about interest rates). They are:

(i) The regulation requiring lending against collateral, which does not include receivables as acceptable collateral.

(ii) The regulation requiring lending only to structured bodies that maintain audited accounts.

(iii) The lack of clarity about mobile banking units.

Banks are permitted to make unsecured loans up to PR100,000, and aggregate exposure is not to exceed capital free of losses and general reserves. This PR100,000 is fine for loans to individual microentrepreneurs but greatly restricts the scope for banks to lend to NGOs, village organizations, or self-help groups for on-lending to poor borrowers, because such organizations generally have little to offer by way of security. Also, other than individuals, banks are only allowed to lend to structured bodies that meet certain conditions. For instance, structured bodies are required to maintain audited accounts, and are subject to regulations concerning debt-equity ratios and other matters. This makes it very difficult for banks to lend to relatively informal group structures such as village organizations and self-help groups.

If NGOs are ever to be able to grow significantly, they will need to borrow from the financial sector, as a few of the large NGOs are currently doing. However, most NGOs do not have sufficient fixed assets to assign as collateral for a bank loan and they need much more than the PR100,000 that the banks are allowed to lend without collateral. There are also banks that would be prepared to lend to these NGOs on the strength of their receivables, if it were allowed by SBP. It has been suggested that a guarantee fund be set up for NGOs that, in every other way, would be good bank clients but simply lack the collateral (ADB 1999a). The Government has supported this idea.

NGO receivables should be recognized as having collateral value

It would seem to be appropriate for SBP to work with banks on a research project to analyze the quality of the receivables of potential client-NGOs which might be offered as collateral against bank loans. (Loans eventually disbursed under any such guarantee fund as suggested in the preceding paragraph could also be examined as part of this research.) If such research showed poor performance, it would reinforce SBP's PR100,000 limit for uncollateralized loans. But if it showed positive performance, it might justify a reconsideration of SBP policy.

SBP has acknowledged that banks need mobile units or part-time booths to reach distant rural communities with cost-effective financial services. It was recognized that there had been some confusion over SBP's position so it would seem to be appropriate for SBP to clarify and streamline the process for their approval (ADB 1999a).

Finally, as already noted, SBP's provisioning requirements do not seem to be strict enough to identify problem loans or to conform adequately to international accounting standard principles of not overstating assets (International Accounting

Standards Committee 1998). In the case of microfinance portfolios there is a need for even tighter provisioning requirements because microfinance loans are generally unsecured.

4.6 Leasing Companies and Cooperatives

SBP no longer regulates the leasing companies that are supervised by the Pakistan Corporate Law Authority; however, these also have to comply with all SBP directives. Cooperative societies must be registered with the Provincial Registrar of Cooperatives and can only take deposits from, and lend to, their members. The Cooperative Banks and Cooperative Societies (Repayment of Loans) Ordinance, 1966, provides for the recovery, according to the law and under the rules in force, of arrears of land revenue (UNDP 1999b).

5 Regulation and Supervision of NGOs and Nonbank MFIs

5.1 Review of NGO Regulation

NGOs in microfinance may register under either of two ordinances, but are not subject to SBP regulation

Most nongovernment organizations involved in microfinance are registered under either the Societies Registration Act, 1860 or the Voluntary Social Welfare Agencies (Registration and Control) Ordinance, 1961 (ADB 1999b).[17] The registration authority for a social welfare agency is the Directorate of Social Welfare in each province and its branch offices, one in each sub-division. This ordinance provides for registration of NGOs operating at local and provincial level but not for those NGOs operating at national and international levels (UNDP 1999b). (NGOs receiving grants typically have to be registered in some way, but the small NGOs, operating independently, are sometimes not registered.)

The laws governing NGOs require them to maintain accounts and have them audited annually, prepare an annual report, and hold election of office-bearers according to their constitutions and bylaws. However, the laws do not require NGOs that receive external funding for program activities to pass these funds through their books of account. As a result “it is common to find no information concerning donor funding in the audited accounts of NGOs” (ADB 1999b, V–3). Needless to say, this results in many questions about the transparency of NGOs.

There is a common opinion amongst government officials (although not SBP) that registration is not enough, that a new legal and regulatory framework is necessary to regulate the working of NGOs at national, provincial, and international levels. This would ensure proper utilization of resources generated by these NGOs and ensure public accountability. As part of this push, an NGO Bill for uniform legislation and regulations for NGOs is under preparation (SEBCON 1999).

17 Refer to McGuire et al. (1998) for more details on the registration of NGOs.

5.2 Should SBP Regulate Microfinance NGOs?

There is some pressure for central bank regulation of microfinance NGOs, but this is clearly not a priority for SBP in terms of its mandate

The desire that microfinance NGOs be regulated is a commonly expressed one in Pakistan. Von Pischke (1998) has summarized many of the issues that have arisen in the debate on regulation of microfinance NGOs in Pakistan:

(i) The political urge to expand the regulatory bureaucracy, creating more government jobs and all that goes with them.
(ii) The desire to obtain more support from donor organizations. Donors are often sympathetic to increased regulation of the microfinance organizations that they fund but do not supervise or monitor very closely themselves.
(iii) The belief that regulation can reduce fraud by unscrupulous NGOs.
(iv) The demand for regulation from clients and NGOs that want what they do to be specifically authorized.

As a result, some think that it is SBP's role to regulate NGOs that are providing microfinance services, as an extension of its bank supervision role. But this is clearly not a priority within its mandate of ensuring monetary stability and a sound financial system. The NGO sector described in Section 2 is not a significant percentage of the total financial sector. The majority of NGOs in Pakistan are highly subsidized by either the Government or international donors, and provide a range of services other than credit. This small sector is not a priority for the institution that is dealing with national economic stability. Rather than attempting to regulate thousands of tiny institutions in a sector for which SBP has no comparative advantage, it would be far more advantageous for SBP to focus on building confidence in the financial sector and ensuring that commercial institutions can enter the market. As described in Section 3, this would generate a much greater contribution to the sustainable development of microfinance. Even if SBP did attempt to regulate these NGOs, international experience has shown that it will face the problems of budget constraints, limited motivation of supervisory staff, and minimal understanding of microfinance risk, which will inevitably undermine its effectiveness (Vogel 1998).

A prime example of these points is the Bolivian Central Bank. It is still not doing credible portfolio quality reviews of microfinance portfolios even with a microfinance industry that is growing in significance in the financial sector.

5.3 Regulation of Savings Services

Only regulated banks may legally accept deposits

Currently, only banking institutions are licensed to take deposits but they are not interested in managing micro deposits. The banking sector, even with over 8,000 branches, does not appear to be able to develop profitable savings services for the majority (unlike the Bank Rakyat Indonesia unit system in Indonesia). Many microfinance organizations require compulsory savings as a form of cash collateral that is deposited in banks and generally cannot be withdrawn, or withdrawn only with difficulty. When there are such forced savings, clients reasonably start to question why they are paying interest to borrow their own money (UNDP 1999b).

There are powerful arguments for local institutions that have the community's trust and already require their clients to save to be able to collect those savings directly from their members/clients. Turning micro-lending locations into deposit-taking offices greatly reduces the transaction costs of savers. This, in turn, helps get savings in monetary form into the financial system where some portion of it can be intermediated (Von Pischke 1998). The proportion of total savings that may be in money rather than in kind may also increase. Allowing community-based micro-lending institutions to mobilize savings legally would also put people in charge of managing their cash flow. Research has shown that poor people use savings, credit,

It is doubtful whether many NGOs have the systems or capacity to manage deposits

and insurance arrangements as a single package of tools for managing risk (Zeller et al. 1997).[18]

However, poor people should be able to save their money with institutions that are financially secure. A review of the existing accounting systems and procedures followed by NGOs indicate that they may not be able to comply with prudential regulations similar to scheduled banks (UNDP 1999b). It would be imprudent to give deposit-capturing licenses to institutions that did not have a proven track record of meeting high financial management and performance standards. Like it or not, licenses for deposit-taking services generally carry an implicit government guarantee and SBP has to be prepared to stand behind the institutions it licenses.

The present stage of development of NGOs in Pakistan means that it is currently too risky for SBP to license NGOs to manage the savings of the low income majority. There is also no evidence to show that it would reduce the cost of credit for the clients. When the added administrative costs entailed by voluntary savings services are factored into the cost of credit, deposits mobilized by NGO MFIs (especially in tiny accounts of poor people) will seldom be much less expensive than commercial funding like bank loans.

However, since the banking sector seems not to be interested in small deposits, an alternative must be found. The majority of the economically active population may have low incomes, but they still need access to saving services. Three options have been discussed and are presented here for consideration.

Finding Ways to Give the Poor Access to Savings Services

Banks are unable to provide savings services to low income people, and the demand for such services clearly exists. Options will have to be found, for example:

- a research program concerned with the viability of small, locally based banks and the appropriate regulatory and supervisory arrangements for such banks should be undertaken
- a pilot project in which selected NGOs were permitted to accept savings would do no more than recognize the status quo and could provide lessons for wider application
- it might be worthwhile trialing a deposit insurance scheme, for which NGOs could be eligible, after locating an entity willing to provide such insurance on a fee-for-service basis.

5.4 Ideas for Savings Services

SBP could usefully undertake research, in collaboration with NGOs and the banking sector, to consider the questions outlined below. This might be done in the course of examining all possible options for ensuring the poor have access to savings services. Innovative approaches are needed, for example, in relation to questions such as:

(i) What are the options to provide client-responsive savings services to low income clients, especially those in rural areas?

(ii) If one option were the creation of a new category of small bank to provide local access to financial services tailored for low income clients, would the new bank structure make a substantial contribution to the clients' development? Would it

18 For a detailed discussion of these issues, refer to Von Pischke (1998).

also add value to a financial system that, to some, already has too many banks with many branches currently making losses?

(iii) What would appropriate prudential and supervisory regulations be for such small banks with riskier clients (for example, a higher capital adequacy ratio)?

(iv) Could SBP establish cost-effective means of ensuring that small banks are adequately supervised? Is there a role for contracting out arrangements?

(v) If another option is deposit insurance, what are the mechanisms that would ensure that the cost was borne by the banking sector and not by the Government?

Transformation of MFIs was successful in Bolivia because it had an infrastructure of good microfinance NGOs — Pakistan is not there yet

One option recommended by McGuire et al. (1998) is the creation of a new category of small, locally based bank whose purpose is to provide low income clients with local access to financial services. This would also enable NGOs to transform into formal financial institutions and so legally provide savings services to their clients. Such a strategy has been helpful in some countries such as Bolivia (Rhyne and Christen 1999). However, the success of the Bolivian example was dependent on a well-developed microfinance sector with a substantial number of financially viable microfinance NGOs that had the financial management capacity to transform and to manage central bank supervision. The Pakistan microfinance sector is still in the early stages of its development and as yet there are no fully commercially viable NGOs. As well, the performance of the Pakistan banking and credit union sector has been less than stellar, so to add another type of formal financial institution to the banking sector would need careful research. However, it may be appropriate to start considering this issue because it will take time to research thoroughly, and in that time several of the NGOs currently providing microfinance services may reach commercial viability.

Another option would be to pilot an initiative with NGOs that met specific financial and management criteria to provide voluntary savings services to members. This is the actual situation in many countries of the region. However, the costs and benefits to the clients do not appear to have been well documented. Perhaps at the same time as piloting an initiative in Pakistan, it would be appropriate to document the results of this approach in the region.

Community-based NGOs could benefit from deposit insurance if a service provider were available

A further innovative option recommended by Von Pischke (1998) would allow all institutions with deposit insurance to collect savings. This could include community-based NGOs. The system would cover its own costs if all micro-deposits had to be insured by a bank doing business in Pakistan, and that bank had to have reinsurance, of which some had to be obtained offshore in hard currency. SBP's role would be:

(i) To define the minimum acceptable insurance contract.

(ii) To verify the capacity of the insurer and reinsurers to undertake the risks they guarantee.

(iii) To ascertain that the insurance contracts are workable.

Again, the costs and benefits of such a proposal would take substantial research to assess.

5.5 Interest Rate Regulation

Since SBP does not oversee any NGO activity it does not have any role in the interest rates charged by NGOs. PPAF, however, will require NGOs to lend at interest rates that cover all the costs of lending including administrative costs, cost of funds, and loan losses. This is imperative if the microfinance sector is ever to become financially sustainable. If PPAF does not fully implement this requirement, the sector will continue to be dependent on donor and government subsidies and will never be able to grow to meet the financial service need of the majority of the poor. (See also the discussion on interest rates in sections 2 and 4.)

PPAF could raise standards of financial reporting by NGOs but the relationship with SBP needs careful handling

5.6 Performance and Reporting Standards

One of the major constraints to the development of the microfinance sector as noted in Section 2 is the lack of financial management capacity in retail MFIs — in particular, the capacity to track financial performance and move the institution to financial sustainability. However, the leading NGOs are fully aware of their need to improve their information systems, the rigor of their financial reporting, and their financial management. To this end the World Bank has included a capacity building component into its PPAF project.

PPAF proposes that NGOs will report to them on both their clients and their financial performance. However, the level of financial reporting is not currently consistent with standard reporting by financial institutions. With NGOs recognizing their need to improve their financial reporting, and particularly with the advent of commercial banks becoming clients of PPAF, a great opportunity exists for PPAF to set the standards for improved financial reporting in the microfinance sector, and to provide the capacity building to ensure that the institutions are able to fulfill their obligations.

It has been suggested that PPAF, in addition to its lending to NGOs, might become a conduit for lending funds to commercial banks for microfinance (ADB 1999a). It is at this point that the role of SBP as bank supervisor and PPAF are aligned. It may be mutually advantageous for SBP and PPAF to work together on standard rigorous financial reporting on the quality of microfinance portfolios and the financial performance of MFIs or microfinance units of commercial banks.

However, this may not be as straightforward as it looks. SBP is not represented on the board of PPAF, and since PPAF is not a bank it will not be supervised by SBP. This means that the relationship needs to be handled carefully. PPAF and SBP need to build credibility with donors and the NGOs for such a relationship to succeed.

6 Conclusions and Recommendations

6.1 Conclusions

The conclusions and recommendations in this final section are based on interviews conducted with the leading institutions involved with microfinance in Pakistan and the extensive international literature on regulation for the microfinance sector. The study has focused on the role of the central bank, the State Bank of Pakistan (SBP), in the development of sustainable microfinance in Pakistan. As such, it purports to provide neither a complete overview of the microfinance sector nor a comprehensive set of recommendations for its development.

SBP's concern for financial sector reform and development appears consistent with the needs of microfinance

The greatest scope for constructive engagement by the central bank with microfinance in Pakistan is to be found in a core area of its responsibility, concerned with financial sector reform. The creation of a policy and regulatory environment supportive of the commercially viable provision of microfinance is a process still far from complete. For example, while in-principle interest rate liberalization has occurred, in practice there is a need for SBP to clarify interest rate policy, in order to remove remaining inhibitions affecting the willingness of banks to price loans, including microcredit, appropriately.

The expansion of savings services available to the poor, and broadening the range of institutions eligible to offer such services, at the same time putting adequate safeguards in place, is another priority. This raises the issue of SBP's relationship with the NGO sector. While it may be inappropriate for the central bank to become involved in their regulation, there is considerable scope for promotional activities to support the strengthening of MFIs. Similarly, SBP could usefully promote innovation in banking services favorable to microfinance in the formal banking system. The recommendations which follow are directed to these objectives.

6.2 Recommendations

These recommendations are divided into three areas. Recommendations 1 and 2 address the economic implications of SBP's activities as they affect microentrepreneurs — the working poor in the informal sector — who currently have very limited access to formal financial services. Recommendations 3, 4, 5, and 6 address SBP's role as the bank supervision agency insofar as it relates to financial services for those working in the informal sector. Finally, Recommendations 7 and 8 address options for how SBP might provide catalytic leadership in the development of sustainable microfinance in Pakistan.

(1) SBP should continue financial sector reform.

The most important role for SBP in the development of sustainable microfinance in Pakistan is to continue its financial sector reform. For SBP, this is the single most important action supporting the development of a financially viable microfinance sector. SBP's role in this regard is to ensure that the regulatory framework and supervisory apparatus governing the financial sector do not inhibit commercial provision of financial services to the majority of the population. Further, as part of its financial sector liberalization, the central bank should reduce the "developmental activities" of the central bank, such as directed credit.

Uncertainties about interest rates should be removed

(2) The central bank should clarify interest rate policy.

SBP should make it very clear to all the banks it supervises (as well as the cooperatives) that interest rates are not an issue for SBP regulation. Interest rates are part of the contractual relationship between the financial institution and its client, and they are set to ensure both the competitiveness and financial viability of the financial institution.

The principle of the bank-client relationship being a contractual one, it is not an appropriate arena for government intervention, except where legal issues are at stake. This applies to all aspects of that relationship, including payment terms and conditions.

(3) SBP should act to ensure the safety of poor people's savings.

SBP should continue the current practice of only allowing licensed and regulated financial institutions to collect demand deposits from the general public. The principle here is that poor people should be able to save their money with institutions that SBP considers financially secure. It would be imprudent to give deposit-capturing licenses to institutions that did not have a proven track record in meeting high financial management and performance standards. Since licenses for deposit-taking services generally carry an implicit government guarantee, SBP has to be prepared to stand behind the institutions it licenses.

If the banks are not interested in small deposits, alternative services must be found

It is recognized, however, that there are powerful arguments for local institutions that have the community's trust to collect savings from their members. The banking sector, even with over 8,000 branches, does not appear to be able to develop profitable savings services for the majority. Turning micro-lending locations into deposit-taking offices not only greatly reduces the transaction costs of savers but helps to get savings in monetary form into the financial system where some portion of it can be intermediated.

Given the present stage of development of NGOs in Pakistan, it is currently too risky for SBP to license NGOs to manage the savings of the low income majority. However, the banks seem not to be interested in small deposits, so an alternative must be found. The majority of the economically active population may have low incomes, but they still need access to saving services, hence the next recommendation.

(4) SBP should research prudent expansion of appropriate savings services for the poor.

SBP should steer clear of regulating, let alone supervising, NGOs in microfinance

SBP, in collaboration with interested parties such as the Microfinance Group,[19] should undertake research to consider the best way to provide client responsive savings services prudently to significant numbers of low income clients, especially those in rural areas.

One option is the creation of a new category of small non-national banks whose purpose is to provide low income clients with local access to financial services. This would also enable NGOs to transform into formal financial institutions and so legally provide savings services to their clients. This would not yet be possible in Pakistan since the Pakistan microfinance sector is still in its early stages and as yet there are no NGOs which are fully commercially viable. However, this option will take time to research thoroughly, and in that time several of the NGOs currently providing microfinance services may reach commercial viability.

Another innovative option would allow all institutions with deposit insurance to collect savings. This could include community-based NGOs. SBP's role would be:

(i) To define the minimum acceptable insurance contract.

(ii) To verify the capacity of the insurer and reinsurers to undertake the risks they guarantee.

(iii) To ascertain that the insurance contracts are workable.

The costs and benefits of such a proposal would take substantial research to assess.

(5) SBP should not get involved in regulating NGOs.

SBP should not get involved in the regulation of NGOs providing microcredit services. The majority of NGOs in Pakistan are highly subsidized either by the Government or by international donors and provide a range of services other than credit. They do not in any way compare with commercial financial institutions and as a percentage of the total financial sector they are insignificant. Rather than attempting to regulate thousands of tiny institutions in a sector for which SBP has no comparative advantage, it would be far more advantageous for SBP to focus on building confidence in the financial sector and ensuring that commercial institutions can enter the market. This would generate a much greater contribution to the sustainable development of microfinance.

(6) SBP should consider working with PPAF to develop rigorous financial reporting.

Collaboration between SBP and PPAF will be desirable

There is arguably a role for central banks in undertaking short-term activities that promote financial systems able to provide poor households with access to both savings and credit services on a sustainable basis. "Promotional activities" are intended to be a catalyst for private sector activity, and may include support for pilot projects using innovative approaches to micro-finance; research, collection, and publication of data; advocacy; and training. Working with PPAF would be this kind of short-term, catalytic intervention.

19 The Microfinance Group is a network of seven microfinance practitioners, two donor agencies, and a support organization dedicated to increasing the outreach and sustainability of microfinance services in Pakistan.

The level of financial reporting by NGOs is not currently consistent with standard reporting by financial institutions. If the Pakistan Poverty Alleviation Fund (PPAF) also becomes a conduit for lending funds to commercial banks, there is an opportunity for SBP to work with PPAF and set the standards for improved financial reporting in the microfinance sector, and to provide the capacity building to ensure the institutions are able to fulfill their reporting obligations.

(7) SBP should collaborate to promote innovation in the delivery of profitable financial products for the majority.

SBP has options for immediate action

An additional short-term catalytic activity for SBP that would contribute to the building of sustainable microfinance, but does not directly relate to its bank supervision role, would be to encourage innovation in the delivery of profitable financial products for the majority of the economically active, that is, those in the informal sector. Practitioners and bankers in Pakistan have suggested the four options presented below. They could be undertaken in collaboration with the Bankers Association, the Microfinance Group and/or PPAF.

(i) Document and disseminate lessons learned by profitable institutions providing microfinance services.

For example, there are two leasing companies that are successfully lending to the smallest businesses based on careful credit analysis by well-trained credit officers. Even though these companies consider it a profitable market niche, no banks will lend to the same clients because they either cannot or do not want to learn about this market. There would seem to be an opportunity for documentation and dissemination of lessons learned that would not breach company confidentiality.

Another example is affordable client “self-insurance” or loan protection that would pay back a loan in the event of an accident/ill health/death etc. The MFI or financial institution charges a fixed fee or raises the interest rate slightly to pay for the protection.

(ii) Research lending against receivables.

The central bank should undertake a research project with banks that would be prepared to lend based on an analysis of the quality of the institution’s receivables. Any loans eventually disbursed under a guarantee fund such as is discussed in Section 4.5, could also be part of this research. If this research showed poor performance, it would reinforce SBP’s PR100,000 limit for uncollateralized loans. If it showed positive performance, it could lead to a reconsideration of SBP policy.

(iii) Speed up approval of mobile banking units.

To reach distant rural communities with cost-effective financial services, banks need mobile units or part-time booths. SBP should streamline the process for their approval.

(iv) Facilitate a private credit bureau.

Most banks are reported to have indicated their desire to participate in a private credit bureau and have nominated a person to work with Dun and Bradstreet to compile required data for the feasibility study to be prepared by them. The facilitation of such an innovation could encourage financially sustainable microfinance as long as it included the smallest businesses in the database and all institutions that were providing micro-lending services participated.

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Appendix 1: Excerpts from The State Bank of Pakistan Act, 1956: mandate of the bank

CHAPTER III

Offices, Branches and Agencies

Point 8

(3) The Bank shall create a special Agricultural Credit Department, the functions of which shall be:

a) To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the Federal Government, Provincial Governments, Provincial Co-operative Banks and other banking organisations;

b) To co-ordinate the operations of the Bank in connection with agricultural credit and its relations with the Provincial Co-operative Banks and any other organisations engaged in the business of agricultural credit (p.6).

Central Board of Directors

Point 9A

Functions and responsibilities of the Central Board. The Central Board shall, in order to secure monetary stability and soundness of the financial system:

a) Formulate and monitor monetary and credit policy and, in determining the expansion of liquidity, take into account the Federal Government's targets for growth and inflation and ensure that the Bank conducts monetary and credit policy in a manner consistent with these targets and the recommendations of the Monetary and Fiscal Policies Co-ordination Board with respect to macro-economic policy objectives:

Provided that the Governor may, in an emergency which in his opinion requires immediate action, take such measure as may be necessary in the circumstances and shall report such measure for the approval of the Central Board at its next meeting:

b) Determine and enforce, in addition to the overall expansion of liquidity, the limit of credit to be extended by the Bank to the Federal Government, Provincial Governments and other agencies of the Federal and Provincial Governments for all purposes it being understood that the Governments will meet their additional credit requirement directly from commercial banks through a market based auctioning system to be conducted by the Bank;

c) Approve the credit requirements of the private sector and intimate the same to the Monetary and Fiscal Policies Co-ordination Board;

d) Tender advice to the Federal Government on the interaction of monetary policy with fiscal and exchange rate policy;

e) Analyse and advise the Federal Government on the impact of various policies on the state of the economy;

f) Submit a quarterly report to the Majlis-e-Shoora (Parliament) on the state of the economy with special reference to economic growth, money supply, credit, balance of payments and price developments; and

g) Discharge such other functions as may be necessary for formulating monetary policy and regulating the monetary system or as may be assigned by the Federal Government (p.7).

Monetary and Fiscal Policies Co-ordination Board

Point 9B (2)

The Co-ordination Board shall:

a) Co-ordinate fiscal, monetary and exchange-rate policies;
b) Ensure consistency among macro-economic targets of growth, inflation and fiscal, monetary and external accounts;
c) Meet for the purposes of clauses (a) and (b) before the finalization of the budget to determine the extent of Government borrowing from commercial banks taking into account credit requirements of the private sector, liquidity expansion determined by the Central Board and expected changes in net foreign assets of the banking system;
d) Meet on a quarterly basis to review the consistency of macro-economic policies and to revise limits and targets set at the time of the formulation of the budget, keeping in view the latest developments in the economy;
e) Consider limits of the government borrowing as revised from time to time in the meetings to be held before and after passage of the annual budget;
f) Review the level of Government borrowing in relation to the predetermined or revised targets after every quarter; and
g) Review the expenditure incurred in connection with raising of loans and Government borrowing.

(3) The State Bank of Pakistan shall place before the Board:
a) Relevant data relating to monetary expansion and Government borrowing; and
b) The assessment of the State Bank regarding the impact of economic policies of the government on monetary aggregates.
c) [omitted]

(4) The Planning Commission and the Ministry of Finance, Government of Pakistan shall, from time to time, bring to the notice of the Board the impact of monetary policy adopted by the State Bank on investment, growth and balance of payment.

(5) The Ministry of Commerce, Government of Pakistan shall, from time to time, bring to the notice of the Board the impact of the monetary policy by the State Bank on imports and exports (p.8).

CHAPTER IV

Businesses which the Bank may transact

Explanation: For the purposes of this clause and section 17D, "agricultural operations" shall include improvement of land, procurement of agricultural inputs, agricultural machinery and other requirements of agriculture (p.22).

Point 17D

Loans Guarantee Fund —

(1) The Bank shall establish and maintain a Fund to be called the Loans Guarantee Fund to which shall be credited:
a) An initial sum of two crores of rupees to be subscribed by the bank out of its surplus profits; and

b) Appropriations of such amounts from the surplus profits of the bank as may be determined by the Bank in consultation with the Federal Government.

(2) The Loans Guarantee Fund shall be applied by the Bank to the financing of a system of guarantees in accordance with a Scheme to be made by the bank to cover a portion, not exceeding fifty per cent of any bonafide loss that a scheduled bank is proved, to the satisfaction of the Bank, to have incurred in any transaction of a loan or advance made for the financing of approved agricultural operations and such needs of such small borrowers as may be determined by the Bank from time to time (pp.23–24).

Source: The State Bank of Pakistan Act, 1956 (As amended up to 21st January, 1997 in terms of State Bank of Pakistan (Amendment) Ordinance, 1997). See State Bank of Pakistan (1997).

Appendix 2: Persons Consulted

Abbasi, Qurban Ali	Controller Administration, Small Business Finance Corporation, Islamabad
Ahmad, Mr. Zulfiqar	Chief: Finance and Credit, Sarhad Rural Support Corporation
Ahmed, Mr. Shabbir	Deputy Secretary (Investment), Ministry of Finance, Islamabad
Alfrey, Mr. Ramon	Assistant General Manager, Orix Leasing Company, Karachi
Ali, Mr. Syed Sajid	Regulating Officer, State Bank of Pakistan, Karachi
Andrews, Mr. Julio A.	Resident Representative, The Asia Foundation, Islamabad
Ansari, Mr. Nisar Ahmed	Executive Vice President, National Bank of Pakistan, Karachi
Bharvani, Mr. Hira Lal	Assistant General Manager, Orix Leasing Company, Karachi
Elgersma, Mr. Martin	First Secretary — Development, Royal Netherlands Embassy, Islamabad
Euler, Mr. Claus	Acting Resident Representative, Swiss Agency for Development Cooperation, Islamabad
Fazli, Mrs. Sadia	Consultant, Swiss Agency for Development Cooperation
Greener, Dr. Paul	Rural Development Programme Officer, Aga Khan Foundation
Haque, Mr. Syed Samsamul	Joint Secretary, Ministry of Finance, Islamabad
Hussain, Mr. Kausar	Divisional Head — Credit, Habib Bank, Lahore
Hyat, Mr. Kamal	Chief Executive, Pakistan Poverty Alleviation Fund, Islamabad
Ihsan, Ms. Samar	Section Officer, Ministry of Finance, Economic Affairs Division, Islamabad
Janjua, Mr. M. Ashraf	Chief Economic Adviser, State Bank of Pakistan, Karachi
Khan, Mr. M. Jalil	Managing Director, Small Business Finance Corporation, Islamabad
Khattak, Mr. Zarmast Khan	Deputy Secretary, Ministry of Finance, Economic Affairs Division, Islamabad

Nishtar, Mr. Ghalib	Senior Executive Vice President, National Bank of Pakistan, Karachi
Pakistan Microfinance Group	Representatives of six leading Microfinance NGOs in Pakistan including: Aga Khan Rural Support Programme, National Rural Support Programme, Punjab Rural Support Corporation, Sarhad Rural Support Corporation, Kashf Foundation, and Sungi Development Foundation
Raza, Mrs. Tahira	Acting President, First Women Bank, Karachi
Sadiq, Mr. Kamran	Chief Executive, SEBCON Socio-Economic and Business Consultants to United Nations Development Programme and Pakistan Poverty Alleviation Fund, and ADB's Domestic Consultant, Islamabad
Sattar, Mr. Yusuf A.	Executive Director, Network Leasing Company, Karachi
Siddiqi, Mr. Asif	Managing Director, Network Leasing Company, Karachi
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Tiwana, Mr. Sultan	Joint Director, Sector Head and Provincial Chief, Bank of Khyber, Small and Medium Enterprise Development Authority
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