



# Completion Report

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Project Number: 29229  
Loan Number: 1806  
November 2008

## Pakistan: Microfinance Sector Development Project

Asian Development Bank

## CURRENCY EQUIVALENTS

Currency Unit		–		Pakistan Rupee(s) (PRe/PRs)	
		<b>At Appraisal</b>		<b>At Project Completion</b>	
		25 August 2000		22 April 2008	
PRs1.00	=	\$0.0179		\$0.0157	
\$1.00	=	PRs56.00		PRs63.82	

## ABBREVIATIONS

ADB	–	Asian Development Bank
AJK	–	Azad Jammu and Kashmir
CD	–	certificate of deposit
DPF	–	Deposit Protection Fund
EAR	–	equity to assets ratio
ETA	–	equity to total assets
FATA	–	Federally Administered Tribal Areas
FSS	–	financial self-sufficiency
HANDS	–	Health and Nutrition Development Society
HDF	–	Human Development Foundation
IDC	–	interest during construction
IMF	–	International Monetary Fund
IRC	–	Indus Resource Center
KB	–	Khushhali Bank
LLP	–	loan loss provisions
MSDP	–	Microfinance Sector Development Program
NGO	–	nongovernmental organization
NRSP	–	National Rural Support Program
NWFP	–	North West Frontier Province
OSS	–	operational self-sufficiency
PAR	–	portfolio at risk
PCR	–	project completion report
PPTA	–	project preparatory technical assistance
PSA	–	Pakistan Standards of Auditing
ROA	–	return on assets
ROE	–	return on equity
RMF	–	Risk Mitigation Fund
RRP	–	Report and Recommendation of the President
SBP	–	State Bank of Pakistan
SDC	–	Swiss Agency of Development Cooperation
SDR	–	special drawing rights
SOE	–	statement of expenditures

## NOTES

- (i) The fiscal year (FY) of Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends.
- (ii) In this report, "\$" refers to US dollars.

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## BASIC DATA

### A. Loan Identification

1.	Country	Pakistan
2.	Loan Number	1806-PAK(SF)
3.	Project Title	Microfinance Sector Development Project
4.	Borrower	Islamic Republic of Pakistan
5.	Executing Agency	State Bank of Pakistan (SBP)
6.	Amount of Loan	SDR61,845,000
7.	Project Completion Report Number	PCR: PAK 1083

### B. Loan Data

1.	Appraisal	
	– Date Started	7 August 2000
	– Date Completed	25 August 2000
2.	Loan Negotiations	
	– Date Started	18 October 2000
	– Date Completed	20 October 2000
3.	Date of Board Approval	13 December 2000
4.	Date of Loan Agreement	06 February 2001
5.	Date of Loan Effectiveness	
	– In Loan Agreement	09 February 2001
	– Actual	09 February 2001
	– Number of Extensions	None
6.	Closing Date	
	– In Loan Agreement	30 June 2007
	– Actual	22 April 2008
	– Number of Extensions	None
7.	Terms of Loan	
	– Interest Rate	1.0% during grace period, 1.5% during amortization period
	– Maturity (number of years)	32
	– Grace Period (number of years)	8
8.	Terms of Relending (if any)	
	– Interest Rate	Average weighted cost of deposits during the preceding six months in the banking industry, as calculated periodically by SBP (average of 1.28% to 4.33%)
	– Maturity (number of years)	20
	– Grace Period (number of years)	8

## 9. Disbursements

## a. Dates

<b>Initial Disbursement</b>	<b>Final Disbursement</b>	<b>Time Interval</b>
09 August 2001	22 April 2008	80.50 months
<b>Effective Date</b>	<b>Original Closing Date</b>	<b>Time Interval</b>
09 February 2001	30 June 2007	76.67 months

## b. Amount (SDR)

<b>Category or Subloan</b>	<b>Original Allocation</b>	<b>Last Revised Allocation</b>	<b>Amount Disbursed</b>	<b>Undisbursed Balance</b>
Outreach Extension (Credit Component)	52,206,00	52,206,000	51,575,208	630,792
Licensed microfinance institutions	773,000	773,000	543,933	229,067
Vehicles	1,838,000	1,838,000	1,830,522	7,478
Equipment and Systems	1,355,000	1,539,000	1,248,689	290,311
Training	952,000	952,000	316,533	635,467
Studies and Surveys	429,000	229,000	0	229,000
Consultants	1,818,000	418,000	186,800	231,200
Travel	52,000	52,000	1,185	50,815
Interest Charge	1,778,000	1,778,000	1,524,986	253,014
Community Investment Fund	0	2,060,000	1,958,687	101,313
Unallocated	644,000	0	0	0
<b>Total (loan currency)</b>	<b>61,845,000</b>	<b>61,845,000</b>	<b>59,186,543</b>	<b>2,658,457</b>
<b>Total (\$ equivalent)</b>	<b>80,000,000</b>	<b>89,759,226</b>	<b>85,389,869</b>	<b>4,369,357</b>
	<b>a</b>	<b>b</b>	<b>c</b>	<b>d</b>

a = \$ equivalent per the Report and Recommendation to the President (RRP), b = total of (c+d), c = actual \$ equivalent, d = \$ equivalent as report preparation

Note: The undisbursed balance of SDR2,658,457 (\$4,369,357) was cancelled on 22 April 2008.

## 10. Local Costs (financed by the Asian Development Bank [ADB])

- Amount (\$)	41,070,198
- Percent of Total Local Costs	58%
- Percent of Total Project Cost	36%

**C. Project Data**

## 1. Project Cost (\$)

<b>Cost</b>	<b>Appraisal Estimate</b>	<b>Actual</b>
Foreign Exchange Cost	50,000,000	44,319,671
Local Currency Cost	167,200,000	70,789,560
<b>Total</b>	<b>217,200,000</b>	<b>115,109,230</b>

## 2. Financing Plan (\$)

<b>Cost</b>	<b>Appraisal Estimate</b>	<b>Actual</b>
Implementation Costs		
Borrower Financed	4,700,000	0
ADB Financed	80,000,000	85,389,869
Khushhali Bank	74,100,000	20,169,920
Microfinance Social Development Fund and Community Investment Fund	28,100,000	9,549,441
Subborrowers	30,300,000	0
<b>Total</b>	<b>217,200,000</b>	<b>115,109,230</b>

ADB = Asian Development Bank, IDC = interest during construction, Community Investment Fund = Community Investment Fund, MSDF = Microfinance Social Development Fund.

## 3. Cost Breakdown by Project Component (\$)

Component	Appraisal Estimate	Actual
<b>A. Base Cost</b>		
1. Outreach Expansion	165,900,000	93,667,333
2. Social Capital	23,200,000	9,353,596
3. Institutional Strengthening	13,000,000	9,838,373
<b>Subtotal A</b>	<b>202,100,000</b>	<b>112,859,302</b>
<b>B. Contingencies</b>		
1. Physical Contingencies	3,500,000	
2. Price Contingencies	9,300,000	
<b>Subtotal B</b>	<b>12,800,000</b>	
<b>C. Service Charge</b>	<b>2,300,000</b>	2,249,928
<b>Total</b>	<b>217,200,000</b>	<b>115,109,230</b>

## 4. Project Schedule

Item	Appraisal Estimate	Actual
Date of Contract with Consultants	9 February 2001 <sup>a</sup>	3 January 2002 <sup>c</sup>
Equipment and Vehicles		
Dates		
First Procurement	9 February 2001 <sup>a</sup>	18 April 2001
Last Procurement		05 May 2007
Completion of Equipment Installation		08 May 2007
Start of Operations		
Completion of Tests and Commissioning		November 2005
Beginning of Start-Up		10 March 2006

Other Milestones: GL Application software was installed on 11 Nov 2001 prior to approval of ADB loan.

Notes:

<sup>a</sup> As the RRP has no procurement plan, appraisal estimate is deemed concurrent with loan effectiveness.<sup>b</sup> Date of first consultant contract. Source: Loan Financial Information System.<sup>c</sup> The rest of the actual dates were provided by Khushhali Bank based on its withdrawal applications.

## 5. Project Performance Report Ratings

Implementation Period	Ratings	
	Impact and Outcome	Implementation Progress
From 6 Feb 2001 to 31 Dec 2001	Satisfactory	Partly Satisfactory
From 1 Jan 2002 to 31 Dec 2002	Satisfactory	Satisfactory
From 1 Jan 2003 to 31 Dec 2003	Satisfactory	Satisfactory
From 1 Jan 2004 to 31 Dec 2004	Satisfactory	Satisfactory
From 1 Jan 2005 to 31 Dec 2005	Satisfactory	Highly Satisfactory
From 1 Jan 2006 to 31 Dec 2006	Highly Satisfactory	Satisfactory
From 1 Jan 2007 to 31 Dec 2007	Highly Satisfactory	Satisfactory
From 1 Jan 2008 to 22 Apr 2008	Highly Satisfactory	Satisfactory

**D. Data on Asian Development Bank Missions**

<b>Name of Mission</b>	<b>Date</b>	<b>No. of Persons</b>	<b>No. of Person-Days</b>	<b>Specialization of Members<sup>a</sup></b>
Appraisal	7–25 Aug 2000	4	76	a,c,d,e
Inception	12–17 Feb 2001	2	12	a, b
Loan Review	13–17 Aug 2001	1	5	A
Loan Review	20–28 Dec 2001	1	9	A
Loan Review	15–26 Apr 2002	1	12	A
Loan Review	3–15 Feb 2003	2	26	a,b
Loan Review	28–30 Sep 2003	1	3	A
Loan Review	29 Sep–2 Oct 2004	1	4	A
Loan Review	16–18 Apr 2005	1	4	A
Loan Review	27–29 Sep 2005	1	6	A
Project Completion Review <sup>b</sup>	15–26 Jul 2008	2	24	a,b

Notes:

<sup>a</sup> a = project officer, b = project analyst, c = senior counsel, d = financial analyst, e = social development specialist.

<sup>b</sup> The project completion report was prepared by R. Narasimham, Senior Project Management Specialist and Team Leader, assisted by M. Marcelino, Assistant Project Analyst.

## I. PROJECT DESCRIPTION

1. The Asian Development Bank's (ADB) support for microfinance development in Pakistan has been premised on the recognition that effective and sustainable microfinance outreach is necessary to support Pakistan's poverty reduction goals. Such outreach requires an enabling policy environment as well as the availability of microfinance credit and institutions to deliver it sustainably (Report and Recommendation of the President [RRP], para. 62). ADB's Microfinance Sector Development Program (MSDP) appreciated the necessity of formalizing linkages between its policy and investment components to apply a long-term perspective and attain sector-wide benefits for sustained poverty reduction efforts. In pursuit of this rationale, ADB approved from its special funds on 13 December 2000 to Pakistan (i) a program loan for SDR54.114 million (\$70 million), and (ii) the Microfinance Sector Project Investment Loan for SDR61.845 million (\$80 million). The State Bank of Pakistan (SBP) was the investment loan's executing agency. Khushhali Bank (KB), the designated microfinance bank, was its implementing agency. A project management unit was established in SBP and a project implementation unit was set up in KB.

2. The investment loan's objective was to leverage policy actions for poverty reduction by providing the necessary investment resources. Its scope comprised (i) credit outreach expansion through a credit line of SDR52.206 million (\$68 million) to KB to support investment in farm and non-farm income-generating activities to benefit 560,000 households comprising about 4 million people; (ii) social capital creation through community organization and skills development to enable 560,000 households to access microfinance credit; and (iii) institutional strengthening of (a) KB through staff training and financing of vehicles to enhance credit outreach, (b) SBP for a more proactive microfinance policy, (c) two nongovernmental organizations (NGOs) to transform them into registered microfinance institutions, and (d) Zarai Taraqiyati Bank Limited through a portfolio audit.

## II. EVALUATION OF DESIGN AND IMPLEMENTATION

3. The MSDP was consistent with ADB's and the Government's poverty reduction strategies.<sup>1</sup> The investment loan complemented the program loan by streamlining management of the use of microfinance funds both from the supply and demand perspectives. On the supply side, the investment loan provided a credit of SDR52.206 million (\$68 million equivalent)<sup>2</sup> to enable KB to finance the credit requirements of 560,000 household sub-borrowers for farm and non-farm income-generating activities.

4. On the demand side, a Microfinance Social Development Fund was established [Project Completion Report (PCR) of Loan 1805-PAK (SF)] by SBP, KB, and six NGOs, with an intended duration of 25 years, for organizing 560,000 households to build their capacities for future microfinance borrowing and saving.<sup>3</sup> The Government provided financing for the Microfinance Social Development Fund equivalent to \$40 million from the program loan's counterpart funds. KB initially contributed PRs1 million<sup>4</sup> and subsequently funded the Microfinance Social Development Fund with 10% of its annual profits (RRP, para. 76). Simultaneously, a Community Investment Fund [PCR of Loan 1805-PAK (SF)] was established by SBP from the program loan's counterpart

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<sup>1</sup> The MSDP was wholly consistent with the Pakistan Government's Interim Poverty Reduction Strategy Paper (paras. 42-44 and 68 of RRP).

<sup>2</sup> The total investment requirement for this intervention was estimated at \$166 million equivalent. ADB's loan was to finance \$68 million, KB's \$73 million, and the sub-borrowers; \$25 million through their savings deposits (para. 90 of the RRP).

<sup>3</sup> These NGOs were Rahnuma-FPAP, Sindh Graduate Association, Health and Nutrition Development Society (HANDS), Human Development Foundation (HDF), Society for Human Development and Indus Resource Center (IRC).

<sup>4</sup> Based on KB's financial statements.

funds and with an intended duration of 25 years to provide long-term funding for microfinance community infrastructure projects. The Government contributed \$20 million equivalent to the Community Investment Fund from the counterpart funds of the policy loan, and KB contributed PRs1 million (RRP, para. 77).<sup>5</sup> Both the Microfinance Social Development Fund and Community Investment Fund were intended to be dedicated facilities for KB for the first 3 years of the loan's implementation. Thereafter, other licensed microfinance institutions were proposed as donors (RRP, para. 78).

## A. Relevance of Design and Formulation

5. The MSDP was ADB's first experience with a sector-development approach to microfinance. Poverty reduction was ADB's overarching goal in the MSDP through its policy and investment loan interventions. The policy loan sought to create an enabling policy and regulatory framework for microfinance in Pakistan for the first time. The Project leveraged policy actions by providing investment resources to facilitate formal microfinance lending (on a non-collateralized basis) by a dedicated microfinance bank in Pakistan, which was also an innovation. While providing resources on the supply side, the Project simultaneously sought to manage the demand for investment funds by building social capital (para. 2). The Project's rationale was consistent with ADB's microfinance objectives,<sup>6</sup> ADB's country operational framework in Pakistan,<sup>7</sup> and the Government's Poverty Reduction Strategy (footnote 1). The Project was formulated based on the outputs of a well-designed project preparatory technical assistance (PPTA).<sup>8</sup> ADB consulted adequately with the Government, SBP, the World Bank, International Monetary Fund (IMF), and NGOs (in particular, the Microfinance Group)<sup>9</sup> in the (i) design of the MSDP, (ii) direction of expected reforms, and (iii) partnership for outreach expansion (paras. 3-4 of RRP). ADB's consultation with these stakeholders was particularly important given that the MSDP was ADB's first ever microfinance intervention in Pakistan. While designing the Project, ADB incorporated lessons from other rural development projects in Pakistan, and drew upon experiences from other countries with more mature microfinance markets and adapted these lessons to Pakistan's conditions (RRP, para. 51). Importantly, KB was considered as an important microfinance provider based on the experiences of the Grameen Bank of Bangladesh and Bank Rakyat Indonesia (RRP, para. 56). The Project was appropriately designed (in terms of structure), satisfactorily formulated, and consistent with ADB's and the Government's goals. But, its design proved to be only partly relevant.

6. Other than lending, the MSDP has not helped social capital formation on any significant scale. The Project focused on (i) Microfinance Social Development Fund group organization and capacity building, and (ii) Community Investment Fund with microfinance infrastructure whose financing sought to segregate social intermediation costs with financial ones to avoid cross subsidies by KB.<sup>10</sup> [In reality, social and financial intermediation costs could not be segregated (paras. 19 and 32).] Regrettably, this same sound structural logic was not followed in the design of

<sup>5</sup> KB also made an initial contribution of PRs1 million each to Risk Mitigation Fund (RMF) and Deposit Protection Fund (DPF).

<sup>6</sup> ADB. 2000. *Finance for the Poor: Microfinance Development Strategy*. Manila.

<sup>7</sup> ADB's country operational framework for Pakistan (1999-2000) emphasized the importance of microfinance as an important sectoral intervention for a greater poverty reduction impact (RRP, para. 48).

<sup>8</sup> ADB. 1997. *Technical Assistance to the Islamic Republic of Pakistan for the Rural Microfinance Project*. Manila, approved on 12 December 1997 for \$600,000.

<sup>9</sup> The Microfinance Group was sponsored by the Aga Khan Foundation and the Asia Society.

<sup>10</sup> In December 2003, a change in implementation arrangements was effected to allow (i) the cost of social intermediation undertaken directly by microfinance institutions to be reimbursed by Microfinance Social Development Fund, and (ii) other specialized agencies' access to Microfinance Social Development Fund resources for providing social intermediation services.

the loan's re-lending and on-lending arrangements where there were implicit subsidies.<sup>11</sup> This implicit subsidy to KB allowed it to increase microfinance expansion in its early years without needing to generate customer deposits (para. 9). In that context, the loan's low cost funds obviated KB's need for mobilization of deposits to fund its core lending, which would have an adverse impact on its efficient financial intermediation in the future. SBP endorsed this perspective fully in its comments on the draft PCR. The Project's institutional strengthening component covered too wide an area. While capacity building for microfinance supervision in SBP and service delivery in KB were justified to ensure more prudent and efficient credit delivery, the project component relating to the portfolio audit of Zarai Taraqiati Bank Limited, formerly known as the Agricultural Development Bank of Pakistan, was not. Zarai Taraqiati Bank Limited was not an intermediary in this loan and the inclusion of a component for its portfolio audit, whose logic was not explained, is not sound. The upgrading of two NGOs into registered microfinance institutions did not materialize. SBP has stated that they were not ready for transformation. The social capital formation role for KB was based on overly-optimistic assumptions about the NGOs' abilities. In retrospect, the Project's design and formulation would have been more sound and more relevant had it focused only on: (i) strengthening KB's microfinance outreach extension, (ii) enhancing the institutional capabilities of SBP and KB, and (iii) passing on the exchange and intermediation risks to KB to enable it to price its onlending realistically and without implicit subsidies.

## **B. Project Outputs**

7. The Project had three components envisaged at appraisal: (i) strengthening KB's microfinance outreach extension, (ii) enhancing the institutional capacity of microfinance supervision and delivery agencies, and (iii) enhancing community capacity for building social capital. There were two changes in project scope during implementation that related to the third component immediately above (see para. 18 for more detail). The components' achievements are stated below.

### **1. Khushhali Bank's Microfinance Outreach Extension**

8. Under the Project, KB was provided a credit line of SDR52.206 million (\$68 million) to support KB's microfinance outreach extension. By the sixth year of its operations in 2007, KB was expected to meet the following parameters: (i) a loan portfolio of PRs7,430 million; (ii) subloans to 560,000 households, not exceeding PRs19,600 (\$350) equivalent each; (iii) microfinance customers' savings deposits to fund at least 20% of the loan portfolio (PRs158.6 million) and the balance, other than those funded by the investment loan, to be funded by market borrowings; (iv) subloan recoveries of at least 90%; (v) an outreach network comprising 7 control offices, 34 branches, and 1,506 staff; and (vi) women comprising 40% of KB's microfinance subborrowers. In addition, KB established for itself the following financial benchmark ratios to be achieved by 2007: (i) return on assets (ROA) of 2.8%, (ii) return on equity (ROE) of 13.1%, and equity to total assets (ETA) of 21%.

9. By the end of 2006, ADB had disbursed SDR51.575 million (\$74.2 million) to KB under the credit line (Appendix 2).<sup>12</sup> While it played a critical role, KB's achievements of its quantitative and

<sup>11</sup> The Borrower bore the exchange risk and re-lent the loan funds to KB at an interest rate calculated based on average weighted cost of deposits during the preceding six months in the banking industry. In effect, the relending average rate between 2001 and 2007 fluctuated between 1.28% and 4.33% (Appendix 1). Considering that the Pakistani rupee depreciated against the SDR between 2001 and 2007 by 23.3%, this effectively resulted in an additional subsidy to KB. The RRP (para. 100) justified this implicit subsidy. It argued that low cost funding from ADB's special funds was necessary to allow KB to accumulate capital and strengthen its financial position to enable outreach expansion.

<sup>12</sup> The excess disbursement in dollar terms is attributable to the depreciation of the dollar against the SDR between 2003 and 2007.

financial targets have been mixed. KB overestimated the demand for microcredit disbursements between 2001 and 2006. Based on a National Rural Support Program (NRSP) model, KB envisaged that its total credit disbursements for the period 2001–2006 would be PRs21.6 billion and the loans outstanding on 31 December 2007 would be PRs7.43 billion. In reality, KB's loan disbursements between 20 August 2001 and 14 February 2006 (the date up to which KB sought funding from ADB for its credit outreach) were PRs5.51 billion (\$93.66 million), against an appraisal estimate of PRs9.29 billion (\$165.9 million), and its loans outstanding on 31 December 2007 totaled PRs2.65 billion (\$43.5 million). As this was KB's first foray into microfinance, it capped its repeat loans at 20% beginning in 2005 to control loan delinquencies. KB's inability to generate the customers' deposits intended to finance 20% of its lending, which represented a failure to meet another envisaged target, reduced its potential lending and disbursement headroom. Given its collection rate of over 80% and the fact that KB did not generate deposits, the lower-than-projected outstanding portfolio reflects the bank's prudent fund management. It had 283,965 active subborrowers as of 31 December 2007, against its target of 560,000 households. This shortfall was due to a high attrition rate. KB's rapid branch outreach expansion, particularly in the country's remote regions in accordance with the Government's priorities, diverted KB's resources from developing an efficient cash management system to generating and investing deposits in accordance with SBP regulations. This endeavor distracted KB's attention from developing customer deposit products. KB instead relied on a single product, microfinance loans. KB justified this strategy as necessary for concentrating its critical mass of expertise on this single product. SBP believed that KB should have started mobilizing customers' deposits simultaneously in all of its branches.

10. KB's entire lending has been financed by the loan, subborrowers' equity, refinancing by SBP, and borrowings from other banks (Appendix 1). Given the low cost of KB's long term funds from the loan and shareholders' equity, high interest margins, and the short term of its lending, KB has not suffered a liquidity crisis. SBP believes that KB's business model, which is highly dependent on subsidies, is not sustainable unless KB generates customers' deposits to fund its lending.<sup>13</sup> KB recognizes that in the future it will need to access customers' deposit to fund its lending program. KB's average microfinance subloan size was PRs9,710<sup>14</sup> (\$162.8), which was within the ceiling of PRs19,600 (\$350) per subloan that KB set for itself.

11. On average, only 24.5% of KB's subborrowers were women, against a target of 40%. In addition, the percentage of women borrowers declined between 2001 and 2007.<sup>15</sup> KB effected a change in its gender targeting policy in 2003, after which time only those women who were the actual users of loan funds would qualify for lending. This was done to disallow women serving as surrogate borrowers for loan funds actually utilized by their male relatives. Loans were made to women who owned assets or bank balance (not necessarily as collateral) registered in their name. KB reiterated that although the number of its women borrowers fell short of its envisaged target, the bank was certain that its numbers represented actual women borrowers using the funds for businesses owned or managed by women. KB's preference for transparency in reporting actual loans to women, rather than opting for surrogacy, is reflective of its commitment to use microfinance as an instrument of poverty reduction among women. This commitment is commendable.

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<sup>13</sup> This is based on SBP's inspection report on KB through both off-site and on-site supervision for the first 9 months of 2007, which covered KB's operational and financial performance.

<sup>14</sup> The average loan size was PRs9,318 in 2001, PRs10,578 in 2002, PRs9,634 in 2003, PRs9,255 in 2004, PRs9,249 in 2005, PRs9,996 in 2006, and PRs9,940 in 2007.

<sup>15</sup> Women subborrowers accounted for 32.4% in 2001, 30.9% in 2002, 34.1% in 2003, 24.6% in 2004, 18.4% in 2005, 15.6% in 2006, and 15.7% in 2007.

12. KB's average subloan recovery rate between 2001 and 2007 was 81.5%, which fell short of the envisaged target of 90%.<sup>16</sup> KB reported that its delinquency in 2002, 2003, and 2005 increased with repeat loans to the same borrowers. Its reduction of incremental repeat loans (capped since 2005 at 20%) led to an improvement rate in recoveries, albeit at the cost of a higher attrition rate among customers.<sup>17</sup> KB reiterated that it did not reschedule any of its loans and is strict in its definition of loan delinquency. Any loan that was not repaid by its due date, even with minimal slippage, would be declared delinquent. A significant portion of KB's lending goes towards crop and livestock financing. In these sectors, seasonal and other cycles render output turnover and cash realization irregular. When combined with KB's strict definition criteria, the result has been overall collection rates that fall below the envisaged targets. Repayments made after the due date are not taken into account for the determination of the collection ratio. Nonetheless, KB has realized repayments after their due date. This is reflected in KB's declining portfolio at risk (PAR) comprising sub-standard, doubtful, and bad loans. KB's PAR has declined every year between 2003 and 2007: from 7.84% in 2003 to 6.39% in 2004, to 4.83% in 2005, to 2.17% in 2006, and to 1.51% in 2007 (Appendix 1). In light of these circumstances, KB's lower-than-expected loan collection ratio has not significantly affected its portfolio quality. As of 31 December 2007, KB's loan loss provisions (LLP) in its audited financial statements were PRs64.3 million, which prima facie appears adequate. SBP's report (footnote 13) stated that KB's LLP should be PRs67.35 million as of 30 September 2007.

13. Analysis of KB's performance between 2001 and 2007 shows it to be a fast-growing, comfortably-solvent, and highly-liquid institution. KB's branch network expanded from 26 in 2001 to 113 in 2007, which covered 88 districts that included some of the most marginalized areas in the country such as the Federally Administered Tribal Areas (FATA), Balochistan, and earthquake-affected areas. In addition, its staff increased from 341 in 2001 to 1,865 in 2007. These increases exceeded the envisaged targets of 34 branches (covering 30 districts) and 1,506 staff members. Expanding its branch network beyond envisaged targets, KB increased its financial intermediation costs. When coupled with higher loan delinquencies, KB's ROA decreased to 1.32% (against a benchmark of 2.8%) and its ROE decreased to 5.02% (against a benchmark of 13.1%) in 2007 (Appendix 1).<sup>18</sup> KB's equity to assets ratio (EAR) declined from 97.6% in 2001 to 26.8% in 2007, but the bank remains comfortably solvent. This is attributed to KB's access to low-cost and long-term funding from ADB's Special Funds, which facilitated the strengthening of its financial condition in its early years (footnote 11). KB's borrowing rate from the Government ranged between 1.28% and 4.33%. Its onlending rate was 20%, which was raised to 23% in 2008. This provided KB with a significant interest spread cushion.

## **2. Enhancing the Institutional Capacity of Microfinance Supervision and Delivery Agencies**

14. This component envisaged: (i) enhancing the institutional capacity of SBP to monitor and regulate an enabling environment for the growth of microfinance; (ii) training KB staff at SBP's National Institute of Banking and Finance in Islamabad to provide efficient and extensive microfinance services; (iii) conducting studies and surveys, developing and regularly updating training materials, and preparing operation manuals for KB; (iv) engaging consultants to assist in capacity-building activities and trainings; (v) funding related travel expenses; (vi) financing

<sup>16</sup> KB's subloan recovery rate was 85.2% in 2001, 76.1% in 2002, 78.8% in 2003, 85.8% in 2004, 79.6% in 2005, 82% in 2006, and 83.1% in 2007.

<sup>17</sup> SBP's report stated that KB's client attrition rate for the first 9 months of 2007 was 37.25% compared to 22.43% a year earlier. Considering that KB was unable to generate customers' deposits, the mere attrition in numbers of customers is acceptable.

<sup>18</sup> If KB made an additional loan loss provision of PRs2 million in 2007 (as recommended by SBP's observations), its return on assets for 2007 would decrease to 1.22%.

equipment and vehicles' purchase by KB to implement and manage its outreach expansion in remote areas; (vii) transforming two NGOs into regulated microfinance institutions; and (viii) auditing the portfolio of Zarai Taraqiati Bank Limited. The total cost allocated to this component at appraisal was \$15.140 million, of which ADB was to finance \$9.336 million (Appendix 1, para. 21; and Appendix 2).

15. The achievement of capacity-building outcomes was mixed. The actual cost of this component was \$9.8 million (Appendix 1, para. 22; and Appendix 2). SBP did not avail of the funding from this loan for enhancing its capacity for supervising microfinance institutions because SBP received grant funding from the Swiss Agency of Development Cooperation (SDC) for the same purpose. KB's performance on staff training was satisfactory. The training covered new product development, debt collection methodology, microfinance orientation, and supervision of customer services. KB's operational manuals were prepared by using its internal staff resources and not through external consultancy. KB has established a centralized processing unit for the consolidation of all back office processing. Comprehensive banking software was installed for this purpose. Nonetheless, the total amount utilized by KB was lower than the amount originally allocated (or reallocated) for each line item (see Appendix 2). This is attributable to KB's conscious decision to have its staff trained within the country at SBP's National Institute of Banking and Finance, which provided the venue and facilities for courses customized to its needs. Most of its trainers were KB's senior management executives. KB almost fully utilized the amount originally budgeted for vehicles.<sup>19</sup> For equipment, an additional reallocation of SDR644,000 was made to the original allocation of SDR1,355,000 for a new total of SDR1,999,000. This was reduced on 19 February 2008 by SDR460,000, leaving the total reallocated figure at SDR1,539,000. However, utilization of disbursements amounted to only SDR1,248,689 million. This is attributable to KB's decision not to acquire core banking function software from a Singapore vendor as originally envisaged. KB realized that even with the reallocation approved by ADB on 14 March 2005 there was inadequate funding to finance such a package and, therefore, decided against its acquisition. As an interim measure, KB asked a local vendor to develop proprietary credit management systems software on a Microsoft server platform for PRs3.3 million. SBP's inspection report (footnote 13) stated that inadequate system integration resulted in delayed information regarding loans and conflict between branches and the head office.

16. The transformation of the two NGOs into microfinance institutions was not realized as the NGOs were not sufficiently ready. Nevertheless, there are six microfinance banks in Pakistan, including KB.<sup>20</sup> SBP utilized a portion of the loan funds available for microfinance institutions' licensing. SBP also utilized loan funds set aside for consultant services for the portfolio audit of Zarai Taraqiati Bank Limited.

### **3. Enhancing Community Capacity for Building Social Capital**

17. Increasing the social capital of the poor by increasing economic opportunity through a participatory process is necessary to create targeted demand for microfinance on a sustainable basis. This will also enable microfinance interventions to successfully contribute to poverty reduction efforts. The MSDP provided for the establishment of the Microfinance Social Development Fund and Community Investment Fund (para. 4), which were intended to help enhance social capital by creating and strengthening a network of community organizations.<sup>21</sup>

<sup>19</sup> This was facilitated by ADB accepting KB's purchase of foreign vehicles from dealers in Pakistan as indirect foreign exchange expenditure eligible for 100% reimbursement.

<sup>20</sup> The other five microfinance institutions are Rozgar Microfinance Bank, Network Microfinance Bank, Pak Oman Microfinance Bank Ltd., Tameer Microfinance Bank Ltd., and First Microfinance Bank Ltd.

<sup>21</sup> Community organizations are NGOs from a local geographical area listed with the responsibility (as delivery points) for social and financial services to their members.

These community organizations were expected to increase economic and social interactions with the excluded sections of society (para. 78 of RRP).

18. The investment loan provided for the: (i) formation of 24,750 community organizations (40% of each of them comprising women members) covering about 560,000 households; (ii) training of one leader from each of the 24,750 community organizations through a 4-day course on community skills management; (iii) 2-day training to be conducted by the 24,750 community organization leaders for their 560,000 households in basic numeracy and management of income-generating activities, basic introduction to banking including deposit mobilization and access to microfinance borrowing, investment plans, group consensus for borrowing decisions and repayment structures, social awareness, and gender empowerment;<sup>22</sup> (iv) attendance of 12,412 women community leaders at a 3-day capacity-building course;<sup>23</sup> (v) attendance of 1,240 of these women at a 10-day leadership management training course (a total of 1,409 regional workshops were to have been funded during project implementation); and (vi) financing of 4,500 community infrastructure sub-projects by the community organizations (up to 40% of individual subproject costs) and by the Community Investment Fund (up to 60%) (RRP, paras. 92-95). Two changes in scope were effected in this area. The first change in scope, which was approved by ADB on 22 December 2003, reduced the community organizations' contribution for financing community infrastructure subprojects to 20% as a result of KB's assessment that each district of the country has poverty pockets and reducing the community organizations' contribution would better serve the underdeveloped districts and provide a level playing field to all contributors. The second change, which was approved by ADB on 20 December 2005, was the conversion of the Community Investment Fund (and its accrued income and the accrued income on the Microfinance Social Development Fund) into an Emergency Livelihood Restoration Fund (Loan 1805-PAK[SF] PCR) to expeditiously restore the livelihoods of households affected by the earthquake of 8 October 2005. Following its conversion, the fund was allocated an additional SDR1.6 million, and a further SDR460,000 (under the line item "equipment") from the unused funds of the project loan.

19. The realization of the Project's expected social capital outputs has been mixed. Against an appraisal estimate of \$23.2 million, this component's actual cost was \$9.35 million (Appendix 2). A partnership agreement with an NGO service provider, the Family Planning Association of Pakistan, was signed in May 2002 to build social capital in participating communities. More than 90,000 community organizations were formed, which exceeded the Project's target. The cost of forming community organizations was lower than envisaged at appraisal due to the depreciation of the Pakistan rupee. The community organization leaders were trained in the 4-day community skills management courses. The planned trainings for 1,240 women for 10 days, 24,750 team leaders for 2 days, and 12,412 women activists for 3 days were not held due to the absence of available trainers. In addition, no regional workshops were held during project implementation. This was due to the lack of adequate resource persons available. In some instances, KB had to conduct customer training at its own expense. This inevitably increased KB's social intermediation costs, which the project design had sought to separate from the financial intermediation costs (para. 6). One thousand six hundred Community Investment Fund projects were financed jointly by the community organizations (40%) and Community Investment Fund (60%), against a target of 4,500. The shortfall was the result of the balance of the Community Investment Fund being diverted in December 2005 to the Emergency Livelihood Restoration Fund following the earthquake of 8 October 2005.

20. The implementation of the social capital building component fell short of its envisaged targets owing to: (i) delays in the holding of seminars or workshops in remote areas of the country,

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<sup>22</sup> These training programs were to be held in the villages.

<sup>23</sup> Trainings for (ii) and (iii) were to be held at NGOs' facilities wherever available.

particularly in Balochistan, North West Frontier Province (NWFP), and FATA; (ii) difficulties in the standardization of training curricula, given the divergence in skills required of clients spread geographically over a wide area; (iii) cost increments unforeseen at project preparation; and (iv) a decision to divert the balance of the Community Investment Fund to the Emergency Livelihood Restoration Fund. The project design had assumed that NGOs could undertake this task with funding to be provided by the Microfinance Social Development Fund, which was not in existence at the time of project design and had no track record of completing such tasks. KB found that the NGOs it tried to enlist lacked the capacity to effectively link with KB's plans.

### **C. Project Costs**

21. At appraisal, the total project cost was \$217.2 million, comprising \$50.0 million in foreign exchange and \$167.2 million in local currency. ADB agreed to finance 37% of the project cost through a loan of \$80.0 million comprising \$43.8 million in foreign exchange and \$36.2 million in local currency costs (RRP, Table 2). ADB's lending covered credit outreach of \$67.5 million, institution building of \$10.2 million, and interest charges of \$ 2.3 million. The Microfinance Social Development Fund and Community Investment Fund were to finance \$6.2 million in foreign exchange from the proceeds of the policy loan and \$21.9 million in local currency. KB agreed to finance \$74.1 million, KB's subborrowers \$30.3 million, and the Government \$4.7 million (in local currency costs) for institution building (RRP para 99 and appendix 12).

22. On 14 March 2005, ADB approved the reallocation of SDR644,000 (\$986,595) from the unallocated category to systems and equipment to accommodate the cost of a banking software system to support KB's operational efficiency and reduce the cost of service delivery. Subsequently, on 19 February 2008, ADB reduced the allocation for equipment and systems by SDR460,000 (\$726,202) to accommodate the actual claim for the balance of the Community Investment Fund that was transferred to the Emergency Livelihood Restoration Fund (paras. 16-17).

23. Actual project costs (Appendix 2) were \$115.1 million, comprising \$44.3 million in foreign exchange and \$70.8 million equivalent in local currency. ADB financed \$85.39 million,<sup>24</sup> consisting of \$44.32 million in foreign exchange and \$41.07 million equivalent in local currency (Appendix 2).<sup>25</sup> ADB financed a total of \$ 74.2 million in credit outreach through 14 February 2006, the date up to which KB submitted claims to ADB for disbursements under this line item. KB financed \$19.5 million for credit outreach as its contribution. KB financed \$702,324 in institutional strengthening costs in local currency. The Microfinance Social Development Fund financed PRs557,697,025 (\$9.35 million) and the Community Investment Fund PRs205,431,256 (\$3.4 million).

24. This discrepancy in actual vs. projected costs is attributable to (i) lower-than-expected demand for microcredit (para. 9), (ii) lower-than-expected social capital building (para. 19), and (iii) non-utilization of a significant portion of the loan budget for institutional strengthening (para. 15).

### **D. Disbursements**

25. The initial disbursement occurred five months after the loan was declared effective. By the fifth year of implementation in 2006, 98.7% of subloans under the credit line component were disbursed by ADB. The appraisal's disbursement schedule for the credit component was realistic. Except for equipment, systems, and vehicles, the utilization of funds under institutional strengthening was relatively low. This was because SBP financed its institutional strengthening from grant funds provided by SDC and not from loan funds under the investment loan. The

<sup>24</sup> Inclusive of IDC \$2,249,928 (SDR1,524,986).

<sup>25</sup> In effect, ADB financed 74.8% of total project cost against an appraisal estimate of 36.8%.

Government did not finance any part of KB's institutional strengthening cost. The portion not financed by the ADB loan was financed by KB from its own sources.

26. A total of \$83.14 million, excluding interest during construction (IDC), was disbursed from the loan account (Appendix 3) through an imprest account established by SBP, and by direct payment and development finance institution procedures. The first and last disbursements were made in Aug 2001 and April 2008, respectively. From the scheduled project completion on 31 December 2006, the project took 16 months to resolve issues relating to Community Investment Fund financing and cost sharing, liquidation of imprest account advances, and settlement of final payments under the institutional strengthening component. During implementation, SBP used the imprest fund procedure to finance institutional-strengthening expenditures. However, the last four withdrawal applications, including a one-time claim against the Community Investment Fund for \$3.2 million,<sup>26</sup> were paid directly to KB since replenishment of the imprest account was not allowed given the stage of the project with respect to the loan closing date. SBP had received Community Investment Fund claims from KB since April 2005, which were then withheld by SBP due to KB's low customer retention and high attrition rate (para. 9) at the time.<sup>27</sup> On 2 April 2007, SBP requested ADB to reallocate funds and create a Community Investment Fund category under the project loan to accommodate the claims. After the reallocation was approved and subproject agreements between KB and community organizations were reviewed by ADB, KB was directly reimbursed by ADB for the Community Investment Fund claims on 11 April 2008. ADB's use of the imprest account, direct payment, and development finance institution procedures were relevant to the loan's efficient implementation.

27. The SBP and KB had adequate knowledge of ADB disbursement procedures. During 2007, there was extensive communication between ADB, SBP, and KB in (i) sorting, reviewing, reconciling, and eventually clearing settlement of Community Investment Fund claims; (ii) correcting the statement of expenditures or summary sheets attached to the withdrawal applications as those submitted did not comply to the ADB format; and (iii) clarifying payments from the imprest fund made after the loan closing date and items that exceeded the statement of expenditures limit.<sup>28</sup> Consequently, the loan account was kept open until liquidation and payments were finally settled in April 2008.

## **E. Project Schedule**

28. At appraisal, project implementation was envisaged to cover a 6-year period with a completion expected by 30 June 2007. While the credit outreach component was 98.7% disbursed by 31 December 2006, the loan was not closed until 22 April 2008. This was to facilitate disbursements under the loan's non-credit components commuted before the loan's closing date. The diversion of money from the Community Investment Fund to the Emergency Livelihood Restoration Fund under a change in project scope in December 2005 necessitated that the loan account be kept open until 22 April 2008 to facilitate such disbursements (paras. 18-19). This extension arose from changes in project scope following the earthquake and did not impinge on the timely implementation of the outreach component of the microfinance loan. Given the expeditious signing of the loan agreement and its overall effectiveness, the original project schedule did not suffer from any cost overruns.

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<sup>26</sup> Community Investment Fund claims consisted of small infrastructure projects, consultancy fees, and management costs from July 2004 to June 2007.

<sup>27</sup> Source: Letter from SBP dated 2 April 2007 to ADB.

<sup>28</sup> A review of supporting documents in final liquidation application showed that payments and services were incurred before the loan closing date. These eligible payments that were incurred prior to 30 June 2007 were liquidated by ADB after 30 June 2007.

## **F. Implementation Arrangements**

29. A project management unit was established by SBP to oversee submission of periodic reports, arrange for audits of the Microfinance Social Development Fund, Community Investment Fund, Risk Mitigation Fund, and Emergency Livelihood Restoration Fund; and review KB's disbursement requests. KB established a project implementation unit comprising one person in its office.<sup>29</sup> KB was generally punctual in submitting progress and other required reports to ADB throughout the project implementation period. KB, through SBP, submitted reimbursement requests against the ADB credit line on the basis of amounts disbursed to its borrowers. For claims under the institutional strengthening component, SBP reviewed and reimbursed KB's claims through its imprest account. Institutional strengthening claims by KB were reviewed by SBP's project management unit before they were forwarded to ADB for payment. Claims against the Microfinance Social Development Fund and Community Investment Fund were made by submission of claims to the respective fund's secretariat along with proof of engagement and completion of services invoiced by NGO service providers. Both SBP's and KB's implementation arrangements were satisfactory. In delivering the project outputs, two changes in implementation arrangements were effected to (i) alter the financing share of community organizations (para. 18) and (ii) transfer a surplus from the Community Investment Fund to the Emergency Livelihood Restoration Fund.

## **G. Conditions and Covenants**

30. The Loan Agreement was signed and became effective within 2 months of ADB Board approval. The quick effectiveness reflected KB's commitment to expeditious project implementation. There were no procedural problems under this loan.

31. The general and specific covenants in the loan and project agreements were relevant to the Project's objectives. KB complied fully or substantially with the majority of the covenants of the loan and project agreements. The covenants in which KB's compliance was less than full include: (i) maintaining a ratio of its field office staff to borrowers of 1:700 (Loan Agreement Schedule 6, para. 7); (ii) outsourcing community development to NGOs (Loan Agreement Schedule 6, para 7); (iii) training and mobilizing NGO and community organization staff (Loan Agreement Schedule 6, para 16.); (iv) meeting the target of having women comprise a minimum of 40% of microfinance beneficiaries (Loan Agreement Schedule 6, para 26-27); and (v) advising ADB of any changes in KB's charter (Project Agreement Article II Section 2.15) or board membership (Loan Agreement Schedule VI para. 4).

32. KB's ratio of field staff to subborrowers was 1:590. This was due to a high attrition rate among subborrowers. While such a ratio may have impinged on KB's intermediation costs, it nonetheless helped in keeping KB's loan collection ratio high since there were more staff to monitor subborrowers' repayment. KB did not entirely outsource its community development and community organization formation to NGOs due to the dearth of reliable and credible NGOs. KB instead opted to undertake community organization formation for social mobilization at its own cost. While raising KB's intermediation costs, it helped to create an alternative for NGO-envisaged activities and provided KB with practical experience for future replication. This also explains why the training of NGO staff was not fully complied with. KB's target of having women comprise 40% of microfinance beneficiaries did not materialize because KB was strict in ensuring that only genuine women entrepreneurs benefited from this program. Women were prohibited from acting as surrogate subborrowers for the benefit of male beneficiaries. KB's preference for transparency accounted for its conservatism vis-à-vis women subborrowers and was the reason that KB did not

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<sup>29</sup> Seconded from the Ministry of Finance for 3 years and placed in the Office of the President of KB.

meet this target. Overall, KB's partial compliance with these four of the covenants has not adversely affected the Project's performance. KB's partial compliance with these four covenants is understandable given the realities on the ground and KB's prudence in meeting project objectives. KB's failure to inform ADB of the changes to its charter in April 2008 and notification of changes to its board membership on an ex post facto basis were lapses on KB's part.

33. Two changes in project scope were effected (para. 18). Both of these changes were relevant to enhancing the project scope in light of evolving circumstances.

#### **H. Consultant Recruitment and Procurement**

34. The Project provided for 66 person-months of international consultancy and 37 person-months of domestic consultancy to be provided in the areas of: (i) policy and regulatory framework, (ii) KB institutional strengthening, and (iii) social-intermediation strengthening (RRP Appendix 16). The only consultancy financed under the project was for an international firm to conduct the portfolio audit of Zarai Taraqiati Bank Limited to establish the policy and regulatory framework (6 person-months). The firm was selected in accordance with ADB's *Guidelines on Selection of Consultants*.

35. Procurement financed under the Project for the institutional strengthening component comprised vehicles, equipment, and information technology systems for KB. The actual procurement costs were less than appraisal projections (para. 20 and Appendix 2). All procurements were conducted in accordance with ADB's *Procurement Guidelines*.

#### **I. Performance of Consultants, Contractors, and Suppliers**

36. Zarai Taraqiati Bank Limited and SBP were satisfied with the outputs of the international consultants relating to the portfolio audit, which complied with the terms of reference. The international consultants undertook their work in a participatory manner and maintained cordial relations with their Zarai Taraqiati Bank Limited counterparts. KB was satisfied with the vehicles and equipment vendors.

#### **J. Performance of the Borrower and the Executing Agency**

37. As the executing agency, SBP played a central role by its timely establishment of a project management unit in its Microfinance Division. SBP bore the administrative costs of the project management unit from its own funds. The project management unit efficiently managed all expenditures relating to the investment loan and the various funds created under the policy loan. In doing so, SBP thoroughly reviewed KB's claims and submitted them on a timely basis to ADB for reimbursement.

38. KB's operational performance was generally satisfactory. While its outreach expansion into the country's regions was impressive (para. 13), its ability to harness NGO services in forming community organizations and training its clients in the use of loan funds did not meet expectations (para. 15). SBP observed (footnote 13) that KB's corporate governance and internal audit processes were poor.<sup>30</sup> KB's financial performance was satisfactory in spite of its inability to raise customer deposits due to its access to low-cost funding through government subsidies (para. 13). However, under its present business model, the sustainability of KB's future lending outreach is unlikely.

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<sup>30</sup> SBP's report stated that KB's board's audit, risk management and procurement committees had not been met for 2 years.

## **K. Performance of the Asian Development Bank**

39. ADB's project supervision and administration were partly satisfactory. ADB fielded an inception mission in February 2001 immediately after the loan's effectiveness. ADB fielded nine review missions (including the PCR mission) between February 2001 and July 2008. ADB's review missions examined KB's microfinance outreach as well as linkages between the investment loan and the policy loan. ADB was prompt in responding to the Government's requests for changes in project scope to (i) lower the community organizations' share of social capital formation from 40% to 20% of the cost of rural community infrastructure projects due to a lack of available funds (December 2003), and (ii) transfer unused funds of the Community Investment Fund and accrued income from the Microfinance Social Development Fund to the Emergency Livelihood Restoration Fund. In reallocating loan funds between different expenditure categories, ADB was pragmatic in its realization that the Borrower would benefit from using grant assistance for institutional capacity building, rather than financing it from loan funds. Its reallocation decisions reflected such understanding. ADB's project administration missions did not however impress upon KB the need to raise customers' deposits to fund at least 20% of its portfolio as required under the loan. Ideally, ADB should have conducted a mid-term review around 2004 to analyze KB's financial performance against the assumptions made in 2000. A mid-term review would have examined the continued viability and sustainability of KB's subsidy-dependent business model, as observed by SBP in light of KB's failure to generate customer's deposits, once its access to subsidized funding ended. Such a review could have helped KB to revise its business plan early on for eventual long-term sustainability. It appears that ADB's reviews concentrated only on KB's outreach, while ignoring its financial sustainability. Otherwise, the Project mostly had a satisfactory rating between 2002 and 2008. The activities to have been financed by the loan ended on 30 June 2007 (as planned at appraisal), but the loan account was kept open until 22 April 2008 to facilitate disbursements of funds committed before 30 June 2007.<sup>31</sup>

## **III. EVALUATION OF PERFORMANCE**

### **A. Relevance**

40. The project design was partly relevant at appraisal and through implementation. The project design was consistent with ADB's country operational framework, microfinance strategy, and the Government's poverty reduction strategy. It was formulated with the help of a well planned project preparatory technical assistance (PPTA) and in consultation with the Government, and other lenders and stakeholders (para. 5 and Appendix 5). However, the project design (i) covered too wide an area such as a portfolio audit for Zarai Taraqati Bank Limited, which was inconsequential to the project's overall success; (ii) was too optimistic about the role NGOs could play in social capital formation; and (iii) allowed KB access to subsidized credit and reduced the urgency for KB to raise customers' deposits to fund its lending after such subsidies ended. Arguably, the project design could have been more relevant if it had been more focused on ensuring KB's continued operational and financial sustainability after the loan funds would no longer be available.

### **B. Effectiveness in Achieving Outcome**

41. The Project was effective in its outcome (para. 44 and Appendix 5). It had a significant impact on poverty reduction and gender empowerment.

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<sup>31</sup> This was warranted significantly by disbursements on the ELRF component.

### C. Efficiency in Achieving Outcome and Outputs

42. The Project was less efficient than was envisaged at appraisal (Appendix 5) in its delivery and recovery of microcredit. KB's sound financial condition is attributable more to its access to subsidized funding from the ADB loan than to efficient financial intermediation. Nonetheless, project implementation was on schedule and did not require significant changes in scope.

### D. Preliminary Assessment of Sustainability

43. The business model adopted by KB is not sustainable over the long run. At appraisal, it was envisaged that KB would generate customers' deposits to fund at least 20% of its lending during the loan implementation period. Despite being in operation for 8 years, KB has been unable to generate any customer deposits (Appendix 5). It has instead relied on its access to subsidized funding from the loan to finance its lending. SBP's observation of KB's poor corporate governance may impinge on KB's ability to raise independent funding to finance its outreach and render both KB and its outreach efforts unsustainable. KB's performance indicates that it is unsustainable even when judged by its operational self-sufficiency (OSS) ratio and financial self-sufficiency (FSS) ratio, typically used to measure the performance of microfinance institutions, when compared to those of First Microfinance Bank, its comparator.<sup>32</sup>

### E. Impact

44. The Project had a positive impact on the development of microfinance in Pakistan (para. 41 and Appendix 5). According to an independent study,<sup>33</sup> the project demonstrated positive impacts on its participants in terms of monetary and social indicators of welfare and employment. The highest impact was noticed in the agricultural sector, where most outcome variables—assets, inputs, and sales, were higher for those who had more access to the program. In addition, the Project had a positive impact by generating (family and non-family member) employment opportunities in all sectors, which was facilitated by the start-up of household enterprises. Microfinance borrowers demonstrated significantly higher sales and profits than non-participants. Socially, the poorest bottom quintile of the study's sample, including women in this group, benefited significantly. This is attributable to microlending for education and health purposes (preventive medicine, immunization, and family planning), which improved women's health and income-generating capabilities among the poor. The study concluded that, given a supportive regulatory environment, it is possible for a commercial microfinance bank to pursue a humanitarian mission while also seeking profits.

## IV. OVERALL ASSESSMENT AND RECOMMENDATIONS

### A. Overall Assessment

45. Overall, the Project is rated as partly successful with a weighted rating of 1.10 (Appendix 5) in accordance with the definitions and guidelines provided by the Operations Evaluation Department.<sup>34</sup> The Project could have benefited from a more relevant design (paras. 6 and 40), and greater efficiency (para. 42) in achieving its outcome. KB's failure to generate customers' deposits to fund its outreach after the loan is no longer available reduces significantly the sustainability of KB's microfinance interventions.

<sup>32</sup> In 2007, KB's OSS ratio was 76% and FSS ratio was 56%. This compared unfavorably with First Microfinance Bank's OSS of 90%, and FSS of 80%. (Source: *Pakistan Microfinance Review*).

<sup>33</sup> Montgomery, Heather. 2005. *Meeting the Double Bottom Line—Impact of Khushhali Bank's Microfinance Program in Pakistan*. ADB Institute. Tokyo.

<sup>34</sup> ADB. 2006. *Guidelines for Preparing Performance Evaluation Reports or Public Sector Operations*. Manila.

## B. Lessons Learned

46. Three important lessons emerged from this loan:

- (i) **Need for Institutional Sustainability for Microfinance Delivery.** KB, through its outreach, was reasonably successful in addressing problems of poverty reduction and gender empowerment. However, it did not build adequate financial resources to be able to continue to do so sustainably after its access to subsidized funding from the loan ends. The Government's implicit subsidy of bearing the exchange risk of the loan and not charging KB a risk premium further exacerbated KB's complacency about funding its needs independently. KB's financial viability as an institution delivering on its microfinance mandate remains dependent on its access on subsidized funding. To ensure KB's financial viability, the Loan Agreement should have mandated financial covenants for KB such as (i) capital adequacy ratio, (ii) loan to deposit ratio, and (iii) return on assets ratio. Regrettably, these were not included as covenants. If the loan agreement had mandated the exchange risk transfer to KB, the bank might have been more conscious of its need for financial viability. If such covenants had been mandated, and by the fourth year of its operations in 2004 KB still had not raised any customers' deposits, ADB could have then withheld disbursements. Such leverage could have helped to impress on KB the importance of securing its own financial sustainability.
- (ii) **Need for Realistic Assumptions Regarding NGO Capabilities.** Considering that this was ADB's first formal microfinance project and program in Pakistan, ADB should have been more realistic about NGOs' capabilities and willingness to deliver social capital formation services in Pakistan's interior. It appears that the project design sought to replicate experiences of other countries with a stronger NGO success rate than was the case in Pakistan. KB had to finance many such activities out of its own funds. The loan's objective of separating KB financial intermediation costs from its social intermediation cost, which were to be funded by the Microfinance Social Development Fund, was not fully met. Had ADB required KB to undertake the social capital formation function itself and charge its lending rate accordingly, there could have been increased financial transparency and an end to implicit and explicit subsidies to KB.
- (iii) **Need for Project Focus on Institutional Strengthening.** The sub-component for the portfolio audit of Zarai Taraqati Bank Limited was unrelated to any of the deliverables under the loan. The amount spent on the audit could have been better spent on providing advisory services to KB for improving its own financial sustainability once ADB's concessionary loan funds would no longer be made available.

## C. Recommendations

### 1. Project Related

#### a. Certificate of Deposit Issue by Khushhali Bank

47. While KB's outreach and poverty reduction efforts are impressive, it needs to bridge its liquidity gap by 2009 to remain financially sustainable to undertake its mission. For this purpose, the bank's board is requested to consider issuing on a one-time basis a 7-year certificate of deposit (CD) to bridge its expected 2009 liquidity gap, considering that it has thus far been unable to raise customers' deposits. This proposed CD issue will need to be underwritten by investment banks in

Pakistan. To obtain such underwriting, KB will have to improve significantly its corporate governance by holding meetings of its board's committees, which SBP has reported have not taken place in the past 2 years, and stating so in its prospectus. KB would also need to improve its internal audit processes. Apart from addressing its immediate liquidity needs, a CD issue would help KB by (i) establishing a market benchmark for KB in assessing its own creditworthiness, which will determine its future ability to raise customer deposits; and (ii) testing the market based on a future equity issue through an initial public offering. Improving its liquidity through additional equity and deposits raised in the market alone can sustain KB's viability as a financial institution once its access to subsidized funding is over. SBP has endorsed this recommendation completely.

#### **b. Other Aspects**

48. As the loan is already closed, there are no outstanding disbursements or procurement-related issues. It is therefore inappropriate to recommend any changes to the covenants at this stage. The project performance evaluation report may be conducted immediately.

#### **2. General**

49. In future microfinance credit lines in Pakistan, it is essential for ADB to assess carefully the financial viability and sustainability of the microfinance intermediary institution to be able to operate successfully and without subsidized funding during the project's lifetime. Subsidies in interest rates are financially distortionary and should not be allowed to determine relending and onlending rates in microfinance. Only if an institution is found to be potentially viable should it be selected. In such instances, rigorous covenants should be established and enforced during the loan implementation period. It is better for the microfinance banks themselves to facilitate social capital formation and add these costs to their financial intermediation while determining interest rates. While NGOs can complement financial institutions' interventions, in this Project NGOs proved unable to act as a substitute for them. It is also necessary for institutional strengthening to be focused on the microfinance delivery bank and not on unrelated agencies. This is because microfinance is a financial intermediation activity and should not be construed as an act of charity.

## KHUSHHALI BANK

### A. Objectives, Mission, Strategy, and Mandate

1. In August 2000, Khushhali Bank (KB) was established by the Government of Pakistan under the Khushhali Bank Ordinance with commercial banks as its shareholders. It was a vehicle for the country's Poverty Reduction Strategy and its Microfinance Sector Development Program (MSDP). Both were developed with the assistance of the Asian Development Bank (ADB). It is headquartered in Islamabad and operates under the supervision of the central bank (State Bank of Pakistan [SBP]) (para. 5). Its mandate is to retail microfinance services and act as a catalyst in stabilizing the country's newly formed microfinance sector.

2. KB's mission is to strengthen the economic base of Pakistan's low-income populace (particularly the poor and women) by improving their accessibility to financial services. Its mission provides for poverty mitigation and social development promotion through social mobilization. By backing a diverse product set with exemplary customer service, and by combining efficiencies in cost and delivery systems, KB intends to achieve its core objective of attaining financial and operational self-sufficiency.<sup>1</sup>

3. KB's strategy to accomplish its mission (para. 2) is to transfer and build human, social, and physical capital for the poor in an efficient and sustainable manner. KB's strategy requires the bank to provide affordable financial services, comprising savings, credit, money transfer, and risk mitigation insurance to poor households to increase their consumption and augment their income-generating assets. KB intends that its social intermediation<sup>2</sup> will accompany financial services' penetration to ensure that social and gender dimensions of poverty are adequately addressed. KB established a goal of having 40% of its staff and 40% of its clients be women and has set about designing financial products to appeal to the poor in general and to poor women in particular. KB did not achieve either of these benchmarks (paras. 10 and 14).

4. KB's incorporation was Pakistan's first major initiative to bridge the demand for microfinance services. Integral to microfinance services is the intensive and sustained social support for mobilization, management, and development of all clients of the bank and their access to basic infrastructure services. As a commercial microfinance institution, KB's purpose is to:

- (i) establish a sustainable and scalable financial services platform benefiting the poor with retail delivery;
- (ii) catalyze an enabling environment, within which the microfinance sector can develop in Pakistan;
- (iii) assist the central bank in setting up an appropriate and responsive regulatory framework within which microfinance institutions can operate on sustainable grounds, thereby expanding outreach to the poor; and
- (iv) promote transparency, financial rigor, and good governance as leading indicators within the microfinance sector in Pakistan.

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<sup>1</sup> Financial self-sufficiency is the ability to maintain its solvency, liquidity, and profitability without government or donor subsidies. Operational self-sufficiency is the ability to carry out operations necessary to accomplish its mandate independent of political interference.

<sup>2</sup> Improving the conditions for the hitherto excluded segments of the population to access finance through grassroots training in group formation, vocational and financial skills, and other such schemes.

## **B. Ownership and Corporate Governance**

5. The authorized share capital of KB is PRs5 billion. Its paid-up capital of PRs1.7 billion has been subscribed by one state-owned commercial bank (National Bank of Pakistan), ten private commercial banks, and three foreign banks.<sup>3</sup> The maximum single shareholding is 23%.

6. An 8-member board of directors comprising professional bankers and social development specialists governs the bank's policies and provides guidance to the management in establishing a robust, customer-centric platform. The bank's core management is selected from the banking industry bringing skills in operations and financial management. Four of KB's board members are nominees of its shareholding banks. The chairperson of the board is the President of the National Bank of Pakistan, the majority shareholder in KB. The president is the chief executive officer and a professional banker with considerable experience in microfinance. Persons drawing remuneration from the Government and members of political parties are ineligible to become a director.

7. In theory, KB's board meetings are to be held monthly. In practice, according to SBP, KB's board does not ensure effective oversight of the management's operations.<sup>4</sup> SBP stated that sub-committees of the board covering risk management, operations, and procurement remained non-functional for 2 years. The SBP report also stated that the KB board's audit committee did not meet for 2 years, despite this lapse having been flagged by SBP in its earlier inspection reports. KB clarified on 24 October 2008 that its Board comprised three committees for (i) audit, (ii) information technology, and (iii) the social sector. It did not state the frequency of meetings of these committees. These comments did not refute SBP's earlier observations. KB's charter underwent some changes in April 2008 after the loan's physical activities ended on 30 June 2007. ADB was not given prior notification of such changes. It is necessary for KB to upgrade its corporate governance to enable it to raise deposits and equity in the market for its future sustainability as a financially self-sufficient institution.

## **C. Organization**

8. KB has a decentralized structure to maximize efficiency in operations in coordination with NGOs. Headquartered in Islamabad, on 31 December 2007 KB had a total of 113 branches in all five administrative regions of Pakistan. The head office's organization chart is given in Table A1.1. Each branch operates as an independent profit center against a set of financial parameters. Remuneration for KB staff is performance-based. As of 31 December 2007, KB had 1,865 staff, which exceeded earlier projections of 1,506. This is because KB expanded its branch network to 113 much faster than expected. KB's organizational structure is adequate and relevant to its operational requirements.

## **D. Human Resources Management**

9. As of 31 December 2007, KB had 1,865 staff in 113 branches covering 88 districts of Pakistan. Among the staff, 1,022 are officer grade, and 843 comprise other service and support personnel. KB's head office houses 94 staff members, while 1,771 serve in the branch offices. In terms of gender breakdown, 1,700 of KB's staff are male and 165 female. The dispersion of staff

<sup>3</sup> Private sector banks: Allied Bank Limited, Askari Bank Limited, Bank Al Habib Limited, Habib Bank Limited, Habib Metropolitan Bank Limited, KASB Bank Limited, MCB Bank Limited, Mybank Limited, Soneri Bank Limited, SaudiPak Commercial Bank Limited, and United Bank Limited. Public sector bank: National Bank of Pakistan. Multinational Banks: ABN Amro Bank, Citibank N.A., and Standard Chartered.

<sup>4</sup> SBP had undertaken an annual on-site and off-site inspection of KB for the first three quarters of 2007 covering KB's operational and financial performance. KB did not contest SBP's observations.

between its head office and branches, and the balance between its executive and non-executive staff appears appropriate to KB's overall operational requirements. As of 24 October 2008, KB's apex body was its 8-member board of directors (Table A1.1). Its chief executive officer is the bank's president who is assisted by the heads of the following departments: (i) risk management, (ii) finance and accounts, (iii) operations, (iv) human resources, (v) treasury, (vi) retail banking, (vii) information technology, and (viii) compliance. The internal audit department is hierarchically under the bank's president, but is required to report to the audit committee of the board.

10. The minimum entry-level requirement for KB's officer cadre is a university degree or its equivalent. It has five different salary levels for its officer grade staff. Department and branch heads are provided with vehicles. KB's remuneration policy is competitive in attracting the right talent for its staff functions. KB's Human Resources Operation and Policy Manual written in 2003 is a comprehensive document containing information on every aspect of KB's human resources policy and management. SBP's report (footnote 4) stated that this document has not been updated since 2003. SBP's report did not, however, highlight any adverse effects (such as a high staff turnover rate) arising from KB not updating this policy manual. During 2007, a total of 1,678 staff attended training programs.<sup>5</sup> Three staff members attended international training in management skills enhancement. Other staff underwent domestic training conducted at the National Institute of Banking and Finance in KB's products, branch operations, and internal control compliance. The trainings conducted were well-focused and relevant to KB's operational needs.

## **E. Operating Policies and Procedures and their Track Record**

11. **Microfinance Outreach.** In its original operating plan up until 2007, intended opening 34 branches. In its operating plan covering 2007–2011, it had planned to open an additional 120 branches by 2011. By the end of 2007, its branch network comprised 113 branches covering 88 districts and included some of the most marginalized areas of the country such as the Federally Administered Tribal Areas (FATA), Balochistan, and the earthquake-affected areas of Azad Jammu and Kashmir (AJK). KB's rapid expansion into these areas was at the behest of the Government, which believed that penetration into previously-underserved areas of the country was a social and political necessity. Credit outreach was supported by its credit policies, procedures, and risk mitigation efforts. KB believes that its social banking policy does not contradict principles of sound banking.

12. Under the investment loan, KB was provided a credit line of SDR52.206 million (\$68 million) to support microfinance outreach extension. By the sixth year of its operations in 2007, KB was expected to meet the following parameters: (i) a loan portfolio of PRs7,430 million; (ii) subloans not exceeding \$350 equivalent each to 560,000 subborrowers; (iii) microfinance customers' savings deposits to fund at least 20% of the loan portfolio ( PRs158.6 million) and the balance to be funded by market borrowings other than those funded by the investment loan; (iv) subloan recoveries of at least 90%; (v) an outreach network comprising 7 control offices, 34 branches, and 1,506 staff; and (vi) women comprising 40% of KB's microfinance subborrowers. In addition, KB had set itself financial benchmark ratios to achieve by 2007 for return on assets (ROA) of 2.8%, return on equity (ROE) of 13.1%, and equity to total assets (ETA) of 21%.

13. By the end of 2006, ADB had disbursed to KB SDR51.575 million (\$74.2 million) under the credit line (Appendix 2).<sup>6</sup> The achievement of its quantitative and financial targets was mixed. KB

<sup>5</sup> Several staff attended more than one training program, which is why the number of staff attending training programs is higher than its total staff strength.

<sup>6</sup> The excess disbursement in dollar terms is attributable to the depreciation of the dollar against the SDR between 2003 and 2007.

overestimated the demand for microcredit disbursements between 2001 and 2006. Based on a National Rural Support Program (NRSP) model, KB envisaged that its total credit disbursements for the period 2001–2006 would be PRs21.6 billion and the loans outstanding on 31 December 2007 would be PRs7.43 billion. In reality, KB's loan disbursements between 2001 and 14 February 2006 (the date up to which KB sought funding from ADB for its credit outreach) were PRs5.51 billion (\$93.66 million) against an appraisal estimate of \$165.9 million, and its loans outstanding on 31 December 2007 were PRs2.65 billion (\$43.5 million). Since this was KB's first foray into microfinance, in 2005 it capped its repeat loans at 20% to control loan delinquencies. KB had 283,965 active subborrowers in December 2007 against the target of 560,000. This shortfall is attributable to a high attrition rate. KB's rapid branch outreach expansion, particularly in the country's remote regions (in accordance with the Government's priorities), diverted KB's resources from developing an efficient cash management system to generate and invest deposits in accordance with SBP regulations. This endeavor distracted KB's attention from developing customer deposit products. KB instead relied on a single product, microfinance loans. KB justified this strategy as necessary to concentrate its critical mass of expertise on this single product. In addition, a significant portion of KB's loan disbursements, particularly in its rural hinterlands, was in cash. Hence, its credit did not create deposits.

14. **Credit Policy.** As part of its overall credit operational policy and in line with a project agreement covenant, KB was required to (i) maintain a ratio of field staff to subborrowers of 1:700, and (ii) reach a target of having women comprise a minimum of 40% of microfinance beneficiaries. KB was unable to meet either of these operational policy benchmarks. The ratio of field staff to subborrowers was 1:590, resulting from a high attrition rate among its subborrowers. While such a ratio may have impinged on its intermediation costs, it helped in keeping KB's loan collection ratio high (as there were more staff to monitor subborrowers' repayment). KB's target of having women comprise 40% of microfinance beneficiaries did not materialize because KB was strict in ensuring that only genuine women entrepreneurs benefited from this program and that women subborrowers did not act as surrogate subborrowers for the benefit of male beneficiaries. As a consequence, only 24.5% of KB's borrowers were women. KB's preference for transparency, which accounted for its conservatism in lending, was responsible for its not meeting these targets.

15. **Risk Mitigation.** KB contributed PRs1 million and the Government contributed \$5 million (from the counterpart funds of the policy loan) towards the establishment of a Risk Mitigation Fund. The fund was established by SBP as a safety net to mitigate the risks associated with the vulnerability of the poor to the loss of income-generating assets acquired through KB's loans. It was a facility dedicated to KB. Recurring contributions to the Risk Mitigation Fund were made by the Government out of the spread between its cost of funds and its relending rate to KB. KB was required to top up its contribution by (i) paying half the Government's annual contribution to the Risk Mitigation Fund, and (ii) contributing 5% of its after tax income to the fund. To avoid moral hazard, the Risk Mitigation Fund was not made available to subborrowers who willfully defaulted on their subloan repayments, or for subloans with repayment problems arising from the negligence of KB staff.

16. **Credit Procedures.** At the time of its incorporation, KB engaged national consultants at its own expense to prepare operational and credit policy manuals. The original credit policy manual stated that KB's individual loan ceiling would be PRs20,000 (\$350 at the then prevailing exchange rate). Collateral was not mandatory, but a group guarantee by people of the same community was required. In the case of livestock or crop loans, KB demanded that subborrowers insure their livestock and crops. KB's credit decisions were always made at its branch level in accordance with its policy stated in the manuals. Branch credit officers undertook cash flow analysis of their clients to determine their repayment capacity. The size of and approval procedures for subloans confirmed to the standards set forth in these manuals.

17. **Liquidity Management.** KB's entire lending (para. 13) was financed by the ADB's investment loan, subborrowers' equity, refinancing by SBP, and borrowings from other banks. KB's inability to generate any customers' deposits, which were intended to finance 20% of its lending, represented a failure to meet another envisaged target and reduced its potential lending and disbursements' headroom. Given its collection rate of over 80% and the fact that KB did not generate deposits, the lower than projected outstanding portfolio reflects the bank's prudent fund management. Given the low cost of KB's funds from ADB's investment loan and shareholders' equity, the high interest margins, and the short term of its lending, KB did not suffer from a liquidity crisis and did not realize the urgency of raising deposits. However, KB recognizes that in the future it will need to access customers' deposit to fund its lending program. Since January 2008, on a pilot basis, KB has generated PRs500,000 in deposits in its Rawalpindi branch. KB's average microfinance subloan size was PRs9,710<sup>7</sup> (\$162.8 equivalent), which was within the ceiling of PRs19,600 (\$350) per subloan that KB had set for itself.

18. **Social Capital.** As a new entrant into the microfinance sector, KB realized the necessity of creating social capital for the poor by increasing their opportunities for inclusion in economic activities in a participatory manner. KB realized that such an intervention was necessary to create targeted demand for microfinance on a sustainable basis. To avoid social intermediation costs adding financial intermediation spreads, ADB's loan provided for the Microfinance Social Development Fund and the Community Infrastructure Fund to finance the social capital formation. The Microfinance Social Development Fund provided a subsidy to KB of PRs750 for every microfinance loan that it made. KB, in turn, was required to outsource community development activities to viable nongovernmental organizations (NGOs).

19. Accordingly, the investment loan provided for: (i) the formation of 24,750 community organizations, with a total of 560,000 households (40% of their members comprising women); (ii) the training of one leader from each of the 24,750 community organizations for a 4-day course on community skills management; (iii) training for 2 days by the 24,750 leaders of community organizations in basic numeracy and management of income-generation activities' basic introduction to banking, including deposit mobilization and access to microfinance borrowing; investment plans; group consensus for borrowing decisions and repayment structures; social awareness' and gender empowerment;<sup>8</sup> (iv) the participation of 12,412 women in a 3-day activist capacity-building course;<sup>9</sup> (v) the participation of 1,240 of these women in a 10-day leadership management training course (cumulatively, 1,409 workshops were to have been held during project implementation); and (vi) financing on a participatory basis of 4,500 community infrastructure sub-projects by the community organizations (up to 40%) and the Community Investment Fund (up to 60%) (RRP, paras. 92-95).<sup>10</sup>

20. KB's track record in this area was mixed. A partnership agreement with the NGO service provider, the Family Planning Association of Pakistan, was signed in May 2002 for the social capital buildup. More than 90,000 community organizations were formed, which exceeded the Project's target. Their leaders were trained in the 4-day community skills management courses. The trainings for 1,240 women for 10 days, 24,750 team leaders for 2 days, and 12,412 women activists for 3 days were not held due to the absence of available trainers. No workshops were held, as compared to the target of 1,409. This was again due to the lack of adequate resource persons.

<sup>7</sup> The average loan size was PRs9,318 in 2001, PRs10,578 in 2002, PRs9,634 in 2003, PRs9,255 in 2004, PRs9,249 in 2005, PRs9,996 in 2006, and PRs9,940 in 2007.

<sup>8</sup> These training programs were to be held in villages.

<sup>9</sup> Trainings for (ii) and (iii) were to be held at NGOs' facilities wherever available.

<sup>10</sup> A change in scope was approved by ADB on 22 December 2003 changing the community organizations' contribution to 20% and the Community Investment Fund's to 80%.

Sixteen hundred Community Investment Fund projects were financed jointly by the community organizations (40%) and Community Investment Fund (60%), as compared to the target of 4,500. Following the earthquake of 8 October 2005, the balance of the Community Investment Fund was diverted in December 2005 to the Emergency Livelihood Restoration Fund. The implementation of the capacity-building component fell short of its envisaged targets owing to: (i) delays in the holding of seminars or workshops in remote areas of the country, particularly in Balochistan, NWFP, and FATA; (ii) difficulties in standardizing the training curricula given the divergence in skills' required of clients spread over a wide area; (iii) issues of cost efficiencies unforeseen at project preparation; and (iv) a decision to divert the balance of the Community Investment Fund to the Emergency Livelihood Relief Fund. KB did not entirely outsource its community development and community organization formation to NGOs due to the dearth of reliable and credible NGOs. KB instead opted to undertake community organization formation for social mobilization mobilizations on its own. While this inevitably raised KB's intermediation costs, which the project design sought to separate from financial intermediation costs, it helped to create an alternative to NGO activities and provided KB with practical experience for future replication.

21. **Enhancing Institutional Capacity for Microfinance Delivery.** This component envisaged: (i) enhancing the institutional capacity of SBP to monitor and regulate an enabling environment for the growth of microfinance; (ii) training KB staff at SBP's National Institute of Banking and Finance in Islamabad to provide efficient and extensive microfinance services; (iii) conducting studies and surveys, developing and regularly updating training materials, and preparing operation manuals for KB; (iv) engaging consultants to assist in capacity-building activities and trainings; (v) funding related travel expenses; (vi) financing of equipment and vehicles' purchase by KB to implement and manage its outreach expansion in remote areas;(vii) transforming two NGOs into regulated microfinance institutions; and (viii) auditing the portfolio of Zarai Taraqati Bank Limited. The total cost allocated to this component at appraisal was \$15.140 million, out which ADB was to finance \$9.336 million (Appendix 2).<sup>11</sup>

22. The achievements of capacity-building outcomes were mixed. The actual cost of this component was \$9.8 million (Appendix 2). SBP did not avail of the funding from this loan for enhancing its capacity for supervising microfinance institutions because SBP received grant funding from the Swiss Agency of Development Cooperation (SDC) for the same purpose. KB's performance on staff training was satisfactory. The training covered new product development, debt collection methodology, microfinance orientation, and supervision of customer services. KB's operational manuals were prepared by using its internal staff resources and not external consultancy. KB has established a centralized processing unit for the consolidation of all back office processing. Comprehensive banking software was installed for this purpose. Nonetheless, the total amount utilized by KB was lower than the amount originally allocated (or reallocated) for each line item (see Appendix 2). This is attributable to KB's conscious decision to have its staff trained within the country at SBP's National Institute of Banking and Finance, which provided the venue and facilities, for courses customized to its needs. Most of its trainers were KB's senior management executives. KB almost fully utilized the amount originally budgeted for vehicles.<sup>12</sup> For equipment, a further reallocation of SDR644,000 was made to the original allocation of SDR1,355,000 for a new total of SDR1,999,000. This was reduced on 19 February 2008 by SDR460,000, leaving the total reallocated figure at SDR1,539,000. However, utilization in disbursements amounted to only SDR1,248,689 million. This is attributable to KB's decision not to acquire core banking function software from a Singapore vendor as originally envisaged. KB realized that even with the reallocation approved by ADB on 14 March 2005 there was inadequate funding to finance such a package and, therefore, decided against its acquisition. As an interim

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<sup>11</sup> RRP Appendix 12, Table A12.2 and Loan Agreement Schedule VI Table on page 17.

measure, KB asked a local vendor to develop proprietary credit management systems software on a Microsoft server platform for PRs3.3 million. SBP's inspection report stated that inadequate system integration resulted in delayed information regarding loans between branches and the head office.

## **F. Portfolio Distribution, Quality, and Liquidity Management**

### **1. Sectoral and Geographical Distribution**

23. Of KB's cumulative loan disbursements between 2001 and 2007, 45.6% went towards agricultural crop financing (Table A1.2). Another 27.7% went towards livestock financing. Cumulatively, 73.3% of KB's total loan disbursements were for agricultural and other farm-based activities. This is understandable given that KB's branch expansion was into Pakistan's rural areas, where agriculture and livestock farming are the main occupation, and penetration of the lower segments of this market by other commercial banks in Pakistan had been low between 2001 and 2007. Services and trade comprised 23.7% of loan disbursements, mainly in agricultural and ancillary outputs.

24. Geographically, 59.1% of total loan disbursements were to Punjab, 27% to Sindh, 9.2% to NWFP, 3.8% to Balochistan, 0.8% to AJK, and 0.2% to FATA (Table A1.2). Considering that Punjab has the highest income and highest population among Pakistan's provinces and that its agricultural productivity is the highest among the provinces due to better soil and irrigation, its high demand for microfinance is not surprising. Nearly 24% of loan disbursements went towards financing services and trade, mainly in agricultural outputs. This favored the provinces such as Punjab that have higher agricultural productivity. Sparsely populated and topographically- and ecologically-less endowed areas such as FATA, AJK, and Balochistan had less demand for microfinance than Punjab and Sindh.

### **2. Portfolio Quality**

25. Judging from the schedule on its financial statement (Table A1.2), KB's portfolio quality appears satisfactory. Its portfolio at risk (PAR) comprising its substandard, doubtful, and bad debt, declined steadily from 7.84% in 2003 to 6.39% in 2004, to 4.83% in 2005, to 2.17% in 2006, and 1.51% in 2007 (Table A1.3). As of 31 December 2007, KB had provided specific loan loss provisions (LLP) of 25% on its substandard debt, 50% of its doubtful debt, and 100% of its bad debt, in addition to a general provision of PRs16 million. In total, its 2007 LLP was PRs64.3 million. Based on its review of the information relating to loan loss provisioning in KB's audited financial statements between 2001 and 2007, the project completion report (PCR) Mission was satisfied with the adequacy of KB's LLP. However, SBP's annual inspection report (footnote 4) stated that as of 30 September 2007, KB needed a total provision of PRs67.35 million. If SBP's argument is valid, KB's provisioning shortfall would be PRs3.05 million.<sup>13</sup>

26. KB's actual average subloan recovery rate between 2001 and 2007 was 81.5%,<sup>14</sup> which did not meet the target of 90%. KB reported that its delinquency in 2002, 2003, and 2005 increased with repeat loans to the same borrowers. The reduction of its incremental repeat loans (capped since 2005 at 20%) led to an improvement rate in recoveries, albeit at the cost of a higher attrition

<sup>13</sup> If such additional provision were to be made, KB's ROA during 2007 would be 1.2% instead of 1.32% as reported.

<sup>14</sup> KB's subloan recovery rate was 85.2% in 2001, 76.1% in 2002, 78.8% in 2003, 85.8% in 2004, 79.6% in 2005, 82% in 2006, and 83.1% in 2007.

rate among customers.<sup>15</sup> KB reiterated that it did not reschedule any of its loans and is strict in its definition of loan delinquency. Any loan that was not repaid by its due date, even with minimal slippage, was declared delinquent. A significant portion of KB's lending is for crop and livestock financing. In these sectors, seasonal and other cycles render output turn-over and cash realization irregular, which combined with KB's strict definition criteria, has led to overall collection rates that fall below their targets. Repayments made after the due date are not taken into account for the determination of the collection ratio. Nonetheless, KB has realized repayments after their due date. This is corroborated by KB's declining portfolio at risk (PAR) comprising its sub-standard, doubtful, and bad loans. Its PAR comprising sub-standard, doubtful, and bad debts fell from 7.84% in 2003 to 6.39% in 2004, to 4.83% in 2005, to 2.17% in 2006, and to 1.51% in 2007. In light of these circumstances, KB's lower-than-envisaged loan collection ratio does not significantly affect its portfolio quality.

## **G. Financial Statements and Audit**

### **1. Financial Statements**

27. KB's financial statements were prepared in accordance with: (i) the Khushhali Bank Ordinance (2000), (ii) SBP's Prudential Regulations for Microfinance Banks/Institutions, and (iii) generally accepted accounting practices followed in Pakistan.

28. The above financial regulatory standards are different from those required under Basel II of the Basel Committee of Banking Supervision, International Financial Reporting Standards and International Standards of Auditing. Considering the limited ambit of KB's operations allowed by its charter, its existing regulatory architecture appears satisfactory for consideration of the truth and fairness of its financial statements, and establishment of its prima-facie solvency and profitability.

29. KB effected a change in its accounting from 2003 onwards for the capacity-building grant it received from the Government under the subsidiary loan and grant agreement [MSDP ADB Loan 1806-PAK(SF)]. From 2003, grants are recognized in the accounts in the year of the occurrence of the eligible spending (financed by them). This explains the appearance of deferred grants as an external liability until 2002 and under equity from 2003 onwards. The grants' components related to fixed assets are accounted for as deferred income and recognized as non-interest income over the depreciable lives of the assets financed by them. These changes are consistent with the requirements of International Accounting Standards (IAS) 20: *Accounting for Government Grants and Disclosure of Government Assistance*. KB follows selectively only those International Accounting Standards/International Financial Reporting Standards applicable in Pakistan for microfinance banks that are in accordance with Pakistan's Regulations (para. 26). This change in accounting treatment has no material effect on the truth and fairness of the information presented in the financial statements.

### **2. Audit**

30. KB's external auditors, KPMG Taseer Hadi and Company, who have reported on KB's financial statements from 2001 to 2007, stated to have conducted its audit in accordance with auditing standards applicable in Pakistan. These auditing standards' divergence from International Standards of Auditing is not explained. SBP's report on KB (footnote 4) faulted KB's internal audit system for (i) not ensuring the internal auditor's independence, and (ii) underperformance of the

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<sup>15</sup> Considering that KB was unable to generate customers' deposits, the mere attrition in numbers of customers is acceptable.

information technology audit due to the non-availability of information technology audit resources. SBP's report did not state whether deficiencies noted in its internal audit had any detrimental effect on KB's operational or financial performance.

### 3. Financial Performance

31. Analysis of KB's financial statements between 2000 and 2007 reveals KB to be fast growing, comfortably solvent, and satisfactorily profitable. The bank's assets increased from PRs 1,733 million in 2000 to PRs6,703 million in 2007 at an annual compounded rate of 31%. The bank's solvency is demonstrated by its comfortable Equity to Assets Ratio (EAR)<sup>16</sup> which was 44.8% in 2004, 32.6% in 2005, 26.9% in 2006, and 26.8% in 2007, declining gradually in tandem with the bank's asset growth (Table A1.2). The bank's profitability in 2007 measured by its ROA, which was 1.32%, is satisfactory (albeit short of the target of 2.8% which KB set for itself). It improved from 0.78% in 2004 to 0.23% in 2005, and to 0.36% in 2006. If additional LLP of PRs3.05 million (as was believed necessary by SBP) was made in 2007, KB's ROA for 2007 would drop from 1.32% to 1.20%. KB's ROE improved from 0.71% in 2005 to 5.03% in 2007 (albeit short of the target of 13.1%). ADB's appraisal (RRP, Appendix F) estimated these benchmarks on the basis of income projections made without taking into account KB's social intermediation costs, which were shown as an appropriation rather than a charge to profits. Had these expenses been accurately factored in, the ROA projection would have been 2% and ROE 10%. KB nonetheless did not meet these parameters either.

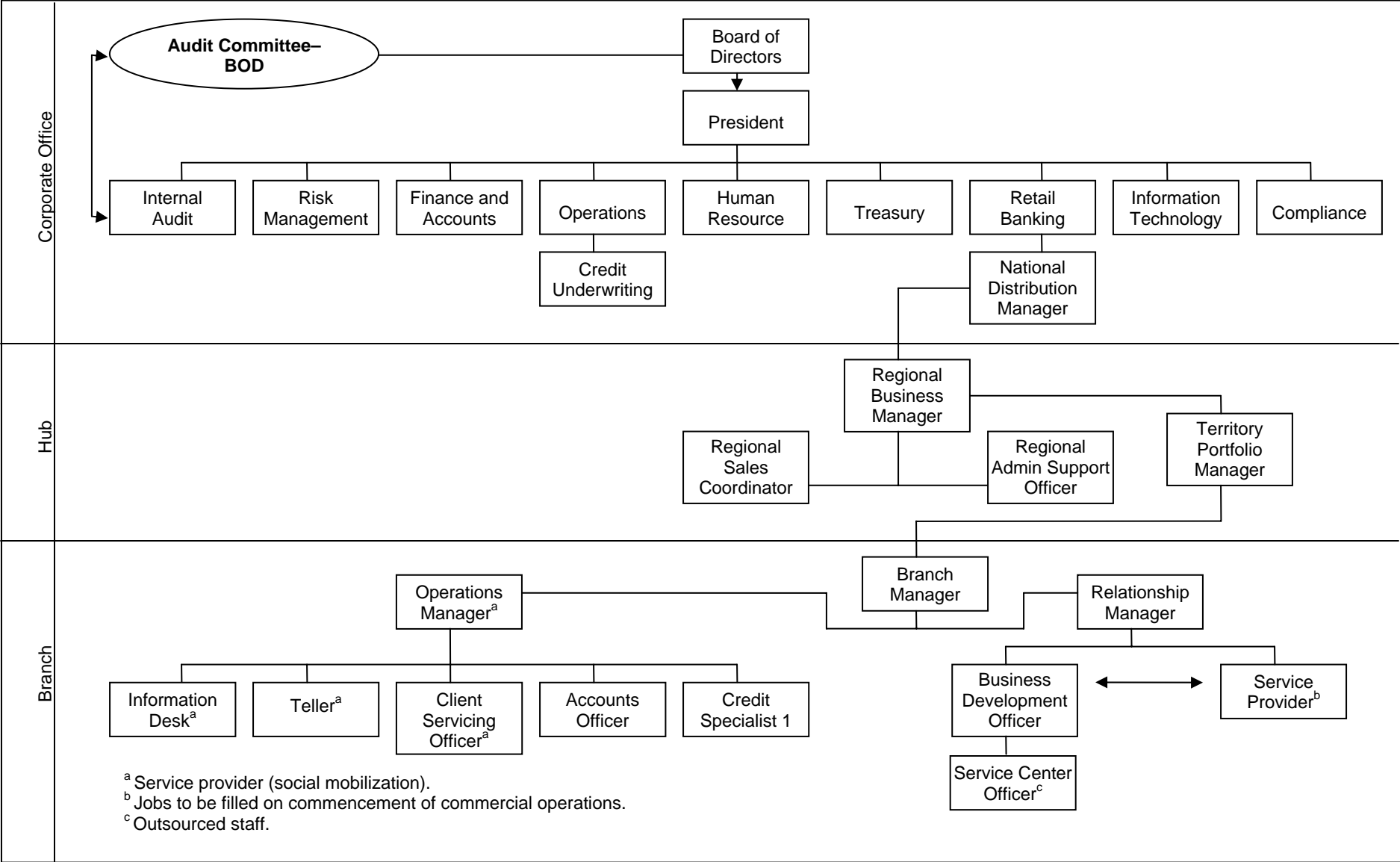
### H. Conclusion

32. While KB's operational outreach and its efforts to use microfinance as a tool for poverty reduction in Pakistan are impressive, the bank urgently needs to address the liability side of its balance sheet for its future sustainability as a viable microfinance bank. Thus far, KB's funding sources have been long term through equity and debt (from the ADB loan). Both are relatively low cost means of funding. All of its lending is short term in nature (up to 1 year). Therefore, KB has not faced liquidity problems and has been assured of an interest spread of 18%–20%.<sup>17</sup> However, it has been unable to generate customer deposits to fund up to 20% of its lending as envisaged at appraisal. Repayment of the ADB loan, which will begin in 2009, will create a liquidity gap for KB. To be sustainable over the long run, the bank needs to raise immediate liquidity as much as it needs to bridge its likely liquidity gap that could commence in 2009 when its repayments to ADB begin. For this purpose, the bank's board is requested to consider issuing, on a one-time basis, a 7-year certificate of deposit (CD) issue to bridge its expected 2009 liquidity gap since it has been unable to raise customers' deposits thus far. This CD issue will need to be underwritten by investment banks in Pakistan. To obtain such underwriting, KB will have to improve its corporate governance significantly by holding meetings of its board's committees, which SBP reported it has not done for 2 years, and stating so in its prospectus. It would specifically need to improve its internal audit processes. Apart from addressing KB's immediate liquidity needs, a CD issue would also help by (i) establishing a market benchmark for KB in assessing its own creditworthiness, which will determine its future ability to raise customer deposits; and (ii) testing the market for a future equity issue through an initial public offering. Improving its liquidity through additional equity and deposits raised in the market alone can sustain KB's viability as a financial institution once it no longer has access to subsidized funding.

<sup>16</sup> EAR is a rudimentary version of the Capital Adequacy Ratio and in KB's specific instance may be considered a suitable substitute.

<sup>17</sup> Its average lending rate was between 20% and 23%, and its average borrowing rate was between 1.28% and 4.33%.

Figure A1.1: Khushhali Bank's Organizational Chart



Source: Khushhali Bank.

**Table A1.1: Sector and Geographic Distribution of Portfolio  
(PRs)**

<b>Sector</b>	<b>Province</b>	<b>Punjab</b>	<b>Sindh</b>	<b>Balochistan</b>	<b>FATA</b>	<b>NWFP</b>	<b>AJK</b>	<b>Total</b>	<b>Percentages (%)</b>
Agriculture (Crops per Acre)		4,216,878,608	1,341,534,600	157,207,000	8,190,900	295,590,100	371,000	6,019,772,208	45.6
Agriculture (Livestock)		1,690,779,610	1,633,034,800	81,934,900	948,800	215,113,300	30,638,700	3,652,450,110	27.7
Manufacturing and Processing		257,966,000	56,535,800	37,405,600	1,006,000	40,002,800	5,004,300	397,920,500	3.0
Service and Trade		1,634,690,700	527,707,400	227,937,300	10,317,500	658,245,700	75,815,300	3,134,713,900	23.7
<b>Total</b>		<b>7,800,314,918</b>	<b>3,558,812,600</b>	<b>504,484,800</b>	<b>20,463,200</b>	<b>1,208,951,900</b>	<b>111,829,300</b>	<b>13,204,856,718</b>	<b>100.0</b>
Percentages (%)		59.1	27.0	3.8	0.2	9.2	0.8	100.0	

AJK = Azad Jammu and Kashmir, FATA = Federally Administered Tribal Areas, NWFP = North-West Frontier Province.

Source: Khushhali Bank.

**Table A1.2: Portfolio Quality Analysis and Loan Loss Provisioning**  
(amounts in PRs)

Category of Classification	2007				2006				2005			
	Amount Outstanding	Specific Provisions Required	Specific Provisions Held	Doubtful Debts Provision - %	Amount Outstanding	Specific Provisions Required	Specific Provisions Held	Doubtful Debts Provision - %	Amount Outstanding	Specific Provisions Required	Specific Provisions Held	Doubtful Debts Provision - %
OAEM	-	-	-	-	-	-	-	-	25,992,340	-	-	-
Substandard	22,180,636	<b>5,545,159</b>	5,545,159	25	20,618,076	<b>5,154,519</b>	5,154,519	25	17,504,225	<b>3,500,845</b>	3,500,845	20
Doubtful	13,108,284	<b>6,554,142</b>	6,554,142	50	19,179,692	<b>9,589,846</b>	9,589,846	50	49,405,292	<b>24,702,646</b>	24,702,646	50
Loss	4,753,961	<b>4,753,961</b>	4,753,961	100	6,880,505	<b>6,880,505</b>	6,880,505	100	-	-	-	100
<b>Total - NPLs</b>	40,042,881				46,678,273				92,901,857			
<b>Performing Loans</b>	2,612,872,904			-	2,100,933,547			-	1,830,343,519			-
<b>Total</b>	2,652,915,785	<b>16,853,262</b>	16,853,262		2,147,611,820	<b>21,624,870</b>	21,624,870		1,923,245,376	<b>28,203,491</b>	28,203,491	

Advances - Gross		2,652,915,785				2,147,611,820				1,923,245,376		
Less Provisions:												
Specific Provision		16,853,262				21,624,870				28,203,491		
General Provision		39,540,938				43,503,035				47,416,326		
Advances - Net of Provisions		2,596,521,585				2,082,483,915				1,847,625,559		
NPL - %		1.51				2.17				4.83		

Category of Classification	2004				2003				2002			
	Amount Outstanding	Specific Provisions Required	Specific Provisions Held	Doubtful Debts Provision - %	Amount Outstanding	Specific Provisions Required	Specific Provisions Held	Doubtful Debts Provision - %	Amount Outstanding	Specific Provisions Required	Specific Provisions Held	Doubtful Debts Provision - %
OAEM	18,894,247	-	-	-	20,661,304	-	-	-	-	-	-	-
Substandard	11,766,902	<b>2,353,380</b>	2,353,380	20	17,373,158	<b>3,474,632</b>	3,474,632	20	1,342,800	<b>268,560</b>	268,560	20
Doubtful	58,638,905	<b>29,319,453</b>	29,319,453	50	17,416,087	<b>8,708,044</b>	8,708,044	50	768,188	<b>384,094</b>	384,094	50
Loss	-	-	-	100	-	-	-	100	128,253	<b>128,253</b>	128,253	100
<b>Total - NPLs</b>	89,300,054				55,450,549				2,239,241			
<b>Performing Loans</b>	1,308,634,126			-	652,019,127			-	493,057,798			-
<b>Total</b>	1,397,934,180	<b>31,672,833</b>	31,672,833		707,469,676	<b>12,182,676</b>	12,182,676		495,297,039	<b>780,907</b>	<b>780,907</b>	

Advances - Gross		1,397,934,180				707,469,676				495,297,039		
Less Provisions:												
Specific Provision		31,672,833				12,182,676				780,907		
General Provision		36,840,712				23,421,226				19,030,975		
Advances - Net of Provisions		1,329,420,635				671,865,774				475,485,157		
NPL - %		6.39				7.84				0.45		

**Specific Provisions Requirement**

Category of Classification	April 2006 to Date		Since Inception to March 2006	
	Period	Provision Rates - %	Period	Provision Rates - %
OAEM				-
Substandard	=> 30 days < 90 days		=> 30 days < 90 days	
Doubtful	=> 90 days < 180 days	25	=> 90 days < 180 days	20
Loss	=> 180 days	50	=> 180 days < 365 days	50
		100	=> 365 days	100

Source: Khushhali Bank.

**Table A1.3: Comparative Balance Sheets**  
**Year 2000–2007**  
 (PRs)

Item	2007	2006	2005	2004	2003	2002	2001	2000
<b>Assets</b>								
Cash and balances with SBP and NBP	305,293,599	318,971,575	487,180,429	673,401,454	665,518,173	205,670,950	107,265,352	137,980,983
Balances with other banks	219,515,248	697,327,240	821,929,844	699,623,312	532,761,125	79,084,588	31,079,674	60,000,000
Lending to financial institutions - unsecured	1,119,500,000	1,242,500,000	840,000,000	0	0			
Investments - net of provision	1,190,701,412	1,369,416,056	1,373,236,435	1,132,553,999	998,412,808	1,200,000,000	1,500,000,000	1,493,788,980
Advances - net of provisions	2,596,521,585	2,082,483,915	1,847,625,559	1,329,420,635	671,865,774	475,485,157	110,350,702	12,311,005
Operating fixed assets	158,711,009	199,676,508	219,293,083	219,293,083	102,037,163	97,202,828	87,021,854	
Other assets	1,113,037,545	889,760,380	536,705,827	466,261,699	246,738,262	147,230,752	31,846,253	18,635,748
Deferred tax asset	0	47,338,151	37,549,895	25,976,579	17,957,749			7,043,095
<b>Total Assets</b>	<b>6,703,280,398</b>	<b>6,847,473,825</b>	<b>6,163,521,072</b>	<b>4,546,530,761</b>	<b>3,235,291,054</b>	<b>2,204,674,275</b>	<b>1,867,563,835</b>	<b>1,733,759,811</b>
<b>Liabilities</b>								
Borrowings	(4,718,926,822)	(4,886,754,322)	(4,221,128,654)	(2,600,538,174)	(1,377,555,446)	(386,607,846)	(77,392,800)	(20,000,000)
Other liabilities	(109,095,323)	(88,020,862)	(61,914,804)	(38,401,488)	(26,586,063)	(10,983,678)	(23,102,386)	0
Deferred grant						(55,350,454)	(9,975,049)	
Deferred tax liability							(145,849)	
<b>Total Liabilities</b>	<b>(4,828,022,145)</b>	<b>(4,974,775,184)</b>	<b>(4,283,043,459)</b>	<b>(2,638,939,662)</b>	<b>(1,404,141,509)</b>	<b>(452,941,978)</b>	<b>(110,616,084)</b>	<b>(25,432,027)</b>
<b>Net Assets</b>	<b>1,875,258,253</b>	<b>1,872,698,641</b>	<b>1,880,477,613</b>	<b>1,907,591,099</b>	<b>1,831,149,545</b>	<b>1,751,732,297</b>	<b>1,756,947,751</b>	<b>1,708,327,784</b>
<b>Represented by:</b>								
Share capital	1,705,000,000	1,705,000,000	1,705,000,000	1,705,000,000	1,705,000,000	1,705,000,000	1,705,000,000	
Statutory reserve	40,090,828	22,161,994	22,161,994	15,023,392	15,023,392	10,555,939	10,555,939	
Reserve for contingencies	28,385,353	28,385,353	28,385,353	17,809,739	4,390,253			
Unappropriated profit	66,105,808	12,319,306	101,930	1,479,114	45,188,466	36,176,358	41,391,812	
	1,839,581,989	1,767,866,653	1,755,649,277	1,739,312,245	1,769,602,111	1,751,732,297	1,756,947,751	
Deficit on revaluation of securities - net of deferred tax	(27,138,878)	(16,331,258)	(10,834,093)	3,202,072	(936,443)			
Deferred grants	62,815,142	121,163,246	142,102,374	126,764,511	62,483,877			
<b>Total Capital</b>	<b>1,875,258,253</b>	<b>1,872,698,641</b>	<b>1,886,917,558</b>	<b>1,869,278,828</b>	<b>1,831,149,545</b>	<b>1,751,732,297</b>	<b>1,756,947,751</b>	<b>1,708,327,784</b>

( ) = negative.

Source: Khushhali Bank.

**Table A1.4: Comparative Income Statements**  
**Year 2000–2007**  
**(PRs)**

Item	2007	2006	2005	2004	2003	2002	2001	Four months to 31-Dec-00
Mark-up/return/interest earned	718,993,318	684,870,558	476,609,825	217,712,337	166,682,385	147,772,761	183,890,779	168,699
Mark-up/return/interest expensed/cost/return on borrowings	(181,032,810)	(158,542,627)	(76,109,043)	(22,843,483)	(18,450,467)	(7,104,208)	(2,496,366)	(893,150)
Net mark-up/interest income	537,960,508	526,327,931	400,500,782	194,868,854	148,231,918	140,668,553	181,394,413	(724,451)
Provision against non-performing advances/ lending to financial institutions/other assets	(61,743,197)	(136,028,150)	(90,379,379)	(62,113,362)	(22,325,110)	(14,633,174)	(5,178,708)	
Bad debts written off directly	(2,522,806)	0	0	0	0	(128,253)		
	(64,266,003)	(136,028,150)	(90,379,379)	(62,113,362)	(22,325,110)	(14,761,427)	(5,178,708)	
Net mark-up/interest income after provisions	473,694,505	390,299,781	310,121,403	132,755,492	125,906,808	125,907,126	176,215,705	
<b>Non-Mark-Up/Noninterest Income</b>								
Fee, commission and brokerage income	49,792,400	0						
Other income	397,922,596	268,600,593	222,387,153	155,079,955	128,122,428	28,719,139	2,353,957	
Total non-mark-up/noninterest income	447,714,996	268,600,593	222,387,153	155,079,955	128,122,428			
	921,409,501	658,900,374	532,508,556	287,835,447	254,029,236	28,719,139	2,353,957	
<b>Non-Mark-Up/Noninterest Expenses</b>								
Administrative expenses	(752,725,112)	(626,215,854)	(506,202,417)	(327,037,924)	(228,346,969)	(166,748,704)	(94,904,541)	
Other Provisions/Write offs								
Other charges	(12,378,327)	(20,000)	(20,000)	0	(95,000)		(4,000,000)	
	(765,103,439)	(626,235,854)	(506,222,417)	(327,037,924)	(228,441,969)	(166,748,704)	(98,904,541)	
	156,306,062	32,664,520	26,286,139	(39,202,477)	25,587,267	(12,122,439)	79,665,121	
<b>Profit Before Taxation</b>	156,306,062	32,664,520	26,286,139	(39,202,477)	25,587,267	(12,122,439)	79,665,121	
Taxation - Current	(27,273,250)	(16,171,116)	(17,607,125)	(2,648,439)	(17,135,000)	6,761,136	(18,744,313)	
- Deferred	(39,388,641)	6,828,245	3,692,346	11,561,050	17,307,000	145,849	(145,849)	
	(66,661,891)	(9,342,871)	(13,914,779)	8,912,611	(3,250,000)	6,906,985	(18,890,162)	
<b>Profit After Taxation</b>	89,644,171	23,321,649	12,371,360	(30,289,866)	22,337,267	(5,215,454)	60,774,959	
Contributions to MSDF, RMF, DPF							(12,154,992)	
Unappropriated profit brought forward	12,319,306	101,930	1,479,114	45,188,466	36,176,358	41,391,812	2,495,838	
Profit available for appropriation	101,963,477	23,423,579	13,850,474	14,898,600	58,513,625	36,176,358	51,115,805	
<b>Appropriations:</b>								
<b>Transfer to -</b>								
Statutory Reserve	(17,928,834)	(4,664,330)	(2,474,272)	0	(4,467,453)		(9,723,993)	
MSDF	(8,964,417)	(2,332,165)	(1,237,136)	0	(2,233,727)			
RMF	(4,482,209)	(1,166,082)	(618,568)	0	(1,116,863)			
DPF	(4,482,209)	(1,166,082)	(618,568)	0	(1,116,863)			
Reserve for Contingencies	0	(1,775,614)	(8,800,000)	(13,419,486)	(4,390,253)			
	(35,857,669)	(11,104,273)	(13,748,544)	(13,419,486)	(13,325,159)	0	(9,723,993)	
<b>Unappropriated Profit Carried Forward</b>	66,105,808	12,319,306	101,930	1,479,114	45,188,466	36,176,358	41,391,812	
<b>Earnings Per Share (basic and diluted)<sup>a</sup></b>	52,577	13,678	7,256	(17,765)	13,101	(3,059)	35,645	

( )=negative, DPF=Depositors' Protection Fund, MSDF=Microfinance Social Development Fund, RMF=Risk Mitigation Fund.

<sup>a</sup>Calculated by profit after taxation divided by number of shares.

Source: Khushhali Bank.

**Table A1.5: Comparative Financial Ratios**  
**Year 2001–2007**  
 (%)

<b>Item</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Return on Equity	5.03	1.34	0.71	(1.73)	1.27	(0.30)	3.51
Return on Assets	1.32	0.36	0.23	(0.78)	0.82	(0.26)	3.38
Debt to Equity	264.81	280.05	242.53	148.12	78.23	22.03	4.47
Equity to Total Assets	26.75	26.92	32.58	45.01	65.02	86.07	97.57

( ) = negative.

Source: Khushhali Bank.

## PROJECT COSTS

Table A2.1: Project Costs

Item	Foreign Cost	Local Cost	Total Cost
A. Investment Costs			
1. Outreach Expansion			
Credit Line	37,099,868	56,567,464	93,667,332
<b>Subtotal (A1)</b>	<b>37,099,868</b>	<b>56,567,464</b>	<b>93,667,332</b>
2. Social Capital			
Community Organizations	0	9,353,596	9,353,596
Community Infrastructure <sup>a</sup>	0	0	0
<b>Subtotal (A2)</b>	<b>0</b>	<b>9,353,596</b>	<b>9,353,596</b>
3. Institutional Strengthening			
MFI Start-Ups	269,499	512,719	782,218
Vehicles	2,499,259	42,269	2,541,528
Equipment	1,657,720	541,736	2,199,456
Training	299,533	373,653	673,186
Studies, Surveys, and Audits	0	0	0
Consultants	242,240	0	242,240
Travel	1,624	0	1,624
CIF	0	3,398,123	3,398,123
<b>Subtotal (A3)</b>	<b>4,969,875</b>	<b>4,868,500</b>	<b>9,838,375</b>
B. Recurrent Costs			
Interest Charge	2,249,928	0	2,249,928
<b>Total</b>	<b>44,319,671</b>	<b>70,789,560</b>	<b>115,109,231</b>

<sup>a</sup> ADB reallocated SDR2.06 million (\$3.2 million) from consultancy, studies and surveys, and equipment and systems towards CIF. In March 2006, CIF was converted to ELRF. To accommodate the CIF claims that were lodged from July 2004 to June 2007, Category 04: CIF was created under the investment loan.

CIF = Community Investment Fund, ELRF = Emergency Livelihood Restoration Fund, MFI = microfinance institution.  
Source: Asian Development Bank.

**Table A2.2: Actual Total Project Cost and Financing**  
(\$)

Item	Asian Development Bank			Khushhali Bank			Microfinance Social Development Fund			Community Investment Fund			Total		
	Foreign	Local	Total	Foreign	Local	Total	Foreign	Local	Total	Foreign	Local	Total	Foreign	Local	Total
<b>A. Credit Outreach</b>															
Credit Line	37,099,868	37,099,868	74,199,737		19,467,596	19,467,596							37,099,868	56,567,464	93,667,333
<b>B. Institutional Strengthening</b>															
02A Licensed MFIs	269,499	512,719	782,218										269,499	512,719	782,218
02B Vehicles	2,499,259	0	2,499,259		42,269	42,269							2,499,259	42,269	2,541,528
02C Equipment and Systems	1,657,720	110,863	1,768,583		430,873	430,873							1,657,720	541,736	2,199,456
02D Training	299,533	144,470	444,003		229,182	229,182							299,533	373,653	673,185
02E Studies and Surveys	0	0	0										0	0	0
02F Consultants	242,240		242,240										242,240	0	242,240
02G Travel	1,624		1,624										1,624	0	1,624
03 Interest Charge	2,249,928		2,249,928										2,249,928	0	2,249,928
04 Community Investment Fund		3,202,277 <sup>a</sup>	3,202,277								195,846	195,846	0	3,398,123	3,398,123
<b>C. Social Capital</b>															0
2001-2007								9,353,596	9,353,596 <sup>b</sup>					9,353,596	9,353,596
<b>Total</b>	<b>44,319,670</b>	<b>41,070,198</b>	<b>85,389,869</b>		<b>20,169,920</b>	<b>20,169,920</b>		<b>9,353,596</b>	<b>9,353,596</b>		<b>195,846</b>	<b>195,846</b>	<b>44,319,670</b>	<b>70,789,560</b>	<b>115,109,230</b>

**Social Capital Component Details**

Year	MSDF		CIF	
	PRs	\$ <sup>c</sup>	PRs	\$ <sup>c</sup>
2001	847,370	13,926	161,571	2,655
2002	3,333,822	57,110		0
2003	104,139,783	1,823,814	415,968	7,285
2004	92,720,502	1,557,019	11,541,515	193,812
2005	111,910,319	1,871,097	51,719,274	864,726
2006	105,157,033	1,726,433	85,472,704	1,403,262
2007	139,588,196	2,304,196	56,120,226	926,382
<b>Total</b>	<b>557,697,025</b>	<b>9,353,596</b>	<b>205,431,258</b>	<b>3,398,123</b>

<sup>a</sup> ADB reallocated SDR2.06 million (\$3.2 million) from consultancy, studies and surveys and equipment and systems towards CIF. In March 2006, CIF was converted to ELRF. To accommodate the CIF claims that were lodged from July 2004 to June 2007, a CIF budget line was created under the investment loan.

<sup>b</sup> Funded from counterpart funds of program loan.

<sup>c</sup> Using year-end exchange rates.

CIF = Community Investment Fund, ELRF = Emergency Livelihood Restoration Fund, MFI = microfinance institution, MSDF = Microfinance Social Development Fund.

Source: Asian Development Bank.

**Table A2.3: Expenditure Accounts by Financiers**  
(\$'000)

Item	Projection						Actual					
	ADB	KB	Government	MSDF and CIF	Subborrowers	Total	ADB	KB	Government	MSDF and CIF	Subborrowers	Total
A. Outreach Expansion												
Credit Line	67,532.3					67,532.30	74,199.7					74,199.7
KB and Subborrower Investment		73,764.5			24,588.0	98,352.50		19,467.6				19,467.6
<b>Subtotal (A)</b>	<b>67,532.3</b>	<b>73,764.5</b>			<b>24,588.0</b>	<b>165,884.8</b>	<b>74,199.7</b>	<b>19,467.6</b>	<b>0</b>		<b>0</b>	<b>93,667.3</b>
B. Institutional Strengthening												
MFI Start-Ups	1,000.0	307.7			230.8	1,538.50	782.2					782.2
Vehicles	2,615.3		3,196.5			5,811.80	2,499.3	42.3				2,541.6
Equipment and Systems	1,928.6		545.3			2,473.90	1,768.6	430.9				2,199.5
Training	1,447.7		276.5			1,724.20	444.0	229.2				673.2
Studies, Surveys and Audits	516.7		129.2			645.90	0					
Consultants	2,586.2		251.1			2,837.30	242.2					242.2
Travel	73.3		31.4			104.70	1.6					1.6
(CIF) <sup>a</sup>				8,133.6	5,422.5	13,556.10	3,202.3					3,202.3
<b>Subtotal (B)</b>	<b>10,167.8</b>	<b>307.7</b>	<b>4,430.0</b>	<b>8,133.6</b>	<b>5,653.3</b>	<b>28,692.4</b>	<b>8,940.2</b>	<b>702.4</b>			<b>0</b>	<b>9,642.6</b>
C. Social Capital												
Community Organizations				20,005.4		20,005.40				9,353.6		9,353.6
(CIF) <sup>a</sup>										195.8		195.8
<b>Subtotal (C)</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>20,005.40</b>		<b>20,005.40</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>9,549.40</b>	<b>0</b>	<b>9,549.40</b>
Recurrent Cost			282.4			282.40						
Interest Charge	2,298.6					2,298.60	2,249.9					2,249.9
<b>Total</b>	<b>79,998.7</b>	<b>74,072.2</b>	<b>4,712.4</b>	<b>28,139.0</b>	<b>30,241.3</b>	<b>217,163.6</b>	<b>85,389.8</b>	<b>20,170.0</b>	<b>0</b>	<b>9,549.4</b>	<b>0</b>	<b>115,109.2</b>

<sup>a</sup> In March 2006, CIF was converted to ELRF. To accommodate the CIF claims that were lodged from July 2004 to June 2007, a budget line for CIF (category code 04) was created under the investment loan.

ADB = Asian Development Bank, CIF = Community Investment Fund, ELRF = Emergency Livelihood Restoration Fund, KB = Khushhali Bank, MFI = microfinance institution, MSDP = Microfinance Social Development Fund.

Sources: Asian Development Bank, Khushhali Bank, and State Bank of Pakistan.

## ALLOCATIONS AND DISBURSEMENTS

**Table A3.1: Allocation and Disbursements  
(SDR)**

Category or Subloan	Original Allocation	First Reallocation	Second Reallocation	Third Reallocation	Last Revised Allocation	Amount Disbursed	Undisbursed Balance
Outreach Extension (Credit Component)	52,206.0				52,206.0	51,575.2	630.8
Licensed MFIs	773.0				773.0	543.9	229.1
Vehicles	1,838.0				1,838.0	1,830.5	7.5
Equipment and Systems	1,355.0	644.0		(460.0)	1,539.0	1,248.7	290.3
Training	952.0				952.0	316.5	635.5
Studies and Surveys	429.0		(200.00)		229.0	0.0	229.0
Consultants	1,818.0		(1,400.00)		418.0	186.8	231.2
Travel	52.0				52.0	1.2	50.8
Interest Charge	1,778.0				1,778.0	1,525.0	253.0
Community Investment Fund			1,600.0	460.0	2,060.0	1,958.7	101.3
Unallocated	644.0	(644.0)			0.0	0.0	0.0
<b>Total</b>	<b>61,845.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>61,845.0</b>	<b>59,186.5</b>	<b>2,658.5</b>

( ) = negative, MFI = microfinance institution.

Note: The undisbursed balance of SDR2,658,457 was cancelled on 22 April 2008.

Source: Asian Development Bank.

**Table A3.2: Allocation and Disbursements  
(\$)**

Category or Subloan	Original Allocation	Latest Revised Allocation	Amount Disbursed	Undisbursed Balance
Outreach Extension (Credit Component)	67,532.3	75,284.5	74,199.7	1,084.8
Licensed MFIs	1,000.0	1,153.3	782.2	371.1
Vehicles	2,615.3	2,511.4	2,499.3	12.1
Equipment and Systems	1,928.6	2,238.8	1,768.6	470.2
Training	1,447.7	1,473.4	444.0	1,029.4
Studies and Surveys	516.7	370.9	0.0	370.9
Consultants	2,586.2	616.8	242.2	374.6
Travel	73.3	83.9	1.6	82.3
Interest Charge	2,298.6	2,659.8	2,249.9	409.9
Community Investment Fund	0.0	3,366.4	3,202.3	164.1
<b>Total</b>	<b>79,998.7</b>	<b>89,759.2</b> <sup>a</sup>	<b>85,389.8</b>	<b>4,369.4</b>

<sup>a</sup> Rounded off to \$80 million.

MFI = microfinance institution.

Source: Asian Development Bank.

### COMPLIANCE TO LOAN COVENANTS

Covenants	Reference to Loan Documents	Status
1. The Borrower shall make available to State Bank of Pakistan (SBP) and Khushhali Bank (KB), promptly as needed, the funds, facilities, services and other resources which are required, in addition to the proceeds of the Loan, for the carrying out of the Project and for the maintenance of the Project facilities.	Loan Agreement, Article 4, Section 4.02	<i>Complied.</i>
2. The Borrower shall ensure that the activities of its departments and agencies with respect to the carrying out of the Project and operation of the Project facilities are conducted and coordinated in accordance with sound administrative policies and procedures.	Loan Agreement, Article 4, Section 4.03	<i>Complied.</i>
3. The Borrower shall furnish, or cause SBP or KB to furnish, as appropriate, to the Asian Development Bank (ADB) all such reports and information as the ADB shall reasonably request concerning (i) the Loan, and the expenditure of the proceeds and maintenance of the service thereof; (ii) the goods and services and other items of expenditure financed out of the proceeds of the Loan; (iii) the Project; (iv) the administration, operations and financial condition of KB, any of the licensed microfinance institutions (MFIs), or any of the nongovernmental organizations (NGOs) engaged by KB under the Project; (v) financial and economic conditions in the territory of the Borrower and the international balance-of-payments position of the Borrower; and (vi) any other matters relating to the purposes of the Loan.	Loan Agreement, Article 4, Section 4.04  Project Agreement, Section 2.08	<i>Complied.</i> Quarterly report updated on regular basis by KB.
4. The Borrower shall enable the ADB's representatives to inspect the Project, the goods financed out of the proceeds of the Loan, and any other relevant records and documents.	Loan Agreement, Article 4, Section 4.05	<i>Complied.</i> Review missions conducted.
5. It is the mutual intention of the Borrower and the ADB that no other external debt owed a creditor other than the ADB shall have any priority over the Loan by way of a lien on the assets of the Borrower. To that end, the Borrower undertakes (i) that, except as the ADB may otherwise agree, if any lien shall be created on any assets of the Borrower as security for any external debt, such lien will ipso facto equally and ratably secure the payment of the principal of, and interest charge and any other charge on, the Loan; and (ii) that the Borrower, in creating or permitting the creation of such lien, will make express provision to that effect.	Loan Agreement, Article 4, Section 4.08	<i>Complied.</i> No lien created on ADB loan.

Covenants	Reference to Loan Documents	Status
<p>6. Upon privatization of the Habib Bank Ltd. or United Bank Ltd., the Borrower shall ensure that the ownership of KB shares held by any of these banks is also transferred to the private sector. The Borrower shall not allow any other change in ownership structure of KB, except in consultation with ADB. Upon finalization of the microfinance framework pursuant to paragraph 1 of the Attachment 2 to Schedule 3 of the Program Loan Agreement, the Borrower shall amend the KB Ordinance, if required, to ensure a level playing field between KBs and MFIs.</p>	<p>Loan Agreement, Schedule 6, Paragraph 3</p>	<p><i>Complied.</i></p>
<p>7. Subject to regulations issued pursuant to the Microfinance Bank (MFB) Ordinance, MFB shall have complete autonomy with regard to its operations, including writing-off loans, disposal of assets, pricing of products, appointment and termination of staff, and payment of salaries and other incentives to staff, and the Borrower shall not interfere with the exercise of such autonomy. The Borrower shall inform, or cause KB to inform, the Bank of any change planned in KB's board of directors or its senior management team. Any such change shall be made in accordance with procedures set forth in the MFB Ordinance or any regulations issued thereunder.</p>	<p>Loan Agreement, Schedule 6, Paragraph 4</p>	<p><i>Partly complied.</i> Annual report was provided to ADB post facto.</p>
<p>8. The Borrower shall cause KB to provide financing to Subborrowers on terms and conditions that enable KB to recover all of its financial intermediation costs. For the purpose of determining the cost of resources and its financing charges, KB shall apply the average costs of deposits in the banking industry as determined by SBP for the preceding six years.</p>	<p>Loan Agreement, Schedule 6, Paragraph 6</p>	<p><i>Complied.</i></p>
<p>9. Unless the ADB otherwise agrees, the Borrower shall ensure that the ratio of one KB field staff to Subborrowers at the end of year 5 is in the range of 1:700-950. KB shall maintain a loss provision of at least 4 percent of the net outstanding loans for the first five years of its operations.</p>	<p>Loan Agreement, Schedule 6, Paragraph 7</p>	<p><i>Partly complied.</i> KB achieved 1:590 staff to subborrowers ratio.</p> <p><i>Complied.</i> KB's provisions were at least 4% of loan's outstanding.</p>
<p>10. Subloans shall be made by KB to individual Subborrowers only if the individual concerned is a member of a community organization (CO) and the CO concerned agrees to pledge its collective savings as collateral for at least the first loan made to a Subborrower. Any first-time loan to a Subborrower shall not exceed \$350 or such other sum as may be determined by KB in consultation with SBP.</p>	<p>Loan Agreement, Schedule 6, Paragraph 8</p>	<p><i>Complied.</i> Maximum loan limit defined at PRs10,000 or \$166 at 1USD:60PRs exchange rate.</p>

Covenants	Reference to Loan Documents	Status
11. KB shall onlend the Subloans at a rate of interest that is based on its cost profile, including financial and operating costs. Cost of community mobilization and capacity building of the poor, to the extent covered by the Microfinance Sector Development Fund (MSDF), shall not be included in the interest rate charged to Subborrowers.	Loan Agreement, Schedule 6, Paragraph 9	<i>Complied.</i> At 20% (declining balance).
12. For the purpose of utilizing the Loan proceeds onlent to KB pursuant to Section 3.01(b) of the Loan Agreement, in selecting and mobilizing Subborrowers, KB and licensed MFIs shall follow a group approach agreed upon by the Borrower and the ADB that shall include the requirements of regular savings for a specified period by CO members prior to gaining access to Subloans.	Loan Agreement, Schedule 6, Paragraph 10.	<i>Complied.</i>
13. The Borrower shall credit to Risk Mitigation Fund (RMF) and Deposit Protection Fund (DPF) in equal amounts the difference between (a) the interest rate payable by the Borrower to the ADB under this Loan Agreement, and (b) the rate of interest/return charged by the Borrower on such onlending to KB, which shall be calculated on the basis of the average weighted cost of deposits in the banking industry. In addition, the Borrower shall cause KB to credit to RMF and DPF such provisions as SBP may require KB to create for purposes of RMF and DPF. Such provisions shall not exceed 5 percent of KB's net income.	Loan Agreement, Schedule 6, Paragraph 11	<i>Complied.</i>
14. For the purposes of MSDF and CIF, the Borrower shall cause KB to either directly provide social intermediation, including CO formation, preparation of CO member for microfinance, technical and vocational training of poor clients, and CIPs, or outsource these services to NGOs and agencies specialized in social intermediation that meet the eligibility criteria as determined by the Fund Committee established under the Microfinance Social Development Fund Rules 2000 and Community Investment Fund Rules 2000, each as amended from time to time. The Fund Committee shall monitor on continuous basis, and the Bank shall periodically review the performance of KB, and the NGOs and agencies specialized in social intermediation. For this purpose, KB shall build core capacity in social intermediation.	Loan Agreement, Schedule 6, Paragraph 12. As amended on 22 December 2003	<i>Complied.</i> KB using its own resources directly provided social intermediation which included the formation of COs. KB did not outsource its community development and CO formation to NGOs due to the dearth of reliable and credible NGOs.
15. The Borrower and SBP shall take appropriate steps, in consultation with the ADB, to strengthen SBP's supervisory and regulatory capacity for microfinance, including establishment of a system for supervision of KB.	Loan Agreement, Schedule 6, Paragraph 13 and 14	<i>Complied.</i>

Covenants	Reference to Loan Documents	Status
16. The Borrower shall cause SBP to promptly provide to the ADB copies of its inspection reports of KB.		<i>Partly complied.</i> Only the inspection report for 1 <sup>st</sup> Qtr of 2007 was furnished to ADB.
17. The Borrower and SBP shall take appropriate steps, in consultation with the ADB, to review and assess operations of the Agricultural Development Bank of Pakistan (ADBP), including auditing of its loan portfolio, and develop a plan for its restructuring.	Loan Agreement, Schedule 6, Paragraph 15	
18. The Borrower shall cause KB to organize training in banking, social mobilization and other areas as required for its staff and NGOs, including CO activists and women leaders. Regular reports on training shall be included in the quarterly reports submitted to the ADB.	Loan Agreement, Schedule 6, Paragraph 16	<i>Partially complied.</i> Number of NGOs and their representatives travel was below target envisaged due to the shortage of credible NGOs.
19. The Borrower shall ensure that KB and its Subborrowers comply with the requirements of the Borrower's environmental laws, rules and regulations. If warranted, the Borrower shall conduct or cause KB to conduct, prior to the provision of a Subloan, an initial environmental rules and regulations.  20. To raise awareness of its staff, KB shall establish an environment unit, prepare a manual on environmental assessment in training courses of its staff.	Loan Agreement, Schedule 6, Paragraph 17 and 18	<i>Complied.</i>  <i>Complied.</i>
21. External reviews of KB, licensed MFIs and select NGOs and agencies specializing in social intermediation participating in MSDF and CIF shall be carried in manner and in accordance with procedures acceptable to the Bank 12 and 36 months after commencement of social and financial services. A final external review shall be carried out at the time that KB carries out a project completion review. The external review shall, among other things: a. analyze data from information systems of NGOs and agencies specializing in social intermediation, KB and licensed MFIs; b. carry out sample surveys and participatory research; c. carry out environmental reviews based on representative samples of Subprojects; d. review operations of KB, especially with respect to autonomy of management, institutional role and strategy, organizational structure, credit policy and procedures, service delivery systems, repayment performance, financial and funds management, management information system, internal audit, and training policies and programs;	Loan Agreement, Schedule 6, Paragraph 19. As amended on 22 December 2003.	<i>Complied.</i> All items (a) to (f) were followed. ADB Institute, Tokyo, carried out a review of KB's operations in 2005.

Covenants	Reference to Loan Documents	Status
<p>e. review operation and management of the Funds; and</p> <p>f. carry out poverty reduction impact of KB's operations.</p>		
<p>22. KB shall establish an internal information system that shall generate monthly, quarterly and annual reports that include: (a) financial reports covering loan portfolio growth and performance, liability growth and management especially of savings deposits, and financial performance indicators concerning earnings and liability structures, (b) details concerning the number of poor by gender provided with services and the size of transactions, (c) information on the performance of staff measured by financial volume, numbers of customers and earnings ratio, (d) information showing planned levels of activities against actual, (e) annual financial statements, (f) number of staff desegregated by gender, and (g) impact of microfinance operations at the household level on annual basis.</p>	<p>Loan Agreement, Schedule 6, Paragraph 20</p>	<p><i>Complied.</i></p>
<p>23. The Borrower shall cause SBP to audit the Funds annually by auditors acceptable to the ADB and submit such audit reports to the ADB.</p>	<p>Loan Agreement, Schedule 6, Paragraph 21</p>	<p><i>Complied.</i></p>
<p>24. KB or the licensed MFIs shall not be entitled to any reimbursements for social mobilization and community formation from MSDF that exceed the total income of the MSDF.</p> <p>25. KB shall seek the approval of its board of directors for any reimbursements sought from the Funds. Such requests for reimbursement shall be submitted to administrators of the Funds on a semiannual basis.</p>	<p>Loan Agreement, Schedule 6, Paragraph 22 -23</p>	<p><i>Complied.</i></p> <p><i>Complied.</i></p>
<p>26. Any interest or income earned by MSDF and Community Investment Fund (CIF) that cannot be spent in accordance with the purposes set forth in the instruments setting them up shall be reinvested in the MSDF and CIF.</p>	<p>Loan Agreement, Schedule 6, Paragraph 24</p>	<p><i>Complied.</i></p>
<p>27. The Borrower and KB shall take necessary steps to meet the targets agreed with the Bank for extending microfinance outreach to women. In particular, adequate provision shall be incorporated for this purpose in KB's partnerships agreements with NGOs and agencies specializing in social intermediation participating in the MSDF and KB shall carry out regular monitoring to ensure that agreed targets are met.</p> <p>28. By the end of 31 December 2006, 40 percent of the clients and staff of KB shall be women.</p>	<p>Loan Agreement, Schedule 6, Paragraph 26-27. As amended on 22 December 2003.</p>	<p><i>Partially complied.</i> Gender targets were not fully achieved.</p> <p><i>Partially complied.</i> Shortfall in gender ratio.</p>

Covenants	Reference to Loan Documents	Status
29. In the carrying out of the Project, SBP and KB shall employ competent and qualified consultants and contractors, acceptable to the ADB, upon terms and conditions satisfactory to the Bank.	Project Agreement Article II Section 2.03(a)	<i>Complied.</i> On need basis.
30. SBP and KB shall carry out the Project in accordance with plans, designs and standard, specifications, works schedules and construction methods acceptable to the ADB. SBP and KB shall furnish, or cause to be furnished, to the ADB, promptly after preparation, such plans, design standards, specifications and work schedules, and any material modifications subsequently made therein, in such detail as the ADB shall reasonably request.	Project Agreement Article II Section 2.04	<i>Complied.</i>
31. SBP and KB shall maintain, or cause to be maintained, records and accounts adequate to identify the goods, services and other items of expenditure financed out of the proceeds of the Loan, to disclose the use thereof in the Project, to record the progress of the Project (including the cost thereof) and to reflect in accordance with consistently maintained sound accounting principles, its operations and financial condition.	Project Agreement Article II Section 2.06	<i>Complied.</i>
<p>32. The ADB, SBP and KB shall cooperate fully to ensure that the purposes of the Loan will be accomplished.</p> <p>33. Each of SBP and KB shall promptly inform the ADB of any condition which interferes with, or threatens to interfere with, the progress of the Project, the performance of its obligations under this Project Agreement or the Subsidiary Loan and Grant Agreement, or the accomplishment of the purposes of the Loan,</p> <p>34. The Bank, SBP and KB shall from time to time, at the request of either party, exchange views through their representatives with regard to any matters relating to the Project, SBP, KB, the Loan, Subloans, Subborrowers and Subprojects.</p>	Project Agreement Article II Section 2.07	<p><i>Complied.</i></p> <p><i>Complied.</i></p> <p><i>Complied.</i></p>



Covenants	Reference to Loan Documents	Status
<p>the Loan proceeds) from time to time with its auditors, and shall authorize and require any representative of such auditors to participate in any such discussions requested by the ADB, provided that such discussion shall be conducted only in the presence of an authorized officer of SBP or KB unless SBP or KB shall otherwise agree.</p> <p>39. Each of SBP and KB shall enable the ADB's representatives to inspect the Project, the goods financed out of the proceeds of the Loan, all other plants, sites, works, properties and equipment of SBP or KB and any other relevant records and documents maintained by them or the IAs.</p>		<i>Complied.</i>
<p>40. KB shall, promptly as required, take all action within its powers to maintain its corporate existence, to carry out its operations, and to acquire, maintain and renew all rights, properties, powers, privileges and franchises which are necessary in the carrying out of the Project or in the conduct of its business.</p> <p>41. KB shall at all times conduct its business in accordance with sound administrative, financial, environmental and banking practices, and under the supervision of competent and experienced management personnel.</p> <p>42. KB shall at all times operate and maintain its plants, equipment and other property, and from time to time, promptly as needed, make all necessary repairs and renewals thereof, all in accordance with sound administrative, financial, engineering, environmental, banking, and maintenance and operational practices.</p>	Project Agreement Article II Section 2.11	<i>Complied.</i>  <i>Complied.</i>  <i>Complied.</i>
<p>43. Except as the ADB may otherwise agree, KB shall not sell, lease or otherwise dispose of any of its assets which shall be required for efficient carrying out of its operations or the disposal of which may prejudice its ability to perform satisfactorily any of its obligations under this Project Agreement.</p>	Project Agreement Article II Section 2.12	<i>Complied.</i>
<p>44. Except as the ADB may otherwise agree, each SBP and KB shall apply the proceeds of the Loan to the financing of expenditures on the Project in accordance with the provisions of the Project Loan Agreement and this Project Agreement, and shall ensure that all goods and services financed out of such proceeds are used exclusively in the carrying out of the Project.</p>	Project Agreement Article II Section 2.13	<i>Complied.</i>

Covenants	Reference to Loan Documents	Status
45. Except as the ADB may otherwise agree, KB shall duly perform all its obligations under the Subsidiary Loan and Grant Agreement, and shall not take, or concur in, any action which would have effect of assigning, amending, abrogating or waiving any rights or obligations of the parties under the Subsidiary Loan and Grant Agreement.	Project Agreement Article II Section 2.14	<i>Complied.</i>
46. KB shall promptly notify the ADB of any proposal to amend, suspend or repeal any provision of the KB Ordinance 2000 and shall afford the ADB an adequate opportunity to comment on such proposal prior to taking of any action thereon.	Project Agreement Article II Section 2.15	<i>Not Complied.</i> Project physical completion was on 30 June 2007 and the charter took effect in 2008. KB, as a courtesy, should have informed the Mission.

### OVERALL ASSESSMENT OF THE PROJECT

Criterion	Weight %	Performance Details	Rating Description	Rating Value	Weight Rating
1. Relevance	20	<p>The Project's impact and outcome (goal and objectives) were partly relevant at the time of its appraisal and throughout its implementation. The loan leveraged policy and regulatory actions by providing investment resources to facilitate formal microfinance lending on a non-collateralized basis by a dedicated microfinance bank in Pakistan for the first time. It simultaneously sought to build social capital to manage demand for investment funds. Its impact and outcome were relevant with the Government's Poverty Reduction Strategy, the Asian Development Bank (ADB)'s microfinance objectives, and ADB's Country Operational Strategy for Pakistan. The project was formulated with the outputs of a well-formulated project preparatory technical assistance (PPTA) and in consultation with the World Bank, International Monetary Fund (IMF), the Government of Pakistan, and State Bank of Pakistan (SBP). Lessons learned in other countries with more mature microfinance markets were incorporated into its design. The project's design covered an area too wide, including a portfolio audit of Zarai Taraqiati Bank Limited, which was not a project intermediary. Its assumption of seeking to separate social intermediation costs from financial ones was unrealistic. The social capital formation by Khushhali Bank (KB)'s engagement of nongovernmental organizations (NGOs) to build social capital to be financed by the Microfinance Sector Development Fund did not materialize as envisaged due to the lack of credible NGOs willing to work with communities in remote regions. As a consequence, KB had to finance these activities from its own resources. The loan provided KB with access to subsidized credit, which allowed the bank to increase its microfinance outreach without generating customers' deposits. Such a business model is not sustainable over the long run. Arguably, the loan's design and formulation would have been more sound and relevant had it focused only on (i) enhancing KB's institutional capabilities in microfinance delivery, (ii) providing a credit line to KB without subsidies by passing on the exchange and intervention risks to KB to enable it to price its microfinance loans accordingly and build up its liquidity through generating customer deposits, and (iii) allowing KB to undertake social capital formation and permitting the bank to add such expenses in determining its interest margin transparently.</p>	Partly Relevant	1	0.20

Criterion	Weight %	Performance Details	Rating Description	Rating Value	Weight Rating
2. Effectiveness	30	<p>The outcome of the Project was effective. The loan was committed and disbursed within its original schedule. KB was established in 2000 and mandated to increase its outreach of financial services to the poor. It has grown to be the largest provider of microfinance services in Pakistan serving 283,965 against an envisaged target of 560,000 subborrowers at the end of 2007. Also, at the end of 2007, KB had 113 branches covering 88 districts, which included some of the most marginalized areas in the country such as the Federally Administered Tribal Areas (FATA), Balochistan, and earthquake-affected areas of the North West Frontier Province (NWFP) and Azzad Jammu and Kashmir (AJK). While its branch expansion exceeded the targets envisaged at appraisal, such expansion increased KB's intermediation costs and could not have been sustainable without subsidized funding. Individual subloans were an average size of PRs9,710 (\$163 equivalent), which was within the limits set under the project agreement. These subloans were 3–12 months in duration, with interest rates between 20% and 23% per annum on a diminishing loan balance basis. Average loan recovery was 81.5% (and improving annually from 76% to 83% in 2007), against a target of 90%. A report by the Asian Development Bank Institute (ADBI)<sup>1</sup> demonstrated that access to and participation in KB's microcredit program had positive impacts both on monetary and social indicators of welfare, and on employment and income-generating activities. The highest aggregate impacts of the project on income-generating activities were in agriculture where almost all variables—assets, input, and sales—were higher for those who had more access to or participation in the project. Employment (from within and outside families) was generated in all sectors financed by enabling the start-up of household enterprises. Participants in such microfinance projects demonstrated higher returns than non-participants. The poorest bottom quintile of the sample benefited significantly from the Project. This was because they borrowed for education and health (preventive medicine and immunization) purposes, which improved their income-generating abilities. Importantly, the Project empowered women in decision-making relating to family planning (financed from microloans), which had a positive impact on their independence, confidence, health, welfare, and income-generation capacity.</p>	Effective	2	0.60

<sup>1</sup> Montgomery, Heather. 2005. *Meeting the Double Bottom Line—Impact of Khushhali Bank's Microfinance Program in Pakistan*. ADB Institute. Tokyo.

Criterion	Weight %	Performance Details	Rating Description	Rating Value	Weight Rating
3. Efficiency	30	The Project's outcome in credit delivery was less than targeted (KB had only 283,965 active borrowers at the end of 2007, against a target of 560,000) and was achieved less efficiently than envisaged at appraisal. KB's average loan recovery between 2002 and 2007 was 81.5%, against a target of 90%. KB was unable to raise customers' deposits to fund its lending. This indicates KB's poor efficiency in financial intermediation. KB's sound solvency, moderate profitability, and comfortable liquidity during loan implementation were attributable to subsidized funding from ADB's loan. Nonetheless, the Project did not suffer time overruns, or require frequent changes in scope or implementation arrangements.	Less Efficient	1	0.30
4. Sustainability	20	At the time of project appraisal, it was assumed that 20% of KB's lending would be financed by customers' deposits. Despite being in operations for over 8 years, KB has been unable to generate customers' deposits to partially fund its lending. <sup>2</sup> Its intermediation costs have been rising concurrent with its branch expansion. Its profitability thus far is attributable to interest margins (of lending at 20% to 23% per annum and borrowing at 4% per annum) made possible by its access to subsidized funding from ADB's loan. SBP in its report stated that such a business model is not sustainable. Particularly from 2009 onwards, when KB will begin to start repaying ADB's loan, KB's liquidity will suffer unless the bank is able to raise customer deposits to at least 20% of its outstanding loans. Given its past and current track records, this appears unlikely. Its inability to raise deposits, coupled with SBP's assessment of KB's poor corporate governance, suggests the bank will be unable to raise additional equity funding through an initial public offering. While KB's microfinance outreach is impressive, the bank's inability to independently fund the liability side of its balance sheet to meet its credit outreach makes the latter unsustainable.	Unlikely	0	0.00
<b>OVERALL WEIGHTED RATING</b>					<b>1.10</b>

<sup>2</sup> In June 2008, KB's Rawalpindi branch raised savings deposits for PRs500,000 (\$7,200).