



Completion Report

Project Number: 36075
Loan Number: 1987, 1988
October 2009

Pakistan: Rural Finance Sector Development Program

CURRENCY EQUIVALENTS

Currency Unit	–	Pakistan rupee(s) (PRe/PRs)
		At Appraisal 15 October 2002
		At Program Completion 17 July 2009
PRe/PRs1.00	=	\$0.0169
\$1.00	=	PRe/PRs59.14
		PRe/PRs82.10

ABBREVIATIONS

ADB	–	Asian Development Bank
IT	–	information technology
MFI	–	microfinance institution
MOF	–	Ministry of Finance
NBF	–	New Bank Fund
NIBAF	–	National Institute of Banking and Finance
PCB	–	provincial cooperative bank
PMU	–	project management unit
RFI	–	rural finance institution
RFRC	–	Rural Finance Resource Center
RFSDP	–	Rural Finance Sector Development Program
RRP	–	report and recommendation of the President
SBP	–	State Bank of Pakistan
SMT	–	senior management team
ZTBL	–	Zarai Taraqati Bank Limited

NOTES

- (i) The Government of Pakistan's fiscal year ends on 30 June. State Bank of Pakistan's and Zarai Taraqati Bank Limited's financial years end on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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BASIC DATA

A. Loan Identification

1.	Country	Pakistan
2.	Loan Number	1987-PAK, 1988-PAK
3.	Program Title	Rural Finance Sector Development Program
4.	Borrower	Islamic Republic of Pakistan
5.	Executing Agency	Ministry of Finance
6.	Amount of Loan	\$225,000,000.00, \$25,000,000.00
7.	Program Completion Report Number	PCR: PAK 1115

B. Loan Data

1.	Appraisal	
	– Date Started	15 October 2002
	– Date Completed	25 October 2002
2.	Loan Negotiations	
	– Date Started	15 November 2002
	– Date Completed	20 November 2002
3.	Date of Board Approval	20 December 2002
4.	Date of Loan Agreement	23 December 2002
5.	Date of Loan Effectiveness	
	– In Loan Agreement	26 December 2002
	– Actual	26 December 2002
	– Number of Extensions	None
6.	Closing Date	
	– In Loan Agreement	
	▪ RFSD Program	30 June 2006
	▪ RFSD Project	30 June 2006
	– Actual	
	▪ RFSD Program	17 May 2007
	▪ RFSD Project	17 July 2009
	– Number of Extensions	One extension – 30 June 2008 ¹
7.	Terms of Loan	
	– Interest Rate	
	▪ RFSD Program	London interbank offered rate (LIBOR)+0.40%
	▪ RFSD Project	LIBOR+0.40%
	– Maturity (number of years)	
	▪ RFSD Program	15
	▪ RFSD Project	24
	– Grace Period (number of years)	
	▪ RFSD Program	3
	▪ RFSD Project	4

¹ The closing dates of Loan 1987 and 1988 were extended in 5 April 2006 up to 30 June 2008. Loan 1987 was, however, closed and the undrawn balance cancelled on 17 May 2007 at the request of the Borrower. While the activities of Loan 1988 ended on 30 June 2008, it was closed only on 17 July 2009 after liquidation of its imprest account.

8. Disbursements

a. Dates

i. RFSD Program

Initial Disbursement	Final Disbursement	Time Interval
26 December 2002	8 December 2004	24 months
Effective Date	Original Closing Date	Time Interval
26 December 2002	30 June 2006	42 months

ii. RFSD Project

Initial Disbursement	Final Disbursement	Time Interval
26 December 2002	17 July 2009	71 months
Effective Date	Original Closing Date	Time Interval
26 December 2002	30 June 2006	42 months

b. Amount (\$)

i. RFSD Program

Category or Subloan	Original Allocation	Last Revised Allocation	Amount Canceled	Net Amount Available	Amount Disbursed	Undisbursed Balance
1	225,000,000		72,750,000		152,250,000	0
Total	225,000,000		72,750,000		152,250,000	0

ii. RFSD Project

Category	Original Allocation	Last Revised Allocation	Amount Disbursed	Undisbursed Balance
Equipment	4,800,000	19,000,000	3,766,120	15,233,880
Vehicles	240,000	240,000	0	240,000
Training	2,200,000	200,000	0	200,000
Studies, Surveys & Audits	480,000	287,478	152,760	134,718
International Consulting Services	9,340,000	3,560,522	1,147,370	2,413,152
Domestic Consulting Services	3,120,000	0	0	0
Front End Fee	250,000	250,000	250,000	0
Interest and Commitment Charge	1,190,000	1,190,000	987,811	202,189
PMU Support Cost		272,000	258,225	13,775
Unallocated	3,380,000			
TOTAL	25,000,000	25,000,000	6,562,286	18,437,714

Note: The undisbursed balance of \$18,437,714 was cancelled on 17 July 2009.

10. Local Costs by the Asian Development Bank

- Amount (\$)	- 1.56 million
- Percent of Local Costs	- 97.64%
- Percent of Total Cost	- 23.57%

C. Program/Project Data

1. Program Cost (\$)

Cost	Appraisal Estimate	First Tranche	Second Tranche	Total
Foreign Exchange Cost	225,000,000	100,000,000	50,000,000	150,000,000
Local Currency Cost	0			0
Total	225,000,000			150,000,000

Note: Total amount disbursed was \$152,250,000, which is the total tranche amount of \$150,000,000 and a front-end fee of \$2,250,000 (1% of loan amount). The front-end fee and cancellation of \$72,750,000 on 17 May 2007 accounted for the difference between the amount at appraisal and at disbursement.

2. Project Cost (\$)

Cost	Appraisal Estimate	Actual
Foreign Exchange Cost	17,240,000	5,006,922
Local Currency Cost	12,380,000	1,592,964
Total	29,620,000	6,599,886

3. Financing Plan (\$)

Cost	Appraisal Estimate	Actual
Implementation Costs		
Borrower Financed	4,640,000	37,600
ADB Financed	24,980,000	6,562,286
Total	29,620,000	6,599,886

ADB = Asian Development Bank.

4. Cost Breakdown by Project Component (\$)

Component	Appraisal Estimate	Actual
A. Base Cost		
1. ZTBL Restructuring	19,010,000	5,066,250
2. SBP Institutional Strengthening	3,200,000	-
3. MOF Institutional Strengthening	1,900,000	295,825
Subtotal A	24,110,000	5,362,075
B. Contingencies		
1. Physical Contingencies	2,440,000	-
2. Price Contingencies	1,630,000	-
Subtotal B	4,070,000	-
C. Service Charge	1,440,000	1,237,811
Total	29,620,000	6,599,886

5. Project Schedule

Item	Appraisal Estimate	Actual
Date of Contract with Consultants ^{a/b}	26 December 2002	6 November 2004
Equipment and Supplies Dates		
First Procurement		26 December 2002 ^a
Last Procurement		23 September 2008

Notes:

^a As the RRP has no procurement plan, appraisal estimate is deemed concurrent with loan effectiveness.

^b Date of first consultant contract. Source: Loan Financial Information System.

6. Performance Report Ratings
 a. RFSD Program

Implementation Period	Ratings	
	Development Objectives	Implementation Progress
From 26 December to 31 December 2002	Highly Satisfactory	Satisfactory
From 1 January 2003 to 31 December 2003	Satisfactory	Satisfactory
From 1 January 2004 to 31 December 2004	Satisfactory	Satisfactory
From 1 January 2005 to 30 September 2006	Satisfactory	Satisfactory
From 1 October 2006 to 30 November 2006	Partly Satisfactory	Satisfactory
From 31 December 2006 to 31 May 2007	Partly Satisfactory	Partly Satisfactory

- ii. RFSD Project

Implementation Period	Ratings	
	Development Objectives	Implementation Progress
From 26 December to 31 December 2002	Highly satisfactory	Satisfactory
From 1 January 2003 to 31 December 2003	Highly satisfactory	Satisfactory
From 1 January 2004 to 31 December 2004	Satisfactory	Satisfactory
From 1 January 2005 to 30 September 2006	Satisfactory	Satisfactory
From 1 October 2006 to 29 February 2008	Partly satisfactory	Partly satisfactory
From 1 March 2008 to 31 March 2009	Satisfactory	Satisfactory
From 1 April to 31 May 2009	Partly satisfactory	Partly satisfactory
From 1 June to 17 July 2009	Partly satisfactory	Partly satisfactory

D. Data on Asian Development Bank Missions

Name of Mission	Date	No. of Persons	No. of Person-Days	Specialization of Members ^a
Inception Mission	8–11 Feb 2003	2	8	a, b
Review Mission 1	5–6 Oct 2003	1	2	a
Special Loan Administration Mission	6–10 Oct 2003	1	5	a
Review Mission 2	26 Sep–2 Oct 2004	1	5	a
Review Mission 3	22–25 Mar 2005	1	7	a
Review Mission 4	16–26 Apr 2005	1	2	a
Review Mission 5	24–29 Sep 2005	1	4	a
Review Mission 6	13–29 Mar 2006	1	17	a
Review Mission 7	9–16 Oct 2006	2	16	a, b
Review Mission 8	9–13 Mar 2008	1	5	a
Program and Project Completion Review ^b				

Notes:

^a a = project officer, b = project analyst.

^b The project completion report was prepared by R. Narasimham, Senior Project Management Specialist and Team Leader, CWFPM, assisted by L. Lerum, Associate Operations Analyst, CWFPM, in headquarters during 14–29 March 2009 (as there was no need for the physical fielding of a mission). The first draft project completion report was submitted for comments to the government, State Bank of Pakistan, and Zarai Taraqiati Bank Limited in April 2009. The government's comments were received on 1 July 2009 and have been incorporated as appropriate into this revised draft.

I. PROGRAM AND PROJECT DESCRIPTION

1. On 20 December 2002, the Asian Development Bank (ADB) approved the Rural Finance Sector Development Program (RFSDP). RFSDP comprised (i) a program loan¹ of \$225 million, and (ii) a project loan² of \$25 million from ADB's ordinary capital resources.³

2. The program loan was intended to assist the government in accelerating rural economic growth by addressing key constraints in rural finance. Its goals were to ensure permanent access to institutional financial services for a majority of middle- and low-income rural households at minimal transaction cost and to encourage private participation in the rural finance sector. This was expected to generate rural income and reduce poverty. The loan was to be released in four tranches over a 3-year period.⁴ The Ministry of Finance (MOF) was the executing agency for the loans, and the State Bank of Pakistan (SBP) and Zarai Taraqiyati Bank Limited (ZTBL) were implementing agencies for the New Bank Fund (NBF) and ZTBL components, respectively. The program loan's original closing date was 30 June 2006, but this was extended in April 2006 to 30 June 2008.

3. The project loan's objectives were to provide institutional support to ZTBL, SBP, and the project management unit (PMU) in MOF for the entire RFSDP. Its execution and implementation structures were similar to those of the program loan. The project loan's original closing date was 31 December 2005, but this was extended in April 2006 to 30 June 2008.

II. EVALUATION OF DESIGN AND IMPLEMENTATION

A. Relevance of Design and Formulation

4. RFSDP was consistent with ADB's Poverty Reduction Partnership Agreement⁵ and Country Strategy Program.⁶ Both documents emphasized ADB's support for sustainable poverty reduction interventions through private sector-led pro-poor economic growth and employment generation (particularly in agriculture and through rural development), sound social sector development, and improved governance. To achieve these goals, an integrated package of policy and institutional strengthening was considered necessary. The sector development program modality was therefore chosen to foster a long-term sector-wide perspective that was expected to yield considerable benefits. RFSDP's design recognized the constraints to rural credit access in Pakistan and identified measures necessary to alleviate them. Its appraisal included consultations with the government and SBP and with ZTBL (RRP, para. 35).

5. The program had recognized that access to rural finance in Pakistan remained weak (RRP, para. 13) due to (i) the fact that directed credit was often at subsidized interest rates (which resulted in rent-seeking), (ii) prolonged subsidy dependence that undermined

¹ ADB. 2002. *Report and Recommendation of the President to the Board of Directors on Loans to the Islamic Republic of Pakistan for the Rural Finance Sector Development Program*. Manila (Loan 1987-PAK).

² ADB. 2002. *Report and Recommendation of the President to the Board of Directors on Loans to the Islamic Republic of Pakistan for the Rural Finance Sector Development Project*. Manila (Loan 1988-PAK). Both loans (1987-PAK and 1988-PAK) had a common RRP.

³ The program loan was for a 15-year period (inclusive of a 3-year grace period). The project loan was for a 24-year period (inclusive of a 4-year grace period). Both loans had commitment charges of 0.75% per annum, front-end fees of 1%, and were subject to the terms and conditions set forth in their loan agreements.

⁴ The first tranche of \$100 million was released on 26 December 2002 on loan effectiveness, and the second tranche of \$50 million on 8 December 2004. The loan was cancelled on 17 May 2007, and its third and fourth tranches were not released.

⁵ Signed with Pakistan on 16 September 2002.

⁶ ADB. 2002. *Pakistan Country Strategy Program (2002–2004)*. Manila.

sustainability, (iii) weak agricultural and exchange-regime policies, and (iv) inefficient agricultural financial institutions such as ZTBL (RRP, paras. 8, 24–27, and 58).

6. To achieve greater access for the rural poor to sustainable credit, ADB's program loan was designed to support (i) a favorable and market-oriented policy environment for efficient financial intermediation in the agricultural and rural sectors through abolition of interest caps and loan waivers plus prudential supervision and regulation of rural finance institutions (RFIs) on par with that for commercial banks, (ii) institutional restructuring and reforms particularly of ZTBL and cooperatives, (iii) creation of the NBF to provide financing for lending to the lower market segments, and (iv) product and process innovations (such as crop insurance) to mitigate risks at the farm level.

7. RFSDP's design by ADB suggests a victory of hope over available empirical evidence in its assumptions for ZTBL's successful restructuring, sustainable prudent financial governance in Pakistan, and other envisaged synergies. Its design also encompassed too wide an area to enable meaningful and specific focus on goals. There is no information in the RRP for RFSDP's design incorporating lessons learned elsewhere. In 2002, despite ZTBL's questionable solvency, high illiquidity, poor profitability, inefficient intermediation, and high loan arrears (RRP, paras. 24–27, 42–43, and 58), ADB nonetheless selected ZTBL as an implementing agency rather than another leaner, more profitable, and more efficient nongovernment-owned microfinance institution (MFI) that would have been less politicized than ZTBL. ZTBL's financial condition and governance deteriorated instead of improving during the loan's implementation. There were no covenants in the loan agreement to benchmark ZTBL's financial performance (paras. 40 and 47). The government's policy letter (Appendix 2 of the RRP) contained its explicit assurance that it would not intervene in the granting of loans, setting of deposit and lending rates, pardoning loan repayments, or discouraging debt recovery. Yet the Government of Pakistan in 2004 set a lending interest rate cap at 8% for ZTBL and in 2005 announced loan remissions on ZTBL's lending. The latter created a moral hazard that encouraged ZTBL's borrowers to default willfully.⁷ The former made ZTBL's lending unsustainable, given that (due to its inefficiencies) its cost of funds averaged 16% p.a. and SBP's refinance rate was 9%.⁸ These moves discouraged private commercial banks' entry into rural finance (para. 17), defeating another program goal. ZTBL's internal restructuring could not be implemented as envisaged due to institutional politics. The NBF's linkage with the Microfinance Sector Development Program⁹ was not successfully realized (para. 19). Nor were innovative products and processes envisaged under RFSDP (RRP, para. 51) realized as expected (para. 21). Better analysis of the sector and of the political economy could have helped to better identify the problems and design a more suitable intervention. Recognizing (i) the low possibility of compliance with the conditions for the release of the loan's third tranche, (ii) the damage caused to ZTBL's financial condition during 2002–2005 by reversal of the government's policy assurances and ZTBL's own internal mismanagement, and (iii) poor achievements of other goals, the government requested ADB to cancel the loan forthwith. ADB did so on 17 May 2007, and there were no further tranche releases. The project loan was reformulated in 2007 to assist ZTBL to improve its information technology architecture. Regrettably, ZTBL was unable to utilize the loan funds expeditiously for this purpose before its closure. ADB appears to have overestimated the government's resolve in

⁷ ADB's release of the loan's second tranche on 7 December 2004 and its extension of the closing dates of the two loans, even after the government's interest rate cap imposition, may have sent conflicting signals on the continued relevance of this condition in its design.

⁸ ZTBL Chairman's testimony in November 2006 to Parliament's Public Accounts Committee.

⁹ ADB. 2000. *Report and Recommendation of the President to the Board of Directors on Loans to the Islamic Republic of Pakistan for the Microfinance Sector Development Program*. Manila (Loan 1805-PAK Program Completion Report circulated to the Board in December 2008).

its commitment to prudent financial governance and in its ability to enforce the same. In retrospect, the RFSDP's design, which was partly relevant at appraisal, became irrelevant during implementation.

B. Program and Project Outputs

8. The program loan had four components: (i) creating a favorable policy environment for rural finance; (ii) institutional restructuring of ZTBL, reforming cooperatives, and strengthening commercial banks' rural operations; (iii) creating NBF; and (iv) innovating products and processes. The project loan had three components: (i) ZTBL's restructuring, (ii) strengthening SBP's rural finance regulation, and (iii) institutional strengthening of MOF for implementing the program and project and in providing assistance for the credit unions and pilot insurance plans. The project loan's components were theoretically complementary to those of the program loan. Following cancellation of the program loan and non-realization of the crop insurance and credit union plans (paras. 14 and 21), the project loan's scope and implementation arrangements underwent major change (paras. 26–29). The components' achievements are analyzed below.

1. Program Loan

a. Creating a Favorable Policy Environment

9. This component, which sought to create an enabling, market-based rural finance policy environment, comprised (i) mandating an end to directed lending,¹⁰ interest rate ceilings, and loan waivers; (ii) supervising RFLs on par with commercial banks; (iii) SBP's restricting itself to being a lender of last resort and not providing refinance to RFLs while converting its equity in ZTBL to subordinated debt to avoid conflict of interest; and (iv) phasing out ZTBL's magisterial powers for loan recovery, replacing them with provisions of the Banking Ordinance.

10. Compliance with the policy conditions for this component has been disappointing (Appendix 3). There was compliance with items (ii), (iii), and (iv) from the paragraph above. In 2004, however, the government announced for nonbanking reasons an interest rate ceiling of 8% on ZTBL's lending and, in 2005, a remission on ZTBL's loan repayments. Given that ZTBL's average cost of funds was 16%, its deposit base low, and SBP's refinancing rate (as lender of last resort) 9%, the interest rate cap created a negative interest margin for ZTBL. The loan waiver created a moral hazard that encouraged politically powerful clients to default willfully on borrowings (footnote 8). Both these measures were deliberate distortions violating the government's explicit assurance in this context (RRP Appendix 1, Policy Letter). They also created operating losses for ZTBL, thereby defeating a seminal program goal, while rendering conditions (ii), (iii), and (iv) inconsequential.

b. Institutional Restructuring and Reforms

i. Restructuring of ZTBL

11. Recognizing its deficiencies, and as the consequences of its liquidation were considered politically and financially unacceptable (RRP, paras. 26 and 58), the government and ADB consciously opted for restructuring ZTBL. It was believed that with the right policies ZTBL could be reformed (para. 41) by concentrating on the causes of its weaknesses rather than on their effects. Accordingly, it was decided to (i) install a new management team with specific terms of

¹⁰ Such loans existed in Pakistan due to mandatory quotas for commercial banks to meet in agricultural lending.

reference to replace ZTBL's existing management team; (ii) financially restructure by adequately provisioning for bad and doubtful debts, ensuring ZTBL's capital adequacy ratio at over 10%, converting the government's debt in ZTBL to equity and SBP's equity to subordinated debt, while benchmarking ZTBL's performance to agreed parameters for solvency, liquidity, and profitability (Appendix 2); (iii) streamline ZTBL's organization through a golden handshake scheme; (iv) redesign its products and processes through improved use of information technology; (v) reduce corruption within ZTBL through improved forensic capabilities; and (vi) reach out to 600,000 clients by 2005.

12. ZTBL's overall performance on these counts has been disappointing. Regarding (i), a new seven-member senior management team was appointed but was incompatible with ZTBL's existing management. Its regularization created further morale problems for ZTBL's existing staff. ZTBL was unable to win its staff's acceptance for its internal reorganization. Regarding (iii), achievements under the golden handshake scheme fell short of targets.¹¹ Regarding (vi), ZTBL was in 2005 able to reach out to 413,829 clients against its target of 600,000. Regarding (v), ZTBL did set up a forensic unit within its organization to report on corruption but it was not effective (footnote 8). Regarding (iv), at ZTBL's request, the scope and implementation arrangements of the project loan were modified to facilitate the funding of ZTBL's information technology (IT), including hardware and software systems, but ZTBL was unable to utilize the earmarked funds for this purpose. Regarding (ii), ZTBL did not achieve during 2002–2006 most of the financial parameters set out for it (Appendix 1). Its capital adequacy ratio has remained at 10% or higher due to government guarantees on its lending that allow loans to be classified as risk-free.¹² Otherwise, ZTBL was poorly profitable (judging from its low returns on assets and equity), highly inefficient (judging from its high intermediation cost ratios), and highly illiquid (judging by its high loan to deposit ratios). ZTBL's financial performance failed to meet the parameters agreed with ADB (Appendix 1) but not covenanted (paras. 7, 40, and 47). ZTBL's profitability improved in 2007 and further so in 2008 (after loan cancellation) due to increases in other income. The government had not, up to May 2007, injected a promised PRs3 billion into ZTBL's equity. SBP did convert its equity in ZTBL into subordinated debt.

ii. Reform of Cooperatives

13. Recognizing the intractable problems faced by provincial cooperative banks (PCBs) and the difficulties in their restructuring (RRP, para. 44), RFSDP called for (i) the transformation of PCBs into provincial MFIs under the MFI Ordinance (2001), and (ii) preparation of a credit union plan and its implementation on a pilot basis in up to four districts.

14. Neither of the above goals was achieved. No PCBs were transformed into provincial MFIs. The government created an interprovincial working group for outlining the scope of the credit union plan. The Borrower did not thereafter develop a credit union plan (containing a legal framework) for strengthening cooperatives. It was therefore unable to implement and pilot test the credit union plan in four districts.¹³

¹¹ Staff reductions totaled 109 in 2004 and 7 in 2005, thus falling short of the target 300. Likewise, its reduction in 2003 by 1,116 fell short of its target of 2,000, and in 2002 its retrenchment of 732 missed its target of 1,000.

¹² Loan loss provisions created during 2002–2005 accorded with its external auditors' recommendation while regarding government-guaranteed debt as risk-free. If its entire loan portfolio had been treated as normal risk-bearing assets in accordance with international norms, its capital adequacy ratio would have been lower.

¹³ In October 2006, the government requested of ADB (i) a change in implementation arrangements in order to use domestic instead of international consultants to prepare the credit union plan, and (ii) extended time to pilot test the plan in four districts. These two requests were superseded by the government's request in February 2007 for partial cancellation and closure of Loan 1987-PAK.

iii. Strengthening Commercial Banks' Rural Operations

15. It was assumed at project design that 75% of Pakistan's commercial banks would be privately owned by 2003 and that an improved rural finance environment would enable commercial banks to cater to the upper segments of the rural finance market. Accordingly, RFSDP required the National Institute of Banking and Finance (NIBAF)¹⁴ to establish the Rural Finance Resource Center (RFRC). Its goal was to strengthen commercial banks' rural operations by (i) creating awareness of possibilities, prospects, and risks in rural finance; (ii) improving governance of rural finance operations; (iii) developing demand-adapted products and services recognizing gender dimensions; (iv) enhancing commercial banks' portfolio management capabilities; and (v) installing cost-reducing systems and procedures.

16. These goals (to be financed from the project loan) were achieved only partially. SBP incorporated NIBAF in 2003 and established the RFRC but until 2007 was unable to find a suitable person to head it.¹⁵ As of October 2006, NIBAF was still planning its curriculum and training materials and procuring equipment and books for RFRC's library. RFRC had conducted basic training programs in rural finance and microfinance for banks and nongovernment organizations regarding items (i) and (ii) above. It could not achieve (iii), (iv), and (v).

17. Although this component aimed to encourage private commercial banks' entry into rural finance, the government's policies on loan waivers and interest rate caps discouraged that entry. Even had NIBAF achieved what was expected, it is therefore doubtful that more private commercial banks would have been willing to risk exposure in the rural sector.

c. New Bank Fund

18. RFSDP mandated that the government create (using counterpart funds of the program loan's second tranche) a fund (NBF) for \$15 million (RRP, paras. 46–50). NBF was to be administered and managed by SBP, which was to create rules for the fund's description, objectives, investments, access eligibility criteria, and audit. NBF was created to provide credit access (through refinance) to the lowest market segment (RRP, para. 4) that constitutes over 50% of farm holdings and rural enterprises. It sought to do so by providing loans to MFIs transformed from PCBs for an initial period of 3 years, after which, depending on the MFIs' financial self-sufficiency, it could convert such loans into subordinated debt. In doing so, it was intended to increase MFIs' lending capacity by leveraging itself to the Microfinance Sector Development Program Loan (footnote 9). That is because its intended beneficiaries were also considered eligible to access to the community investment funds under that loan (footnote 9 and RRP, para. 21). It was assumed that this linkage would improve MFIs' gender orientation in their credit targeting by making long-term loans available to women subborrowers.

19. The compliance with these conditions was satisfactory technically but not fundamentally. As required, the government created the NBF from the second tranche's counterpart funds. As required of it, SBP prepared, in consultation with its stakeholders, the fund's rules. SBP posted these rules on its website after obtaining its board's approval. NBF's intended institutional beneficiaries were to be those PCBs that had transformed into MFIs by 2007. As no PCBs had so transformed themselves by 2007 (para. 14), however, NBF remained undisbursed. Thus, the intended access to long-term funds by the lowest market segment did not materialize.

¹⁴ NIBAF is a subsidiary of SBP.

¹⁵ NIBAF approached headhunters in October 2006 to help it find a suitable candidate. However, its remuneration structure did not sufficiently attract the talent it needed.

d. Product and Processes Innovation

20. Given the crop risks to small and marginal farmers, a viable crop insurance scheme was deemed necessary (RRP, para. 51). Accordingly, RFSDP envisaged the establishment of a pilot crop insurance plan for up to four districts in consultation with sector specialists. With preferential access to ZTBL borrowers, that plan was intended to (i) cover drought and flood damage, (ii) adopt actuarially calculated premium rates, (iii) link and activate claims after declaration by a competent authority, and (iv) restrict indemnity to verifiable instruments.

21. These goals were not achieved. The government constituted a group of experts in 2004 that outlined the proposed insurance plan's scope. No further progress occurred thereafter. The government tried to find a single consultant to advise it on both the credit union and crop insurance plans. Given that neither had been tried in Pakistan before, this task was onerous. Technical proposals submitted by short-listed firms did not meet the government's required standards. In October 2006, the government explored the possibility of separating the two packages for credit unions and crop insurance, which would have needed more time. At that time, the government requested ADB for a change in loan implementation arrangements to use domestic instead of international consultants to prepare the credit union plan (footnote 13). In any case, the government's request for the loan's partial cancellation precluded further progress on this component.

2. Project Loan

a. ZTBL's Restructuring

22. This component of the project loan (RRP, para 69) was intended to support the program loan's goal of restructuring ZTBL (para. 11). It sought to do so by (i) establishing an environment for facilitating accountability and good governance; (ii) hiring a new management team of local and international specialists to assist in achieving item (i) above; (iii) streamlining business products and processes to make them financially and economically viable; (iv) improving ZTBL's human resources skills through staff training; (v) installing new IT hardware and software platforms to improve its communications, risk management, and management information systems; and (vi) upgrading its other office equipment and facilities as part of its overall modernization. This component was estimated to cost \$19.1 million, comprising \$10.4 million in foreign exchange and \$8.7 million in local currency (RRP, para. 73).

23. ZTBL was unable to achieve the above items (i), (ii), and (iii) successfully. Given its internal management politics, ZTBL could not establish an environment for facilitating better accountability and good governance [item (i)]. ZTBL had by August 2007 drawn down loan funds totaling \$955,799 (or 3.8% of the loan amount) to pay staff salaries for its new senior management team (SMT) of \$724,591 in domestic currency and \$231,208 in foreign currency as remuneration to foreign consultants in pursuit of item (ii) above.¹⁶ ZTBL believed that it could hire better expertise by hiring consultants to its SMT and that their remuneration would not be blocked by ZTBL's internal salary ceilings. Since the SMT could not integrate seamlessly into its managerial setup (para. 12), however, the hiring of consultants to its senior management (with the exception of its chief information officer) was discontinued. Complaints of deteriorating corporate governance in ZTBL were attributed to faulty selection procedures for its SMT financed out of the ADB loan. ZTBL's staff association petitioned its board about these matters.

¹⁶ This is because in the original plan, ZTBL intended financing the salaries of its SMT from the loan categories international consultants and domestic consultants.

ZTBL's management and financial restructuring envisaged under the program and project loan did not materialize. In 2007, the government appointed a new chairperson for ZTBL who decided the costs of its SMT would now be borne by ZTBL from its own budget. ZTBL reported to have trained its staff [item (iv)] to improve the viability of its human resources but drew down no ADB loan funds for this purpose. Neither did ZTBL draw loan funds for upgrading its office equipment and facilities [item (vi)]. Due to these factors, and coupled with SBP's decision not to use loan funds for strengthening rural finance regulation (para. 28), \$22.51 million of loan funds remained uncommitted and \$22.45 million of this remained undisbursed as of August 2007.

24. The government in consultation with ZTBL requested that ADB permit a major change in scope and implementation arrangements to utilize the remaining loan funds of \$22.51 million. This request covered (i) purchase of a core banking application system, (ii) its accompanying IT hardware, and (iii) extension of the services of ZTBL's chief information officer until December 2008 to oversee the installation of (i) and (ii). The total cost of the IT system proposed by ZTBL was \$19 million and was to be funded from the unutilized portion of the loan. This necessitated a reallocation of \$14.2 million (Appendix 2) from the unallocated domestic consulting services, international consulting services, and training to the equipment category. The original sum of \$4.8 million allocated to equipment at the loan's approval was considered inadequate for this purpose. Reallocation was sought only from those line items for which funds had otherwise remained unutilized. ADB also agreed to international and domestic consulting services being merged into a single line item, to which the remuneration of its chief information officer at \$5,000 (PRs300,000) per month from 1 July 2007 to 31 December 2007 would be charged. This reallocation did not result in transfer for any line item from the Borrower's counterpart funding to ADB's loan funding. ADB approved this major change of scope on 7 September 2007.

25. In approving a major change of scope, ADB accepted ZTBL's and the government's arguments that installing the new IT system could improve ZTBL's accountability and governance. ADB agreed that better interbranch connectivity and reduced arrears (made possible by the new IT system) could help improve liquidity management and reduce occurrences of fraud. The changes in scope were within the loan's original ambit as highlighted in Schedule I of the loan agreement and did not impact adversely on its other two components. ZTBL's procurement methodology was transparent and consistent with ADB's *Procurement Guidelines* (2007 as amended from time to time). Importantly, the government and ZTBL believed that the benefits of this change of scope would be realized before the loan's closing date of 30 June 2008 (para. 3). ADB was willing to provide ZTBL a chance to improve its loan utilization with the specific condition that ADB would not extend the loan anymore beyond 30 June 2008. ZTBL and MOF agreed to this condition.

26. As of 30 June 2008, the total loan funds ZTBL had committed to its IT systems enhancement was \$4.12 million and disbursements were \$3.77 million. ZTBL's utilization of loan funds fell short of its and ADB's expectations because (i) 10 months (21 August 2007 to 30 June 2008) was inadequate for ZTBL to finalize its systems purchase decisions, and (ii) ZTBL's IT department was initially unfamiliar with ADB's procurement processes. To help ZTBL familiarize itself with the latter, ADB invited a ZTBL delegation to visit Manila and confer with the Central and West Asia Department and the Central Operations Services Office. ZTBL's delegation visited Manila in February 2008, but the consultations were too late to be very helpful.¹⁷

¹⁷ Had ZTBL decided to seek the change of project scope in 2005 instead of 2007, and consulted with ADB in 2006, it might have utilized the loan better and more expeditiously.

b. SBP Institutional Strengthening for Rural Finance Regulation

27. The loan agreement mandated SBP as the implementing agency for this component. It provided for supporting institutional strengthening of SBP through (i) reviewing the prevailing supervisory and regulatory policy, systems, and framework for rural finance; (ii) upgrading and formulating guidelines and standards for off-site and on-site inspection, supervision, and reporting; (iii) assessing human resource skills and IT requirements; (iv) installing basic IT infrastructure, facilities, and equipment; (v) assisting NIBAF's RFRC with staffing, library, equipment, and partial support for recurring costs of training and speaker visits; (vi) providing training and skills development; and (vii) strengthening SBP's Agriculture Credit Department.

28. This component's goals were realized, albeit without using loan funds. SBP undertook (i) to (vi) above between 2003 and 2006. It held orientation workshops for its staff in rural finance and microfinance supervision functions and identified 25 of its staff for further training. SBP financed these activities from its own resources and using a technical assistance grant from the Swiss Agency for Development Co-operation.¹⁸ SBP financed RFRC's library and its own IT requirements also from its own budget. SBP's preference for using its own resources and grant funding over loan funding is understandable.

c. MOF Institutional Strengthening

29. As the loan's executing agency, MOF was required to establish a PMU for its execution. This component of the loan was intended to build institutional capacity in MOF's PMU for (i) implementing the project, and (ii) preparing the credit union and pilot insurance plans in consultation with stockholders. The amount allocated to this component was \$1.9 million, comprising \$1.3 million in foreign exchange and \$0.6 million in local currency.

30. The achievements under this component were partial. A PMU was established and headed by a joint secretary in MOF. A domestic consultant was recruited as project director to assist and report to the joint secretary. MOF committed \$264,293 and disbursed \$258,225 of loan funds in financing (i) the project director's salary, (ii) acquisition of a vehicle, (iii) acquisition of office equipment, and (iv) travel and other administration expenses (including vehicle operations maintenance). The PMU did not, however, prepare the credit union and pilot insurance plans (paras. 14 and 21).

C. Program and Project Costs

31. ADB's program loan of \$225 million from its ordinary capital resources (footnote 3) was intended to support reforms addressing complex, sensitive, and long-standing issues related to rural finance (RRP, para. 58). These were: (i) dismantling the repressive rural finance paradigm to enhance flow of resources to the rural sector, (ii) enhancing governance and institutional norms for the benefit of the middle and lower rural finance market segments, (iii) reducing misdirected and nontargeted subsidies, and (iv) encouraging sustainable public-private partnerships to enhance employment opportunities for the poor. The adjustment cost of implementing RFSDP was estimated at \$547 million (RRP, para. 58).¹⁹

¹⁸ ADB. 2008. *Project Completion Report on the Microfinance Sector Development Project in Pakistan*. Manila (Loan 1806-PAK PCR, para. 15).

¹⁹ This comprised: (i) government loan to ZTBL (\$274 million), (ii) government equity to ZTBL (\$170 million), (iii) ZTBL's golden handshake (\$84 million), (iv) RFRC (\$1 million), (v) credit union plan (\$1 million), (vi) pilot insurance plan (\$2 million), and (vii) NBF (\$15 million).

32. At appraisal, the project cost was estimated at \$29.6 million, comprising \$17.2 million in foreign exchange and \$12.4 million in local currency (Appendix 2). This included \$19.0 million for ZTBL restructuring, \$3.2 million for SBP's institutional strengthening, \$1.9 for MOF's institutional strengthening, \$2.4 million for physical contingencies, \$1.7 million in price contingencies, and \$1.4 million in service charges. ADB committed financing for equipment, vehicles, training, studies, surveys, audit, international and domestic consulting services, front-end fee, interest, and commitment charges (Appendix 2, Table 2, and Attachment to Schedule 3 of the loan agreement).

33. MOF utilized \$0.29 million in loan funds,²⁰ comprising \$0.26 million in foreign currency and \$0.03 million equivalent in local currency, for institutional strengthening. SBP used none of the \$3.2 million allocated to it (para. 28). ZTBL utilized \$955,799, comprising \$724,591 in local currency and \$231,208 in foreign currency, respectively for domestic and international consultancy. Despite ADB's reallocation of \$14.2 million to ZTBL's IT systems acquisition (para. 24), ZTBL was able to commit \$4.12 million and disburse \$3.77 million of the reallocated amount (para. 26).

34. Actual project costs were \$6.60 million, of which ADB financed \$6.56 million. The project had a cost underrun of \$18.44 million because (i) SBP did not use the loan for institutional strengthening, and (ii) ZTBL was unable to draw down the funds reallocated to it before 30 June 2008.

D. Disbursements

35. The actual amount of the program loan amount disbursed was \$150 million, consisting of \$100 million in the first tranche on 26 December 2002 on loan effectiveness and \$50 million in the second tranche on 6 December 2004. Due to the loan's cancellation on 17 May 2007, its third and fourth tranches cumulatively amounting to \$75 million were not released.

36. A total of \$6.56 million of the project loan excluding interest during construction was disbursed through an imprest account opened with SBP and by direct payment procedures (Appendix 2). The imprest account was operated and maintained in accordance with ADB's *Loan Disbursement Handbook*. The first and last disbursements were made on 26 December 2002 and 17 July 2009, respectively. The initial disbursement made on 26 December 2002 was the front-end fee capitalized upon effectiveness of the loan. MOF used the imprest fund procedure to finance institutional strengthening expenditures. From the (revised) scheduled project completion date of 30 June 2008, it took 12 months to resolve outstanding matters and the loan was closed financially on 17 July 2009. ADB's use of the imprest account and direct payment procedures were relevant to the loan's implementation, given its structure. ZTBL and SBP had adequate knowledge of ADB's disbursement procedures.

E. Program and Project Schedule

37. At appraisal, it was envisaged that the program loan would be utilized by 30 June 2006 and the project loan by 31 December 2005 (paras. 2–3). Both loans were extended in April 2006 to 30 June 2008. The program loan was extended in the hope that the Borrower would be able to comply with the conditions for the release of its third tranche. The program loan was closed on 17 May 2007. The project loan was extended with the hope to support (i) ZTBL's restructuring and SBP's institutional strengthening necessary for the program loan's third

²⁰ Includes withdrawal applications submitted late by MOF.

tranche; and (ii) maintaining MOF's PMU office, which outlived the program loan's cancellation. It was kept open until 17 July 2009 to facilitate payments incurred prior to 30 June 2008 and for closing down of the PMU.

F. Implementation Arrangements

38. MOF established a PMU to supervise both the project and program loans (para. 30). MOF's PMU was most punctilious and responsive to ADB's concerns during implementation. Overall, MOF was exemplary in the discharge of its functions. ZTBL established a project implementation unit comprising three people. ZTBL, since July 2006, submitted all financial statements and information requested by ADB. Estranged relations between MOF's PMU and ZTBL's project implementation unit at times delayed communications with ADB. ZTBL submitted reimbursement requests to ADB for its IT systems and other purposes through MOF, which carefully reviewed ZTBL's claims before forwarding them to ADB for payment. The major change in project scope and implementation arrangements effected by ADB on 7 September 2007 (para. 34) did not significantly increase ZTBL's loan utilization for its IT systems' upgrading.

G. Conditions and Covenants

39. The project and program loan agreements were signed on 23 December 2002 and became effective on 26 December 2002, within a week of their approval. Their quick effectiveness was necessary for the program loan's first tranche's release that very day.

40. The general policy-related covenants of the program loan (Appendix 3) mandating the creation and maintenance of an enabling financial environment were relevant to the program's successful outcome. The program loan's component-specific covenants were also relevant to the successful outcome of individual components. The Borrower did not comply with the most important covenants of the program loan. By imposing an interest cap, the Borrower made ZTBL's agricultural lending unviable. The loan waiver created a moral hazard that encouraged willful default. Both measures vitiated the favorable policy environment necessary for the success of the loan. ZTBL was not restructured as envisaged. Cooperatives were not reformed, as PCBs did not transform into MFIs. NBF, although created, did not lend. The credit unions and crop insurance schemes were not established. Compliance was marginal for those covenants related to strengthening commercial banks' rural operations. As a consequence of such noncompliance and marginal compliance, the program's envisaged outcome did not materialize. The Borrower and ZTBL's compliance with the majority of the procedural covenants of the project loan relating to project execution and reporting requirements was satisfactory (Appendix 3). Satisfactory compliance with the procedural covenants of the project loan alone while not complying with the substantive covenants of the program loan could not ensure a successful outcome for a sector development program. There were no covenants in the loan agreement to benchmark ZTBL's financial performance (paras. 7 and 47).

41. ADB effected a major change in the project loan's scope and implementation arrangements in August 2007 to enable ZTBL to use the project loan's funds (heretofore unutilized) to enhance its IT systems architecture (paras. 24–25). ADB did so in the expectation that such investment would improve ZTBL's interbranch connectivity, reduce arrears, improve liquidity, and reduce fraud. Overall, this reallocation was expected to improve ZTBL's accountability and governance.

H. Consultant Recruitment and Procurement

42. The project loan allowed for the financing of 438 person-months of international and 651 person-months of domestic consultancy by MOF's PMU, ZTBL, and SBP. The PMU's project director was a domestic consultant hired to provide 66 person-months of service between January 2003 and June 2008. ZTBL hired 164 person-months of domestic consultancy and 20 person-months of international consultancy up to 30 June 2008. All consultants were selected in accordance with ADB's *Guidelines on the Use of Consultants*.

43. All withdrawals from the program loan were in accordance with the stipulations contained in Schedule 3 of the loan agreement. Procurements of vehicles, office equipment for MOF's PMU, and IT systems for ZTBL were financed under the project loan in accordance with ADB's *Procurement Guidelines*.

I. Performance of Consultants, Contractors, and Suppliers

44. MOF was satisfied with the performance of the PMU's project director hired as a consultant. ZTBL's management was satisfied with the performance of its chief information officer and SMT members hired as consultants. ZTBL line staff members, however, did not appreciate the performance of the SMT, as indicated in their petition to its board.

J. Performance of the Borrower and the Executing Agency

45. The Borrower, for nonbanking reasons, reneged on its pledge in its policy letter and in Schedule 5 of the loan agreement to not allow loan waivers or introduce interest rate caps (para. 7). Such policies created moral hazards, made ZTBL's lending unsustainable, and discouraged private commercial banks' entry into rural finance. The Borrower, however, recognizing (i) the damage caused to ZTBL's financial condition by its policies, and (ii) the improbability of compliance with the third tranche release condition, requested that ADB cancel the loan. The Borrower's performance was unsatisfactory. MOF, as the executing agency for the program and project loans, acted reasonably in discharging its project and program supervision functions (para. 38). MOF supported ZTBL's request for major change in project scope and implementation arrangements for its IT systems' upgrade (para. 24). While MOF as the executing agency was reasonably satisfactory in project implementation, MOF as the signatory to the Development Policy Letter and as an agent of the Borrower was unable to convince the Borrower to comply fully with the provisions of the loan agreement. MOF's performance was overall partly satisfactory.

46. ZTBL's performance as implementing agency was partly satisfactory. Its financial condition and internal governance deteriorated during loan implementation (paras. 12 and 23). ZTBL was unable to win its staff's acceptance for its proposed internal reorganization. Despite the government's and ADB's attempts to help, ZTBL was unable to use the loan funds for its IT systems' upgrading (paras. 33–34). ZTBL's capacity to restructure itself and improve its financial condition and governance structure were overestimated at appraisal. ZTBL did not provide ADB with its project completion report.

K. Performance of the Asian Development Bank

47. ADB was remiss in its design and implementation of the two loans. At the design stage, ADB did not covenant its desired financial performance benchmarks for ZTBL. Had it done so, this would have provided ADB with a better enforceable monitoring mechanism. ADB proposed

release of the loan's second tranche in December 2004 even though the government had imposed an interest rate ceiling on ZTBL's lending earlier that year. This ceiling violated Schedule 5, para. 1 of the loan agreement and the Development Policy Letter. ADB extended the two loans' implementation period in April 2006 to 30 June 2008 despite the government's declaring a loan waiver in 2005 and its interest rate ceiling of 2004. In both these instances, ADB's actions sent the government conflicting signals as to ADB's commitment to a prudent and enabling financial environment. Despite significant shortfalls in ZTBL's financial performance, ADB did not carry out its special financial and operational review of ZTBL at the end of the second year as required under Schedule 5 of the loan agreement. ADB fielded an inception mission in 2003 and eight review missions thereafter, one of which was of doubtful efficacy.²¹ A review mission fielded during 9–16 October 2006 concluded that the Borrower would not be able to meet the conditions necessary for release of the program loan's third tranche. The Borrower concurred and requested ADB for cancellation of the remainder of the program loan. ADB's change in the project loan's scope and implementation arrangement was not wholly effective in realizing its intentions (paras. 33–34). Overall, ADB's performance was unsatisfactory.

III. EVALUATION OF PERFORMANCE

A. Relevance

48. RFSDP was partly relevant at appraisal but became irrelevant during implementation (para. 7 and Appendix 4). RFSDP was consistent with ADB's Poverty Reduction Partnership Agreement (para. 4) and Country Strategy Program, and it recognized the constraints faced by the poor in their access to rural credit (paras. 5–6). The project's design, however, represented a victory of hope over available empirical evidence and underestimated the impact of the political economy in ensuring favorable conditions for rural finance and in the selection of a financial intermediary.

B. Effectiveness in Achieving Outcome

49. RFSDP's outcome was less effective. None of the program loan's objectives were realized wholly and satisfactorily. Realization of the project loan's objectives were only marginally better (Appendix 4).

C. Efficiency in Achieving Outcome and Outputs

50. RFSDP was far less efficient than was envisaged at appraisal. This was demonstrated by ZTBL's poor operational and financial performance and NBF's undisbursed funds (Appendix 4).

D. Preliminary Assessment of Sustainability

51. RFSDP is not sustainable as the cardinal assumptions for its success (paras. 4–21 and Appendix 4) were not accomplished during the program loan's life. Despite major changes to the scope and implementation arrangements to the project loan, its objectives were not realized.

²¹ An ADB mission fielded 13–29 March 2006 left an aide memoire with the government but did not file a back-to-office report. In the absence of an approved back-to-office report, that mission's findings were not binding on ADB.

E. Impact

52. RFSDP had limited impact on (i) reducing poverty, (ii) increasing access of the rural poor to credit, (iii) improving governance in ZTBL, (iv) creating new and innovative products to help achieve items (i) and (ii), and (v) increasing the role for private sector participation in support of sustainable growth in agriculture and rural development. Pakistan's population below the poverty line was 34.5% in 2000/01 and declined to 22.3% in 2005/06.²² RFSDP's target of reducing the poverty level to 15% of the population by 2011²³ appears unachievable. Total lending by RFIs and MFIs as of 31 December 2005 was PRs73 billion²⁴ against an envisaged PRs240 billion. ZTBL under RFSDP was able to reach out to 413,829 clients against a target of 600,000 (para. 12). The anticipated better governance in ZTBL to promote better access for the rural poor to credit did not materialize. The new and innovative products envisaged were either not created or remained stillborn. The credit unions and pilot insurance plans were not formulated as envisaged. The PCBs did not transform into MFIs. NBF, although established, did not disburse any funds because its intended beneficiaries, the PCBs, did not transform into MFIs. The government's interest rate cap and loan waivers discouraged private sector initiatives in rural finance. The only area where RFSDP impacted positively was in financial supervision. SBP retained its role as lender of last resort while divesting its equity in ZTBL and ending its refinancing for ZTBL's subsidized lending. SBP's supervision of RFIs is now at par with that for commercial banks. ZTBL's tribunal powers were ended, and the institution was brought into the ambit of the banking ordinance.

IV. OVERALL ASSESSMENT AND RECOMMENDATIONS

A. Overall Assessment

53. Overall, RFSDP is rated as unsuccessful with a weighted rating of 0.60 (Appendix 5) in accordance with Operations Evaluation Department's guidelines.²⁵ RFSDP could have benefited from (i) the government creating and maintaining a favorable environment for rural finance (without interest rate caps and loan waivers); (ii) selection of a more financially viable institution than ZTBL as an intermediary; and (iii) the creation, development, and realization of new and innovative financial products as envisaged.

B. Lessons

54. Four important lessons have emerged from RFSDP: (i) ADB's processing and administering of RFSDP showed a prevalence of hope over circumstance; (ii) the sector development program strategy, particularly with its multiple goals, was not a suitable intervention mechanism for Pakistan's rural finance sector, as borne out by this and the Microfinance Sector Development Program (footnote 9); (iii) the success of any sector development program in the financial sector of any country requires the prevalence of a favorable environment for financial markets throughout the program period, which the government was unable to ensure in this case; and (iv) importantly, any ADB intervention in the financial sector in any country needs to be based in a strong and viable financial intermediary at the outset and cannot depend on the assumption of successful policy interventions to turn around a financially troubled institution.

²² Pakistan Economic Survey 2007-2008, page 216. Government of Pakistan, Islamabad.

²³ RRP, para. 15 and Appendix 1 (Development Policy Letter).

²⁴ CGAP. 2007. *Pakistan—Country Level Effectiveness and Accountability Review*. Washington D.C.

²⁵ ADB. 2006. *Guidelines for Preparing Performance Evaluation Reports for Public Sector Operations*. Manila.

C. Recommendations

1. RFSDP Related

55. Although RFSDP has ended, ADB should nonetheless pursue policy dialogue with the government to (i) prevent future distortions (such as loan waivers and interest rate caps) from creeping back into bank lending, and (ii) encourage ZTBL in its own interest to improve its financial and operational performance by internal reforms.

56. As both the loans are already closed, there are no outstanding disbursements or procurement-related issues. The project performance evaluation may be conducted immediately.

2. General

57. For any future financial sector intervention in Pakistan (such as a credit line), ADB should select as intermediaries only institutions demonstrating by their track records that they are financially viable. Hope should not be allowed to prevail over empirical evidence. Any financial performance benchmark for a financial institution should be covenanted in the loan agreement and enforced rigorously. Given ADB's lessons learned from these two loans and the Microfinance Sector Development Program, an intervention of sector development program type in Pakistan's rural finance sector is not recommended again.

ZARAI TARAQIATI BANK LIMITED FINANCIAL PERFORMANCE

Table A1.1: Consolidated Balance Sheet, 2002–2008
(PRs)

Item	2008	2007	2006	2005	2004	2003	2002
Assets							
Cash and balances with treasury banks	1,732,495	2,103,682	1,295,464	1,585,421	1,593,898	744,276	656,045
Balances with other banks	15,881,673	11,943,898	7,781,056	7,813,844	14,791,268	11,399,640	6,766,606
Lending to financial institutions							
Investments	5,055,690	7,604,233	5,634,499	12,820,668	2,849,677	2,621,397	2,636,734
Advances	69,923,497	61,313,006	61,514,057	52,925,286	54,335,440	54,172,386	60,669,949
Operating fixed assets	1,142,886	865,293	817,003	690,141	976,985	1,045,269	1,104,770
Deferred tax assets				1,829	1,222	1,227	1,220
Other assets	8,604,549	9,556,224	8,409,442	6,667,463	9,381,766	8,755,617	3,066,018
Total Assets	102,340,790	93,386,336	85,451,521	82,504,652	83,930,256	78,739,812	74,901,342
Liabilities							
Bills payable	613,378	392,726	276,333	235,741	197,434	190,280	118,133
Borrowings	51,257,213	51,257,213	51,257,213	51,257,213	51,257,213	51,257,213	51,257,213
Deposits and Other Accounts	5,425,259	4,323,150	2,882,384	2,644,647	3,122,206	2,277,329	1,463,769
Sub-ordinated loans	3,204,323	3,204,323	3,204,323	3,204,323	3,204,323	3,204,323	
Government of Pakistan Funds							16,142,900
Liabilities against assets subject to finance lease	-	-	-	-	-	-	-
Deferred tax liability	185,557	119,191	7,629				
Other liabilities	24,289,347	19,134,241	14,223,468	12,100,331	13,048,358	9,543,444	8,657,796
Deferred income					17,105		1,249,452
Total Liabilities	84,975,077	78,430,844	71,851,350	69,442,255	70,846,639	66,472,589	78,889,263
Net Assets	17,365,713	14,955,492	13,600,171	13,062,397	13,083,617	12,267,223	(3,987,921)
Represented by:							
Share capital	12,522,441	11,869,612	11,869,612	11,869,612	11,869,611	8,950,656	3,214,323
Advance against equity					1	2,918,954	
Statutory reserve	1,086,169	565,911	359,348	245,387	215,387	82,590	4,070,768
Unappropriated profit	3,262,655	1,834,453	1,008,200	702,355	861,549	330,360	(12,607,065)
Surplus/(Deficit) on revaluation of assets - net of tax	16,871,265	14,269,976	13,237,160	12,817,354	12,946,548	12,282,560	(5,321,974)
	494,448	685,546	363,011	245,043	137,069	(15,337)	1,334,053
Total Capital	17,365,713	14,955,522	13,600,171	13,062,397	13,083,617	12,267,223	(3,987,921)

()=negative.

Note: Numbers may not sum precisely due to rounding.

Source: Audited financial statements.

Table A1.2: Consolidated Profit and Loss Account, 2002–2008
(PRs)

Item	2008	2007	2006	2005	2004	2003	2002
Mark-up/return/interest earned	8,470,169	7,022,360	5,996,030	6,822,719	8,105,383	10,110,307	1,374,523
Mark-up/return/interest expensed	3,489,411	3,418,023	2,802,785	391,738	3,135,736	3,288,108	36,315
Net mark-up/interest income	4,980,758	3,604,337	3,193,245	6,430,981	4,969,647	6,822,199	1,338,208
Provision against non-performing loans and advances	1,922,988	3,090,206	1,767,234	4,731,992	3,406,277	3,961,558	2,148,408
Provision/(reversal) for diminution in the value of investment	1,271	(686)	10,110	(585)	998		
Write offs under Government relief packages		567,445					
Provision/(reversal) against portfolio audit					(1,098,570)		
Provision against other assets			2,048,971	12,936	2,698	(75,499)	6,414
Bad debts written off directly							
	1,924,259	3,656,965	3,826,315	4,744,343	2,311,403	3,886,059	2,154,822
Net mark-up/interest income after provisions	3,056,499	(52,628)	(633,070)	1,686,638	2,658,244	2,936,140	(816,614)
Non-Mark-Up/Interest Income							
Fee, commission and brokerage income	4,406	2,338	2,544	3,157	2,410	3,235	44,920
Dividend income	11,410	2,153	6,458	6,458	6,028	9,722	
Deferred income					6,349	2,875,231	750,548
Other income	5,777,120	5,729,582	5,514,077	828,519	939,990	601,172	179,813
	5,792,936	5,734,073	5,523,079	838,134	954,777	3,489,360	975,281
Total non-mark-up/interest income	8,849,435	5,681,445	4,890,009	2,524,772	3,613,021	6,425,500	158,667
Non-Mark-Up/Interest Expenses							
Administrative expenses	4,520,459	3,788,935	2,760,452	2,612,337	2,437,251	2,762,592	1,366,751
Amortization of deferred income					6,349	2,875,231	750,548
Provision against other assets	337,061	72,149					
Provision for stolen fixed assets	2,598						
Government relief packages written off			1,482,448				
Other charges	912	5,849	306	3,802	2,196	5,492	19,428
Total non-mark-up/interest expense	4,861,030	3,866,933	4,243,206	2,616,139	2,445,796	5,643,315	2,136,727
	3,988,405	1,814,512	646,803	(91,367)	1,167,225	782,185	(1,978,060)
UNUSUAL ITEM		30,366					
Profit Before Taxation	3,988,405	1,784,146	646,803	(91,367)	1,167,225	782,185	
Taxation - Current	1,387,835	631,484	217,539	38,434	503,234	369,242	6,873
- Prior years	12,606	8,285					
- Deferred	(13,325)	111,561	9,458	(607)	5	(7)	6,158
	1,387,116	751,330	226,997	37,827	503,239	369,235	13,031
Profit After Taxation	2,601,289	1,032,816	419,806	(129,194)	663,986	412,950	(13,031)
Unappropriated profit brought forward	1,834,453	1,008,200	702,355	861,549	330,360		(12,621,906)
Profit available for appropriation	4,435,742	2,041,016	1,122,161	732,355	994,346	412,950	(12,634,937)
Appropriations							
Transfer to statutory reserve	(520,258)	(206,563)	(83,961)		132,797	82,590	
Transfer from surplus on revaluation of fixed assets to accumulated loss							27,872
Transfer to contingencies reserve			(30,000)	30,000			
Issuance of bonus shares	(652,829)						
Unappropriated profit carried forward	3,262,655	1,834,453	1,008,200	702,355	861,549	330,360	(12,607,065)

()=negative.

Note: Numbers may not sum precisely due to rounding.

Source: Audited financial statements.

Table A1.3: Financial Ratios, 2002–2008
(%)

Item	2008	2007	2006	2005	2004	2003	2002
Capital Adequacy Ratio	24.11	24.50	24.75	25.65	25.77	25.32	25.65
Return on Assets	2.66	1.16	0.50	(0.16)	0.82	0.54	(0.03)
Return on Equity	16.10	7.23	3.15	(0.99)	5.24	9.98	0.65
Debt to Equity	317.17	359.00	384.49	392.08	404.38	1,238.20	(2,570.62)
Equity to Total Assets	17.74	16.73	16.19	15.70	16.09	15.97	(10.65)
Loan to Deposit Ratio	1,288.85	1,418.25	2,134.14	2,001.22	1,740.29	2,378.77	4,144.78
Intermediation Cost Ratio (non-interest expenses to total income)	34.08	30.31	36.84	34.15	27.00	41.50	90.93

()=negative.

Notes:

1. ADB had set as uncovenanted target for Zarai Taraqati Bank Limited (ZTBL) to achieve a minimum 5% return on equity.
2. ADB required ZTBL to have a recovery rate on current dues of 75% in 2003, 80% in 2004, and 90% in 2005. Its actual recoveries (of current dues) were 75% in 2003 and 2004, and 82% in 2005. Its collection of past dues was lower at 29% in 2003, 25% in 2004, and 62% in 2005 against targets of 40%, 50%, and 60% respectively.
3. ADB required ZTBL to increase its customers' deposits by PRs2.5 billion in 2003, PRs4.5 billion in 2004, and PRs8.5 billion in 2005. ZTBL's customer deposits increased by PRs2.3 billion in 2003, PRs1.19 billion in 2004, and PRs2.6 billion in 2005. PRs higher increase of its lending relative to its deposits resulted in its loan to deposit ratio remaining over 100%.

Source: ZTBL audited financial statements.

PROJECT COSTS AND LOAN EXPENDITURE CATEGORIES

Table A2.1: Expenditure Accounts by Financiers
(\$ million)

Item	Projections			Actual		
	ADB	Government	Total	ADB	Government	Total
I. Investment Costs						
A. Equipment	4.80	0.85	5.65	3.77	0.03	3.80
B. Vehicles	0.24	0.08	0.32	0.00		0.00
C. Training	2.20	0.24	2.44	0.00		0.00
D. Studies, Surveys and Audits	0.48	0.03	0.51	0.15		0.15
E. Consulting Services						
1. International Consultants	9.34	0.70	10.04	1.15		1.15
2. Domestic Consultants	3.12	0.16	3.28	0.26		0.26
Subtotal Consulting Services	12.46	0.86	13.32	1.41		1.41
Total Investment Costs	20.18	2.06	22.24	5.33	0.03	5.36
II. Recurrent Costs						
A. Staff Expenses	0.00	0.20	0.00		0.01	0.01
B. Vehicle and Equipment Expenses	0.00	0.52	0.52			
C. Communication Expenses	0.00	0.76	0.76		0.00	0.00
D. Office Expenses	0.00	0.39	0.39			
Total Recurrent Costs	0.00	1.87	1.87	0.00	0.01	0.01
Total Baseline Costs	20.18	3.93	24.11	5.33	0.04	5.37
Price and Physical Contingencies	3.36	0.71	4.07			
Total Project Costs	23.54	4.64	28.18	5.33	0.04	5.37
Interest During Implementation	0.93		0.93	0.92		0.92
Commitment Charges	0.26		0.26	0.06		0.06
Front-end fees	0.25		0.25	0.25		0.25
Total Disbursement	24.98	4.64	29.62	6.56	0.04	6.60

ADB = Asian Development Bank.

Note: Numbers may not sum precisely due to rounding.

Sources: Asian Development Bank and Ministry of Finance.

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

Item	ADB			MOF			Total		
	Foreign	Local	Total	Foreign	Local	Total	Foreign	Local	Total
I. Investment Costs									
A. Equipment	2.62	1.15	3.77		0.0307	0.0307	2.62	1.18	3.80
B. Vehicles	0.00	0.00	0.00				0.00	0.00	0.00
C. Training	0.00	0.00	0.00				0.00	0.00	0.00
D. Studies, Surveys and Audits	0.00	0.15	0.15				0.00	0.15	0.15
E. Consulting Services									
1. International Consultants	1.15	0.00	1.15				1.15	0.00	1.15
2. Domestic Consultants	0.00	0.26	0.26				0.00	0.26	0.26
Subtotal Consulting Services	1.15	0.26	1.41				1.15	0.26	1.41
Total Investment Costs	3.77	1.56	5.33		0.0307	0.0307	3.77	1.59	5.36
II. Recurrent Costs									
A. Staff Expenses					0.0053	0.0053	0.00	0.01	0.01
B. Vehicle and Equipment Expenses									
C. Communication Expenses					0.0016	0.0016	0.00	0.00	0.00
D. Office Expenses									
Total Recurrent Costs	0.00	0.00	0.00		0.0069	0.0069	0.00	0.01	0.01
Total Baseline Costs	3.77	1.56	5.33		0.0376	0.0376	3.77	1.60	5.37
Physical Contingencies									
Price Contingencies									
Total Project Costs	3.77	1.56	5.33		0.0376	0.0376	3.77	1.60	5.37
Interest During Implementation	0.92		0.92				0.92	0.00	0.92
Commitment Charges	0.06		0.06				0.06	0.00	0.06
Front-end fees	0.25		0.25				0.25	0.00	0.25
Total	5.00	1.56	6.56		0.0376	0.0376	5.00	1.60	6.60

ADB=Asian Development Bank; MOF=Ministry of Finance.

Note: Numbers may not sum precisely due to rounding.

Sources: Asian Development Bank and Ministry of Finance.

Table A2.3: Allocation and Disbursement
(\$)

Category or Subloan	Original Allocation	First Reallocation ¹	Second Reallocation ²	Last Revised Allocation	Amount Disbursed	Undisbursed Balance
Equipment	4,800,000		14,200,000	19,000,000	3,766,120	15,233,880
Vehicles	240,000			240,000	0	240,000
Training	2,200,000		(2,000,000)	200,000	0	200,000
Studies, Surveys and Audits	480,000		(192,522)	287,478	152,760	134,718
International Consulting Services	9,340,000	2,890,000	(8,669,478)	3,560,522	1,147,370	2,413,152
Domestic Consulting Services	3,120,000	(3,120,000)		0	0	0
Front End Fee	250,000			250,000	250,000	0
Interest and Commitment Charge	1,190,000			1,190,000	987,811	202,189
PMU Support Cost		72,000	200,000	272,000	258,225	13,775
Unallocated	3,380,000	158,000	(3,538,000)	0	0	0
Total	25,000,000	0	0	25,000,000	6,562,286	18,437,714

()=negative, PMU=project management unit.

Note: The disbursement balance of US\$18,437,714 was cancelled on 17 July 2009.

¹ Reallocation on 12 September 2003.

² Reallocation on 7 September 2007.

Source: Asian Development Bank.

COMPLIANCE WITH LOAN AND PROJECT COVENANTS

Covenant	Status of Compliance
Loan Agreement Covenants (Loan 1987)	
Article IV. Particular Covenants	
<u>Section 4.01 (a)</u> The Borrower shall cause the Program to be carried out with due diligence and efficiency and in conformity with sound administrative, financial, environmental and rural-area banking practices.	Partly complied The interest rate cap announced in 2004 and loan waiver announced in 2005 by the Borrower did not meet these conditions.
<u>Section 4.01 (b)</u> . In the carrying out of the Program and operation of the Program facilities, the Borrower shall perform, or cause to be performed, all obligations set forth in Schedule 5 to this Loan Agreement.	Not complied
<u>Section 4.02</u> . The Borrower shall make available, 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 Program.	Complied
<u>Section 4.03</u> . The Borrower shall ensure that the activities of its departments and agencies with respect to the carrying out of the Program are conducted and coordinated in accordance with sound administrative policies and procedures.	Complied
<u>Section 4.04 (a)</u> . The Borrower shall maintain, or cause to be maintained, records and documents adequate to identify the Eligible Items financed out of the proceeds of the Loan and to indicate the progress of the Program.	Complied
<u>Section 4.04 (b)</u> . The Borrower shall enable ADB's representatives to inspect any relevant records and documents referred to in paragraph (a) of this Section.	Complied
<u>Section 4.05</u> . As part of the reports and information referred to in Section 7.04 of the Loan Regulations, the Borrower shall furnish, or cause to be furnished, to ADB all such reports and information as ADB shall reasonably request concerning (i) the Counterpart Funds and the use thereof; and (ii) the implementation of the Program, including the accomplishment of the targets and carrying out of the actions set out in the Policy Letter.	Complied
Schedule 5. Program Implementation and Other Matters	
<u>Program Implementation</u>	
1. The Borrower shall (a) ensure that the policies adopted and actions taken as described in the Policy Letter prior to the date of this Loan Agreement continue in effect for the duration of the Program period and subsequently, and (b) promptly adopt the other policies and take the other actions indicated in the Program as specified in the Policy Letter, including the Policy Matrix, and ensure that such policies and actions continue in effect during and after the Program period.	Not complied Two important conditions in the policy letter (and in Schedule 5 of the loan agreement) and matrix that there should be no interest rate caps nor loan waivers were not followed.
2. The MOF shall be the Program Executing Agency and shall coordinate with SBP on policy reforms. The MOF has established and shall maintain a Program/Project Management Unit and with a program/project director and two full time officers acceptable to ADB to coordinate, monitor and supervise implementation of the Program and the Project.	Complied

Covenant	Status of Compliance
3. ZTBL shall be the implementing agency for the ZTBL Restructuring and SBP shall be the implementing agency for the New Bank Fund. SBP shall strengthen its Rural and Microfinance Support Division with the appointment of, initially, one additional officer, to be followed by the appointment of a second additional officer on a timeframe acceptable to ADB. The Borrower shall consult the National Credit Consultative Council, consisting of a broad array of stakeholders, on policy matters.	Complied
<u>Policy Dialogue</u>	
4. The Borrower shall keep ADB informed of, and the Borrower and ADB shall from time to time exchange views on, the progress made in carrying out the Program.	Not fully complied There is no record available of Borrower consulting ADB before announcing its interest rate cap on ZTBL's lending in 2004 and loan waivers in 2005.
5. The Borrower shall continue timely policy dialogue with ADB on problems and constraints encountered during implementation of the Program and on appropriate measures to overcome or mitigate such problems and constraints.	Not fully complied
6. The Borrower shall keep ADB informed of policy discussions with other multilateral and bilateral agencies that have implications for implementation of the Program, and shall provide ADB with an opportunity to comment on any resulting policy proposals. The Borrower shall take ADB's views into consideration before finalizing and implementing any such proposals.	Not complied Borrower did not discuss with ADB its decisions to announce loan waivers or interest rate caps.
<u>Use of Counterpart Funds</u>	
7. (a) Upon release of the First Tranche, the Borrower shall utilize the Counterpart Funds to make grants as follows: (i) \$50,000,000 for the Golden Handshake Scheme; and (ii) \$50,000,000 for ZTBL cash equity for bad debt provisioning.	Partly complied Borrower released \$50 million for ZTBL's golden handshake. Borrower had not up to May 2007 injected \$50 million into ZTBL as equity.
(b) Upon release of the Second Tranche, the Borrower shall utilize the Counterpart Funds to make grants as follows: (i) \$34,000,000 for the Golden Handshake Scheme; (ii) \$1,000,000 for the Rural Finance Resource Center, and (iii) \$15,000,000 for the New Bank Fund.	Complied. The Second Tranche was released on 8 Dec 2004. The 3 amounts (i), (ii), and (iii) were utilized as covenanted.
(c) Upon release of the Third Tranche, the Borrower shall utilize the Counterpart Funds to make grants as follows: (i) \$47,000,000 for ZTBL cash equity for bad debt provisioning; (ii) \$1,000,000 for development/implementation of the Credit Union Plan; and (iii) \$2,000,000 for development/implementation of the Pilot Insurance Plan.	Not complied The loan was cancelled before its third tranche was released.
(d) Upon release of the Fourth Tranche, the Borrower shall utilize the Counterpart Funds to make grants as follows: \$25,000,000 for ZTBL cash equity for bad debt provisioning.	Not complied

Covenant	Status of Compliance
<u>ZTBL Restructuring</u>	
8. Notwithstanding any other provision of the Loan Agreement, if there is a significant shortfall in the achievement of Performance Indicators by ZTBL, ADB will carry out a special financial and operational review of ZTBL and reach an agreement with ZTBL and the Borrower regarding implementation of recommendations of such mission, and until such agreement has been reached, the Borrower may not make withdrawals from the Deposit Account.	Not complied
9. The Borrower shall ensure that ZTBL shall have complete autonomy for disposal of assets, pricing of financial service products, appointment and termination of staff, and payment of salary and performance incentives to staff.	Complied
10. ZTBL shall acquire and install forensic accounting capability to support the Audit Committee of the Board of Directors in tracking and minimizing corruption cases.	Complied
11. ZTBL shall promptly inform ADB of any change in its Board of Directors or its senior management team and ensure that any such change shall be made in accordance with good corporate governance.	Complied
<u>Reform of Cooperatives</u>	
12. The Borrower shall ensure that the Credit Union Plan, including a comprehensive framework for modifications in structure, constitution, accreditation criteria, financial systems, bylaws and supervisory arrangements of cooperative societies is implemented in a manner satisfactory to ADB.	Not complied
<u>Strengthening Commercial Bank Rural Operations</u>	
13. The Borrower shall ensure that the Rural Finance Resource Center at NIBAF shall design and provide training with a view to (i) creating awareness of the possibility, prospects and risks in rural finance; (ii) improving governance of rural finance operations; (iii) developing demand adapted to products, and services with recognition of gender dimensions in rural finance; (iv) instituting enhanced portfolio management capability; and (v) installing systems, procedures and financial technology for reducing transaction cost.	Partially complied RFAC at NIBAF was established. (i) to (iii) were achieved. (iv) and (v) were not accomplished. SBP stated that it revised its branch licensing policy mandating commercial banks to have 20% of their branches in rural and underserved areas. SBP also issued branchless banking regulations to reduce commercial banks' rural operations' transaction costs.
<u>New Bank Fund</u>	
14. SBP shall implement the New Bank Fund with the objective of encouraging the establishment and licensing of MFIs for rural areas at provincial and district levels, providing institutional strengthening, and providing incentives through the New Bank Fund and access of eligible MFIs to specialized funds established under the Microfinance Sector Development Program.	Partly complied NBF was established but had no lending. PCBs did not transform into MFIs.
15. SBP shall encourage MFIs to include outreach to rural communities, especially women borrowers, and recruitment, training and retaining of women staff.	Partly complied SBP has taken several measures to expand

Covenant	Status of Compliance
	financial outreach to rural poor women.
16. The Borrower shall (i) assist private sector participants in identifying and promoting small MFIs; (ii) ensure Program resources are provided to SBP and MFIs in a timely manner; and (iii) review the Microfinance Institutions Ordinance 2001 in light of experience under the New Bank Fund in promoting MFIs in rural areas.	Partly complied SBP has through its Finance Bill 2007 incorporated amendments in the MFI Ordinance (2001) to provide a more conducive legal and regulatory environment for MFIs.
<u>Product and Process Innovations</u>	
17. The Borrower shall ensure that the Pilot Insurance Plan is implemented in up to four pilot districts in a manner satisfactory to ADB.	Not complied
<u>Review and Evaluation of the Program</u>	
18. Without limiting the generality of Section 4.05 of this Loan Agreement or paragraphs 4 to 6 of this Schedule, the MOF shall assist ADB by providing relevant data and information in such detail as ADB may reasonably request to facilitate review by ADB of the progress in the implementation of the Program.	Complied
19. The Borrower shall implement a performance monitoring system for monitoring and evaluation of the Program during and after implementation in accordance with a schedule and terms of reference to be mutually agreed upon by the Borrower and ADB.	Not complied
20. The PMU shall provide ADB with quarterly progress reports assessing: (i) implementation of policy reform measures; (ii) the Rural Finance Resource Center, Credit Union Plan, Pilot Insurance Plan; and (iii) details of entities that avail of the New Bank Fund. The Borrower, ADB and SBP shall conduct a comprehensive midterm review at the end of the second year of program implementation to evaluate the progress of reform measures and the impact of the Program on the rural finance sector. If requested by ADB, the Borrower shall undertake an audit of the use of loan proceeds and ADB retains the right to (i) audit any account relating to the Program; and (ii) verify the validity of certification issued by the Borrower for each withdrawal application.	Complied
Project Covenants (Loan 1988)	
Article IV. Particular Covenants	
<u>Section 4.01 (a).</u> The Borrower shall cause the Project to be carried out with due diligence and efficiency and in conformity with sound administrative, financial, environmental and rural-area banking practices.	Partly complied
<u>Section 4.01 (b).</u> In the carrying out of the Project and operation of the Project facilities, the Borrower shall perform, or cause to be performed and cause each of ZTBL and SBP to perform, all obligations set forth in Schedule 6 of this Loan Agreement.	Complied
<u>Section 4.02.</u> The Borrower shall make available and shall cause ZTBL and SBP to make available, 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 operation and maintenance of the Project facilities.	Complied

Covenant	Status of Compliance
<u>Section 4.03 (a).</u> In the carrying out of the Project, the Borrower shall cause competent and qualified consultants acceptable to ADB, to be employed to an extent and upon terms and conditions satisfactory to the Borrower and ADB.	Complied
<u>Section 4.03 (b).</u> The Borrower shall cause the Project to be carried out in accordance with plans, specifications, work schedules and construction methods acceptable to ADB. The Borrower shall furnish, or cause to be furnished, to ADB, promptly after their preparation, such plans, specifications and work schedules, and any material modifications subsequently made therein, in such detail as ADB shall reasonably request.	Complied
<u>Section 4.04.</u> The Borrower shall ensure that the activities of ZTBL and SBP, and 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.	Partly complied
<u>Section 4.05 (a).</u> The Borrower shall (i) maintain, or cause to be maintained and shall cause ZTBL and SBP to maintain, separate accounts for the Project; (ii) have such accounts and related financial statements audited annually, in accordance with appropriate auditing standards consistently applied, by independent auditors whose qualifications, experience and terms of reference are acceptable to ADB; (iii) furnish to ADB, as soon as available but in any event not later than six months after the end of each related fiscal year, certified copies of such audited accounts and financial statements and the report of the auditors relating thereto (including the auditors' opinion on the use of the Loan proceeds and compliance with the covenants of this Loan Agreement as well as on the use of the procedures for imprest account/statement of expenditures), all in the English language; and (iv) furnish to ADB such other information concerning such accounts and financial statements and the audit thereof as ADB shall from time to time reasonably request.	Complied
<u>Section 4.05 (b).</u> The Borrower shall enable ADB, upon ADB's request, to discuss the Borrower's, ZTBL's and SBP's financial statements for the Project and its financial affairs related to the Project from time to time with the Borrower's, ZTBL's and SBP's auditors, and shall authorize and require any representative of such auditors to participate in any such discussions requested by ADB, provided that any such discussion shall be conducted only in the presence of an authorized officer of the Borrower unless the Borrower shall otherwise agree.	Complied
<u>Section 4.06.</u> The Borrower shall enable ADB's representatives to inspect the Project, the goods financed out of the proceeds of the Loan, and any relevant records and documents.	Complied
<u>Section 4.07.</u> The Borrower shall ensure that the Project facilities are operated, maintained and repaired in accordance with sound administrative, financial, environmental, rural-area banking and maintenance and operational practices.	Complied
Schedule 6. Execution of Project and Operation of Project Facilities; Financial Matters	
<u>Project Execution and Implementation</u>	
1. The MOF shall be the Project Executing Agency and shall coordinate implementation of the Project. MOF shall ensure that the PMU established under the Program Loan Agreement shall also act as the Project Management Unit for the Project.	Complied
2. ZTBL shall be the implementing agency for the ZTBL Restructuring described in Part A of Schedule 1. SBP shall be the Implementing Agency-for the Strengthening Supervision and Regulation of Rural Finance subcomponent of Part A of Schedule 1 and the New Bank Fund and Outreach Expansion of Part B of Schedule 1. MOF shall	Complied

Covenant	Status of Compliance
be the implementing agency for all other components of the Project.	
3. ZTBL shall establish a Project Implementation Unit (PIU) with two full time staff at the Islamabad headquarters to coordinate implementation of the ZTBL Restructuring. The PIU shall submit information and analysis to the PMU and coordinate the fielding and work of consultants for the ZTBL Restructuring.	Complied
<u>Project Component Implementation</u>	
4. <u>ZTBL Restructuring</u> . ZTBL shall promptly inform ADB of any change in its board of directors or its senior management team and ensure that any such change shall be in accordance with principles of good corporate governance.	Complied
5. <u>SBP Institutional Strengthening</u> . SBP shall ensure that the Rural and Microfinance Support Division shall be responsible for the investment, management and operation of the New Bank Fund in accordance with the New Bank Fund Rules to be issued by SBP as a condition for the release of the Third Tranche under the Program. SBP shall include in its website a separate page on the New Bank Fund for international dissemination of information.	Partly complied SBP has issued NBF rules and posted them on its website. NBF operations have however not commenced.
<u>Accounts, Audits and Reports</u>	
6. Without limiting the provisions of Section 4.06 of this Loan Agreement, SBP shall ensure that independent auditors acceptable to ADB annually audit the New Bank Fund and Rural Finance Resource Center at NIBAF and shall furnish, within six months of the close of the financial year, certified copies of the audit reports together with the auditor's opinion in English to the Borrower and ADB. SBP shall make the audit reports public. SBP shall also ensure that MFIs which are recipients of financing under the New Bank Fund shall maintain separate records and accounts, adequate to identify goods and services financed out of the New Bank Fund to disclose the use thereof following sound accounting principles, and shall require MFIs to have such accounts and records audited annually by auditors on the panel of auditors of SBP, and shall furnish, within six months of the close of the financial year, certified copies of the audit report together with the auditor's opinion in English to the Borrower and ADB.	Partly complied
7. Without limiting the provisions of Section 4.06 of this Loan Agreement, the Borrower shall ensure that audited annual accounts of ZTBL shall be submitted to ADB within six months of the end of the reporting period. SBP shall share the key findings of its inspection reports on ZTBL and MFIs with ADB. The Borrower shall ensure that three annual management audits of ZTBL shall be carried out to evaluate management autonomy, institutional role and strategy, organizational structure, credit policy and procedures, service delivery systems, performance measurement, management information system, and training policies and programs.	Complied
<u>Project Review and Reporting</u>	
8. The PMU shall submit reports to ADB concerning the use of loan proceeds, project administration, and financial management. The reports shall include (i) semiannual and annual project implementation reports; (ii) a midterm review report; and (iii) a project completion report to be submitted not later than six months after project completion. The reports shall cover (i) expenditures, (ii) activities financed by the New Bank Fund, (iii) highlights of audit reports, of ZTBL, MFIs which are recipients of New Bank Funds, and rural finance operations of commercial banks, (iv) training activities and their impact, and (v) performance of Credit Union Plan and Pilot Insurance Plan. These aspects shall be discussed in greater detail in the annual reports. ZTBL shall prepare quarterly reports analyzing overall financial and operational aspects including the status of implementation of the Restructuring Plan.	Partly complied (i) was submitted to ADB. (ii), (iii) and (iv) were not submitted to ADB.

Covenant	Status of Compliance
<p>9. ADB and the Borrower shall periodically review project implementation. The reviews shall include (i) evaluation of the project scope, and implementation arrangements; (ii) consultation with ZTBL, SBP, MFIs which are recipients of the financing under the New Bank Fund, commercial banks, implementation of Restructuring Plan; Oil) progress with the policy reform agenda, and capacity building measures. ADB shall also field regular review missions, including midterm, and project completion review missions. A comprehensive midterm review at the end of year two shall be undertaken to evaluate actual physical and financial progress. Based on this review, modifications and improvements shall be considered by ADB and the Borrower.</p>	<p>Partly complied ADB fielded review missions but not the comprehensive midterm review mission 2 years into project implementation.</p>
<p>10. In case of natural calamities and unforeseen circumstances that affect the equity and liquidity of ZTBL, MFIs that avail of the New Bank Fund, and commercial banks under the Program, ADB shall be consulted immediately and a remedial action plan acceptable to ADB prepared within one month thereafter, and subsequently implemented to the satisfaction of ADB.</p>	<p>Not complied As no microfinance institutions or banks availed NBF resources, it was not possible for SBP to take any action envisaged in this covenant.</p>
<u>Project Performance Management System</u>	
<p>11. ZTBL shall establish and maintain a project performance management system acceptable to ADB on a schedule acceptable to ADB. The PPMS shall generate monthly, quarterly, and annual computer-generated reports. The information system shall comprise (i) 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; (ii) details concerning the number of borrowers by gender, poverty classification, type of services, and the size of transactions; (iii) information on the performance of staff measured by financial volume, number of customers, and earnings ratios; (iv) information showing planned levels of activities against actual; and (v) annual financial statements. A format for assessing poverty reduction impact of services shall be developed in consultation with ADB. Audited operational and financial information shall be made available on the ZTBL website.</p>	<p>Partly complied Only (i) and (v) were furnished to ADB.</p>
<p>12. SBP shall require that MFIs which are recipients of the New Bank Fund shall establish on a schedule acceptable to ADB a project performance management system acceptable to ADB (equivalent to that of Khushhalibankank).</p>	<p>Not complied PCBs were not converted into MFIs and could not hence use NBF funds.</p>
<u>Environmental and Social Considerations</u>	
<p>13. Rural finance activities of the Borrower and ZTBL shall include sufficient strategies to increase the access of women borrowers to rural finance and to include women staff members in rural finance institutions. SBP shall encourage MFIs to include outreach to rural communities, especially women borrowers, and recruitment, training and retaining of women staff.</p>	<p>Not complied PCBs did not transform into MFIs. SBP efforts, if any, did not yield the desired results.</p>
<p>14. ZTBL shall ensure that its lending operations shall be carried out in accordance with all applicable environmental laws and regulations of the Borrower and with applicable ADB environmental policies and procedures. The New Bank Fund Rules shall include a provision that lending operations of MFIs availing of the New Bank Fund shall comply with the applicable environmental laws and regulations of the Borrower.</p>	<p>Not complied</p>

**OVERALL ASSESSMENT OF THE RURAL FINANCE SECTOR
DEVELOPMENT PROGRAM (RFSDP)**

Criterion	% Weight	Performance Details	Rating Description	Rating Value	Rating Weight
1. Relevance	20	<p>RFSDP's design was partly relevant at appraisal but became irrelevant during implementation. RFSDP was consistent with the Poverty Reduction Partnership Agreement and Country Strategic Program of Asian Development Bank (ADB). The sector development program modality was chosen to foster a long-term perspective. There is no information in the original report and recommendation of the President (RRP) of incorporating lessons learned into RFSDP's design. Its design encompassed too wide an area to enable meaningful focus on specific goals. RFSDP's design by ADB suggests a victory of hope over available empirical evidence in assuming successful restructuring of Zarai Taraqiati Bank Limited (ZTBL), sustainable prudent financial governance in Pakistan, and other envisaged synergies. In 2002, despite ZTBL's questionable solvency, severe illiquidity, poor profitability, inefficient intermediation, and high loan arrears (RRP, paras. 24–27, 42–43, and 58), ADB selected ZTBL as an implementing agency rather than another leaner and more profitable and efficient nongovernment-owned microfinance institution (MFI) that would have been less politicized than ZTBL. Given the risk perspectives of selecting ZTBL, a more thorough problem diagnosis and a more appropriate financing delivery mechanism could have enhanced RFSDP's relevance. ZTBL's financial condition and governance deteriorated instead of improving during loan implementation. The government's policy letter (Appendix 2 of RRP) contained its explicit assurance that it would not intervene in the granting of loans, setting deposit and lending rates, pardoning loan repayments, or discouraging debt recovery. Yet the Government of Pakistan in 2004 set a lending interest rate cap at 8% for ZTBL and in 2005 announced loan remissions on ZTBL's lending. The latter created a moral</p>	Irrelevant	0	0.00

Criterion	% Weight	Performance Details	Rating Description	Rating Value	Rating Weight
		<p>hazard that encouraged ZTBL's borrowers to default willfully.¹ The former made ZTBL's lending unsustainable given that (due to its inefficiencies) its cost of funds averaged 16% p.a. and State Bank of Pakistan's refinance rate was 9%.² These moves discouraged private commercial banks' entry into rural finance, defeating another program goal. ZTBL's internal restructuring could not be implemented as envisaged due to institutional politics. The successful outcome of the New Bank Fund's linkage with the Microfinance Sector Development Program³ was not realized. Nor were innovative products and processes envisaged under RFSDP (RRP, para. 51) realized as expected. Better analysis of the sector and the political economy could have helped to better identify the problems and a more suitable intervention. Recognizing (i) the low possibility of compliance with the conditions for the release of the loan's third tranche, (ii) the damage caused to ZTBL's financial condition by the reversal of the government's policy assurances and ZTBL's own internal mismanagement, and (iii) poor achievements of other goals, the government requested ADB to cancel the loan forthwith. ADB did so on 17 May 2007. There were no further tranche releases. The project loan was reformulated in 2007 to assist ZTBL to improve its information technology architecture. Regrettably, ZTBL was unable to utilize the loan funds expeditiously for this purpose before the loan's closure. ADB appears to have overestimated the government's resolve in its commitment to prudent financial governance and its ability to enforce the same.</p>			
2. Effectiveness	30	RFSDP's outcome was less effective. None of the program loan's objectives were realized wholly and satisfactorily during the program loan's life. A favorable policy environment was not created. ZTBL was	Less Effective	1	0.30

¹ ADB's release of the loan's second tranche on 7 December 2004 and its extension of the closing dates of the two loans, even after the government's interest rate cap imposition, may have sent conflicting signals as to the continued relevance of this condition in its design.

² ZTBL Chairman's testimony in November 2006 to Parliament's Public Accounts Committee.

³ ADB. 2000. *Report and Recommendation of the President to the Board of Directors on Loans to the Islamic Republic of Pakistan for the Microfinance Sector Development Program*. Manila (Loan 1805-PAK Program Completion Report circulated to the Board in December 2008).

Criterion	% Weight	Performance Details	Rating Description	Rating Value	Rating Weight
		<p>not restructured as envisaged. The cooperatives were not reformed. No provincial cooperative banks (PCBs) were converted into microfinance institutions (MFIs). No credit union plan was prepared. No crop pilot insurance plan was prepared. The New Bank Fund was created and its rules prepared, but its funds remained undisbursed because no PCBs were converted into MFIs. The National Institute of Banking and Finance established the Rural Finance Resources Center, which conducted training. But it did not help banks develop demand-adapted products and services recognizing gender dimensions or enhance banks' portfolios or reduce their costs. The outputs of six components of the program loan remained unrealized and the seventh's was only partially realized. Realization of the project loan's objectives were only marginally better. ZTBL's restructuring did not materialize. ZTBL benefited only marginally from ADB's efforts to help ZTBL by a major change in project scope and implementation arrangements for enhancing its IT systems' architecture. State Bank of Pakistan's supervision of rural finance institutions was strengthened, albeit without recourse to loan funds. Ministry of Finance used ADB's loan funds for setting up its project management unit but did not prepare its credit union or pilot insurance plans to have been financed from the loan. Overall, the loan's effectiveness was partial, indeed marginal.</p>			
3. Efficiency	30	<p>RFSDP was far less efficient than was envisaged at appraisal in terms of restructuring ZTBL. ZTBL's profitability and liquidity were worse than was envisaged at appraisal and did not meet ADB's targets (Appendix 2). ZTBL's operating costs (as a percentage of income) increased from 43% in 2003 to 102% in 2005, demonstrating its inefficient financial intermediation. ZTBL's loan-to-deposit ratio was consistently above 1,700% between 2002 and 2005, thereby impinging on its liquidity (Appendix 2). Its deposit mobilizations fell short of ADB targets. ZTBL failed to use loan funds efficiently, effectively, and within the project loan's duration to upgrade its IT systems' architecture. The efficiency of achieving other objectives was poor. The pilot</p>	Less Efficient	1	0.30

Criterion	% Weight	Performance Details	Rating Description	Rating Value	Rating Weight
		insurance plan and credit unions plans were not initiated during the program loan's life. The New Bank Fund, although created, disbursed no funds because its intended beneficiaries did not yet exist. This reveals low efficiency in the loan funds' use.			
4. Sustainability	20	RFSDP is not a sustainable operation as the cardinal assumptions for its success were not accomplished during the program loan's life. These had included: (i) creating a favorable policy environment for rural finance, (ii) reform of cooperatives, (iii) encouraging private commercial banks' entry into rural finance, (iv) successful use of the New Bank Fund, and (v) product and process innovations. ZTBL's financial condition deteriorated during 2002–2005. Recognizing these failures, the Borrower requested closure and partial cancellation of the program loan. Despite major changes to the project loan's implementation arrangements and scope, its objectives were not realized.	Unsustainable	0	0.00
			Total	2	0.60