Working Paper

Challenges and Prospects

Microfinance in Pakistan

1. BACKGROUND

a. The Country Profile

Pakistan is a country with a population of 146 million & an average growth rate of 2.8 % per annum. Women form 48% of the total population and 52 % are men.

According to the estimates 97 million people live in rural areas whereas 49 million in the urban areas. The total labor force is estimated at 41.5 million, of which 28.1 million (67.7%) is in rural areas and 13.4 million (32.3%) in urban areas. Agriculture is the mainstay of economy with sustaining 48.4 % of the employed labor force. The other main sectoral employers are services 15.02 %, trade 13.87 and manufacturing 11.25 %. Per capita income is estimated at US$ 480.

Exports in 2000-01 were estimated at US$ 8925 million or 15.7% of GDP. Exports mainly comprise of primary commodities 11%, semi-manufactures 14% and manufactured goods 75%. The main export items are cotton, leather, rice, synthetic textiles, sports goods etc.

Imports in 2000-01 were US$ 10,171 million reflecting a trade gape of US$ 1,246 million. Major imports include petroleum, machinery, edible oil, chemical and fertilizers.

Persistent fiscal deficit is a major economic issue with fiscal deficit in 2000-01 estimated at 5.7 % of GDP. This led to unsustainable growth in public debt, and the current level of domestic debt rests at US$ 27 billion (PKR 1.6 trillion) and foreign debt at US$ 36 billion. The unsustainable levels of public debt and resulting debt servicing liabilities together with regional security needs leave limited fiscal space for servicing social development in Pakistan.

b. The Present Policy Context

After the relatively difficult phase for Pakistan's economy during the 90's the far reaching structural reforms initiated and accelerated in particular over the past three years have now started to pay off and Pakistan has witnessed a modest rebound in growth, its vulnerability to external shocks has reduced and its key economic fundamentals have improved. The real gross domestic product growth of 3.6% during FY 2001-02 as against 2.5% in the previous year and the growth target of 4.5% for the FY 2003 seems achievable. The current growth rates however need to be strengthened to arrest the current growth in poverty levels. Macro stabilization, governance reforms and re-profiling of external debt stock have created prospects for robust growth in future.

The Government has indicated its willingness to speed up the pace of structural reforms to meet the major challenges of

i. reducing poverty,

ii. improving governance and administration,

iii. improving the fiscal and balance of payments positions,

iv. restoring investor confidence,

v. achieving higher growth on a sustainable basis, and

vi. improving social indicators.

The reform agenda includes structural changes in major economic sectors, fiscal reforms, financial sector reforms, provincial finance reforms, judicial reforms, and private sector development

c. Income distribution & poverty

The Government has brought the issue of poverty alleviation to the center-stage of economic policy making, to which end a strategy to reduce poverty and improve income distribution has been put in place. The strategy is based on the premise that sustained economic growth accompanied by macroeconomic stability is the most powerful mean of reducing poverty in the medium-term. Although growth is absolutely essential, focus on this alone is not sufficient, for which directed programs are required.

While poverty is multi dimensional, its most obvious manifestation is loss of household income. The cost of structural adjustment programs have been distributed unequally and have fallen largely on the poor. Resultantly, gini co-efficient ratio in 1999 was 0.41 reflecting highly unequal income distribution pattern in society. The share of the highest 20% households was 49.7% of the national income while, 20% of the household at the bottom of the pile were receiving only 6.2% of national income.

Based on the requirement of 2150 calories, the Government of Pakistan has adopted the official poverty line in 1998-99 as US$ 10.8 (PKR 650) per capita per month. According to the calorie based poverty definition (headcount ration), 33% people in Pakistan were below the poverty line in 1999. Poverty in Pakistan is largely a rural phenomenon as incidence of poverty in rural areas was 36.3% as against 19% for urban population. Government's overall strategy and policy measures for poverty reduction include program aimed at reviving economic growth and social development. It has adopted a multi pronged approach to promote pro-poor economic growth and reduce poverty: this has been articulated in the Interim Poverty Reduction Strategy 2001-04, which is based on the following core principals:

i. Engendering growth

ii. Implementing broad based governance reforms

iii. Improving Income generating opportunities

iv. Improving social sector outcomes

v. Reducing vulnerability to shocks.

2. The Microfinance Industry In the Country

a. Background

The number of poor people in Pakistan nearly doubled during the 1990s and as mentioned earlier this incidence of poverty will continue to increase if economic performance is not accelerated, directed poverty reduction interventions are not enhanced, and delivery of pro-poor services not improved.

Therefore, the Government has made poverty reduction its prime objective and identified microfinance (MF) as a critical element of its poverty reduction strategy.

b. Sector Description and Recent Performance

I. Overview

Institutional MF is a recent development in Pakistan and, therefore, has a very limited outreach. However, the poverty reduction potential of MF is now widely recognized at the policy-making level and among the development community. In the economic and social context of Pakistan, MF is understood to comprise financial services, particularly savings and credit, for the poor with a significant degree of social intermediation. This involves improving the social condition of the poor who have been largely excluded from access to financial and social services, and includes community mobilization, skills development, risk mitigation, and access to basic infrastructure. Initial savings of up to US$ 35 (PKR 2,000) and a first time loan of about US$ 295 (PKR l6,540) are generally considered as MF.

Policies and guidelines governing the financial system and the framework of the Government's poverty reduction strategy influence the MF sector. The environment for MF has improved with the recognition that MF is critical to poverty reduction and NGOs can be effective development partners to enhance the quality of service through participatory community-based approaches. NGOs can attain legal status, and are eligible to receive resources from government-funded projects.

II. Clients and Client Characteristics

Pakistan's population is estimated at 146 million. Nearly two thirds of the population lives in rural areas. The number of poor is estimated at 47 million (33% of the population) in 6.6 million households. Of the poor, 33 million, representing 4.7 million households live in rural areas. All poor households are potential clients for both financial and non-financial services. Government considers half the adult poor population (nearly 10 million) as potential MF clients. Among this client base, women bear a disproportionately high share of the burden of poverty due to (I) low social status, (ii) lesser endowments of land and productive assets, (iii) limited access to economic opportunities and social services, and (iv) restricted mobility. Women are poorer, less healthy, and less educated than men. These differences are more pronounced in rural areas. Even though economically active, the contribution of women is inadequately documented, understood, and appreciated.

In urban areas, the poor include vendors, small traders, and laborers in the service, transport, and small industry sectors. The four categories of primary rural occupations are: landowners, sharecropper-tenants, rural artisans, and landless laborers. Sharecropper-tenants are among the poorest. Bonded labor is common amongst this group. Artisans, the traditional service providers to the rural community (e.g., blacksmiths, carpenters, weavers, barbers, tailors) are mostly poor. Landless laborers are among the poorest of the poor.

52% of rural income is generated outside agriculture. Reliance on secondary occupations is increasing as agriculture can no longer meet the income needs of the growing rural population and subsistence agriculture cannot absorb the labor surplus. These occupations include (i) paid employment, (ii) investments in small businesses, (iii) diversification into related occupations where possible (i.e., blacksmiths who undertake all forms of metal work), (iv) employment outside the community, and (v) migration to urban areas (estimated at 1.3% per annum).

However, because of limited education and skills, sharecroppers and landless laborers have fewer options other than to provide domestic services, and make and sell handicrafts and toys.

III. Microfinance & the Poor

i. Demand

The average size of loan taken by households as microfinance is about US$ 295 (PKR l6, 540) at an interest rate of 18-20 % per annum. Considering these, the estimated potential demand for micro credit is about US$ 2 billion per annum based on the number of poor households (6.6 million) or about US$ 3 billion based on half the adult poor population (10 million).

Similarly, the estimates for deposit possibilities range from US$ 225 million to US$ 350 million per annum. Based on population distribution, two thirds of this demand is considered to emanate from the rural poor. The NGO-MFIs experience reflects that depositors out-number borrowers by 2-4 times. The poor emphasize the safety and accessibility of savings facilities as many lost their savings in the past due to failures of cooperatives and finance companies.

Most of the demand for MF in rural areas is for agriculture production (50 %), livestock (25 %), and the balance for other household-based income-generating activities (IGAs). In urban areas, most of the demand is for small business and self-employed ventures. Households are extended families and the pool of labor within a family unit creates potential for a diverse range of income-earning opportunities. Demand attributes include (i) small and frequent loans; (ii) flexible terms compatible with the nature of activity; (iii) preference of women, due to restricted mobility, (iv) simple and speedy delivery procedures placed within the community; (v) service proximity, and (vi) significant and sustained social preparation to familiarize the poor with managing IGAs. Interest rate sensitivity is high in rural areas due to the general low level of economic activity. The apprehension of becoming indebted, particularly among women, due to failed enterprises (e.g., death of livestock, failure of business, crop failures) is widespread.

ii. Supply

If the supply of MF services were adequate, the MF sector would be the largest sector of the financial system in terms of clientele base. Overall, the MF market is underdeveloped with an institutional outreach estimated at 200,000 borrowers (60,000 NGOs, 140,000 CBs and DFIs) for micro credit loans. This is about 3% of poor households. The CBs hold about 417,000 savings accounts deposited by NGOs on behalf of their members. A few private sector leasing company has initiated a leasing service to provide assets for hire to poor households. Insurance to mitigate the risks for the poor does not exist. Training skills for social intermediation, though developed by NGO's, is grossly under funded & under capacity.

c. Financial Sector Reforms and Microfinance

The Government of Pakistan considers an efficient financial system necessary for macroeconomic stability. Therefore, the banking system is being strengthened by (i) fundamentally changing norms for governance; (ii) restructuring to conserve assets, downsizing staff and branches, and reducing bad debts; (iii) implementing debt recovery measures; (iv) strengthening the prudential and supervisory framework; (v) improving legal and judicial enforcement of banking courts; and (vi) privatizing all but one state-owned Commercial Bank (CB's). State Bank of Pakistan (SBP), the country's central bank, has been empowered in all matters concerning monetary and banking policies, as well as for governance and management of the financial institutions. These reforms have been extended to the Development Financial Institutions (DFIs) that are presently in restructuring and re-capitalization phase.

Interest rates have been deregulated and loans up to US$ 1,785 (PKR 100,000) may not be collateralized. In general, the reforms constitute a positive financial environment. Enforcing SBP's authority in banking supervision and greater transparency requirements has significantly strengthened good governance.

The banking reforms have now been extended to cover the specific needs of MF, which include

(i) Conducive policy to encourage emergence of MFIs as depository institutions;

(ii) Corresponding creation of a supervisory and regulatory system for orderly sector development;

(iii) Flexibility to adopt practices and procedures for banking with the poor, such as mobile banking and group collateral;

(iv) Free limit to accumulate a non-collateralized loan portfolio; and

(v) Insulation from political interference.

The MF sector can now seamlessly integrate with the broader financial sector of the country.

d. Suppliers of Microfinance

The suppliers of MF services are (i) informal reciprocal arrangements; (ii) semiformal sources such as NGOs, the Pakistan Poverty Alleviation Fund (a wholesaler), and Government-sponsored programs; and (iii) formal sources such as Development Financial institutions commercial banks, and licensed MFIs.

I. Informal Sources

Informal sources account for about 83% of the credit supply. Three principal informal sources of credit are (i) commercial creditors linked with marketing intermediaries, commission agents, village traders, and shopkeepers; (ii) land-based credit arrangement extended by landlords to farmers for inputs and to meet consumption needs; and (iii) socially based arrangements of friends and family (the most numerous). Money lending as a specialized occupation is not significant and gradually declining, Informal sources, both in rural and urban areas, mainly supply short-term credit at terms that reflect the weak bargaining power of the poor, particularly for land-based credit arrangements. Every village has one or more informal committees that collect regular savings and make loans to members. These operate like rotating savings and credit organizations. Informal credit based on reciprocity and social obligations mainly fund urgent consumption needs without any interest charges. However, these are intermittent and tend to be less than US$ 18 (PKR 1,000).

II. Semiformal Sources

The number of registered NGOs is estimated at 12,000 to 20,000, two thirds of which are in urban areas in inverse relation to population and poverty distribution. Most rural NGOs are single community or village-based groups registered as community-based organizations. Of the 100 that seem to supply some Microfinance, only half have outreach beyond the immediate community. The eleven members of the Microfinance Group are considered to have substantive interest in Microfinance and are mostly funded by aid agencies.

The NGOs providing MF can be broadly classified into two categories:

(i) Multi sectoral NGO's engaged in composite services: education, health, infrastructure, and community development. These NGOs offer micro credit as a minor program component.

(ii) There are few NGO's with Microfinance as core activity.

Generally, MF operations of NGO's are sensitive to the demand profile and social needs of the poor and provide services in a participatory manner. The combined outreach of members of the MF Group is estimated at 107,000 active loans with aggregate loans outstanding of US$ 18.3 million (PKR 1.1 billion), and savings of US$ 19.5 million (PKR 1.17 billion). Women borrowers account for 32% of the total.

NGOs deliver MF services through group-based methodology, more commonly known as the Grameen Bank model with adaptations to suit the local context. The prevalent MF delivery model includes (i) CO formation; (ii) social preparation for the poor, including numeracy and skills training; (iii) regular meeting of COs; (iv) savings mobilization and loan disbursement after the approval of a majority of members; and (v) peer pressure to ensure proper credit behavior. Loans between US$ 45-1,250 (PKR 2,520 - 70,000) are given for terms ranging from 3 months to 2 years, and repayments are usually monthly or quarterly. Incentives for repayments are common. Individual loans are also provided in some cases. Pricing of loans is in terms of markup over the principal at 18-20%. This is above the Central Bank markup charges, but below the transaction cost and expenses incurred for social intermediation. Some NGOs charge up to 48%. Most NGOs are unable to meet their costs, and use grant support to bridge their income gap. Loan repayments are reportedly high (90 to 97% of demand) in most cases.

The Government established Pakistan Poverty Alleviation Fund (PPAF) in 1997, with an endowment of PKR 500 million (US$ 9 million), as an apex institution to help the poor. PPAF plans to provide MF services primarily through NGOs to an estimated 200,000 households over the next 4 years. The World Bank is sponsoring PPAF with a US$ 90 million loan. Outreach as of June 2002 was around US$ 15 million (PKR 894 million) to over 65,000 borrowers.

Credit components in Government-sponsored programs is not micro credit either by size, mode of delivery, or terms of credit. The overall impact has been minimal as the services have been presented, promoted, and delivered in a manner that suggests a politically motivated grant facility and has been so understood by those privileged to have access. The budgetary support for such programs has either been curtailed or discontinued.

III. Formal Sources

There are 21 domestic scheduled banks, of which 2 are state-owned, around 18 foreign banks, 4 specialized banks, 4 DFIs, 16 private investment banks and a number of leasing companies. Only a few of them are attempting to develop sustainable and substantive Microfinance programs.

The Agricultural Development Bank of Pakistan (ADBP) provides two thirds of the agricultural credit available in the country through its 49 regional offices, 349 branch offices, and mobile credit offices. During 1998/99, ADBP disbursed US$ 535 million (PKR 30 billion) to 451,992 borrowers or 9% of the total 5.1 million farmers. Lending is collateral based. ADBP does not cater to the poor except under special programs. Of the 0.953 million landless farmers, 19,576 or 2% received loans. Interest rates for loans to individuals are set at 14-16% per annum.

CBs have not expanded into MF on any scale except for experiments by the Bank of Khyber, Bank of Punjab, First Women's Bank, Habib Bank, Muslim Commercial Bank, and National Bank of Pakistan. CBs have generally regarded MF as a social obligation to be cross subsidized by commercial operations.

Licensed MFIs *(see Section 3 for details)*

e) Challenges to the Expansion of Microfinance

With an outreach of less than 5% of poor households, affordable MF services are not available to the majority of the poor; thus they are unable to participate in the local economy. The outreach of the NGOs is expected to grow to 400,000 households (currently about 60,000) by the end of 2004. Commercial banking sector is neither structured nor geared to adopt MF as a substantive part of their portfolio. Therefore, in the absence of complementary or alternative arrangements, the MF market will remain grossly underserved, and its poverty reduction potential largely unrealized in the medium to long term.

For this potential to be realized, the following constraints and issues must be addressed,

I. Social

i. Inadequate Access of the Poor to Services

Inadequate access to productive resources and social services has resulted in low indicators of well-being and lack of employment opportunities. This situation is compounded in rural areas where access is even more difficult due to inadequate or complete lack of basic infrastructure. Low skill level and absence of support for human resource development for the poor prevents them from diversifying their household income. Government interventions have not yielded the desired impact due to inadequate emphasis on community-based participatory approaches. Resource availability relative to the requirements for the social sectors is low. Much of the investment required is for public services where private sector investments are unlikely. Without these services, MF will have less than the intended impact.

ii. Obstacles for Microfinance Outreach to Women

Social intermediation costs to enhance women's access to MF are significantly higher in Pakistan as constraints on mobility, social interaction, and skills development must be addressed on a sustained basis. Although returns from social intermediation in terms of social capital and demonstrative effects are high, investments are limited due to high cost. Consequently, the gender orientation of organizations, products, and delivery mechanisms is insufficient to enhance outreach to women. Inadequate social preparation adversely affects group cohesion, the quality of loan portfolio, and ultimately the sustainability of MF operations.

iii. Absence of Risk Mitigation Measures

The disadvantages of the poor households include lack of access to financial services, unfair terms of participation in the local economy, and vulnerability to economic and physical downturns. Poor households forego potentially viable technologies, production choices and income opportunities due to risk aversion. Mechanism’s to mitigate such risks are not available. In addition poor have no means to secure the safety of their savings, unless deposited with Commercial banks, to which poor have little access.

II. Financial

i. Microfinance-Specific Policy Framework

In the early stages of MF sector development, a conducive policy environment is required to encourage innovations and to allow a diverse set of institutions to provide a range of services, particularly savings, in a supervised and regulated environment. The required policy attributes include (i) promotion of institutions that can target the poor with adequate gender emphasis, (ii) acceptance of individuals as well as groups of individuals for MF transactions, (iii) mechanisms to ensure that social intermediation precedes and accompanies MF services, (iv) significant investments in social intermediation, (v) pro-poor financial innovations such as measures to mitigate risks faced by the poor, (vi) realizing public-private sector synergy, (vii) autonomy in pricing and client selection, (viii) measures to integrate MF with the financial system and (ix) proactive role of the Central Bank in developing the MF sector.

ii. Institutional Limitations

The financial reforms in Pakistan have put in place a policy framework for efficient financial intermediation that enables institutions to concentrate on their core competencies. For the CBs and DFIs, this core competency is serving the upper and middle segments of the market. While the banking system has responded positively to the reform initiatives, an efficient and financially sound system, barring select institutions, has yet to emerge. The high level of nonperforming loans attributed to slack industrial activity is widespread. Some institutions have capital adequacy below the prescribed 8% of risk-weighted assets. Competitive pressures for product differentiation and cost reduction are increasing. Smaller institutions are not able to invest in new technology and a branch network to access low cost retail deposits to gain competitive advantage. The banking system is becoming concentrated in a few large institutions.

MF is unlikely to become a significant part of CBs' portfolios. Operating procedures of CBs are incompatible with the requirements of banking with the poor, and thus their services and delivery mechanisms have excluded the poor. Women have been virtually excluded from institutional credit. In addition, CBs are undergoing reforms that include closing loss-making branches (mostly located in rural areas), downsizing, re-capitalizing and implementing measures to recover and write-off non-performing loans. The CB's priorities therefore are restructuring and reorganization. Slow transformation of DFIs into efficient financial intermediaries due to their overt political considerations in business decisions and persistent poor governance, underlines constraints to change and undermines the development of the rural financial system. For these reasons, MF has been perceived as high risk and unprofitable in Pakistan. Consequently, potential suppliers have avoided entry into MF.

NGOs have small credit operations with limited MF specialization. NGOs do not have the trained staff, financial systems, and, until recently, have not seen the necessity of following successful practices and procedures. Even among the members of the MF Group, most have yet to achieve financial viability. Inadequate investment in social intermediation also effects portfolio quality.

iii. Services

Delivery of financial services to the poor, particularly in rural areas is constrained by low population density in some provinces, inadequate communication services, small loans, and low household savings that increase transaction costs. Seasonally of the agriculture business cycle, the main occupation for poor households, and the high probability of risks add to the problems of providing MF services to the rural poor. In addition, while security of savings is a prime concern for rural households, secure savings facilities are not accessible. CBs find it costly to cater to small depositors. Savings through NGO intermediaries, deposited with CBs, are generally compulsory and do not necessarily provide the maximum return to the depositor. NGOs cannot deploy such savings as micro credit.

3. Towards a new Policy Paradigm:

a. Poverty Reduction

The Government's goal of poverty reduction is to be realized through a comprehensive approach that takes into account the interactions of economic social and governance dimensions. The approach is outlined in the Interim Poverty Reduction Strategy Paper (IPRSP) sponsored by IMF and World Bank.

Expenditure and budgetary allocations for specialized poverty reduction initiatives have been enhanced. These poverty alleviation programs have five components: (i) small infrastructure projects, (ii) social safety nets, (iii) food support program, (iv) improving social indicators, and (v) expanded access to MF and skills development services through grassroots organizations such as NGOs and village organizations. Greater private sector involvement in poverty reduction is envisaged. The policy aims to improve access to basic social services like primary education, primary health care, population welfare services, potable water, sanitation, and MF services. The incidence of poverty is to be reduced from 33% of the population to a target level of 15.2% by end 2008.

b. Microfinance Sector Development

As a part of poverty reduction strategy, the Government of Pakistan with the assistance of the Asian Development Bank has pronounced a comprehensive policy that seeks to broaden and deepen the Microfinance sector in order to enhance service outreach and thereby alleviate poverty. This new sector development policy seeks to address issues and constraints through (i) creating a conducive policy framework, (ii) developing appropriate supervisory and regulatory infrastructure for licensing and regulation of MFIs, (iii) pilot launching a model MFI capable of outreach to the poor, and (iv) investments in social intermediation and basic infrastructure.

This strategy complements the efforts of the Pakistan Poverty Alleviation Fund and other MF suppliers, and provides the basis for a concerted effort to enhance outreach in a grossly underserved market. Main highlights of the Microfinance Sector Development Policy are presented in the Sections that will follow now.

I. Rationale

While many factors contribute to poverty, its most obvious manifestation is insufficient household income. Poor households are permanently in deficit or in debt. Evidence from many countries has shown that access to and efficient provision of savings and credit facilities, along with social intermediation, enables the poor to stabilize their income and consumption, manage risks better, gradually build assets, develop micro enterprises, enhance income-earning capacity, and thus enjoy a relatively better quality of life.

Currently MF services are provided on a very limited scale, and savings at positive real interest rates for the poor are practically excluded. By borrowing at high interest rates in informal markets the poor are trapped in low-risk, low-return investments, which in the long run, will widen income gaps.

Institutions to bridge demand and supply gap for MF services did not exist in Pakistan owing to policy and legal gaps and the lack of a supportive financial infrastructure. As seen in previous Sections CBs, in general, are neither structured nor geared to extend their MF exposure beyond experimental forays. DFIs have numerous financial and organizational issues. CBs and DFIs primarily cater to the upper and middle segments of the financial markets, rural elite, and farmers with sizeable landholdings, rather than to the asset-less poor. Similarly unsustainable operations of NGOs do not offer prospects of a substantive outreach expansion.

Social constraints to enhancing outreach include (i) social barriers affecting women's access to MF, (ii) vulnerability of the poor to economic and physical downturns, and (iii) weak social preparedness for effective utilization of financial services. These are further exacerbated by institutions of governance that tend to exclude the poor, especially women, from the entire decision making process. These have impeded the growth of the MF sector resulting in a majority of the poor without access to affordable MF. The small numbers of poor households with access to institutional MF are not assured of permanent access because of the limited retail capacity and inadequate resource base of MF service providers.

To realize the poverty reduction potential of MF, substantial continuing resources are required to meet the magnitude of demand. Efficient institutional and market mechanisms are needed whereby funds can be sourced in the domestic market and supplemented by funding agencies. Funds need to be allocated efficiently through appropriately designed and priced services to the poor for investment in agriculture and micro enterprises in a profitable manner. To accomplish this, an integrated package of policy, institutional development, capacity building, and outreach expansion is needed, along with strong commitment to pursue reforms.

With a supporting policy framework, sustainable outreach to the poor can be realized by combining social and financial intermediation. Investments in social intermediation and to extend outreach will help realize the poverty reduction potential of MF. Support for institutional arrangements that combine the development efforts of a range of institutions-financial and non financial-will catalyze the development of a critical mass of MF services. This will attract a range of retailers and also a range of organizations providing services to MFIs such as rating agencies and auditors.

II. Policy Objectives

The sector objective is to reduce poverty. The purpose is to develop the MF sector to efficiently provide a range of affordable financial and social services to the poor, especially women who disproportionately bear the burden of poverty. Services provided at affordable prices will have a significant poverty reduction impact and thereby (i) increase incomes of poor households; (ii) enhance outreach, especially to women; (iii) build social capital; and (iv) reduce risks faced by the poor.

III. Policy Framework and Actions

i. Facilitate the establishment of a lead Institution- Khushhalibank (KB)

KB was designed to implement the MF policy in response to the rising incidence of poverty, significant demand and supply gap, negligible institutional outreach, and disarray of DFIs. KB is the lead institution to generate the momentum for the sector to grow, and expected investments and institutional diversity to materialize.

The objective of KB is to provide sustainable MF services to the poor in order to reduce poverty and promote social development and economic Justice through community building and social mobilization. KB was established on 6 August 2000 as a private-public institution with paid-up capital of US$ 30 million subscribed by 16 CBs:14 private sector CBs including 2 foreign CBs and 2 state-owned CBs. Investors have selected the seven-member board of directors. The Board includes two women as independent directors from the NGO sector.

While observing successful MF practices KB plans to provide affordable services, including savings, credit, leasing, money transfer, and risk mitigation. KB combines the development efforts of a range of service institutions in a synergistic and catalytic manner. NGOs undertake social intermediation, and financial services are be provided by KB. KB has adopted an innovative management structure to reduce transaction costs. 40% of KB staff and 32% of its clients are women. Service delivery methodology and products has a strong gender bias. Outreach is projected to be 560,000 borrowers by 2006 with portfolio outstandings projected at US$ 133 million.

Khushhalibank's design incorporates global experiences and best practices of the microfinance industry. By October 2002, KB was operating 31 branches and servicing 33 districts. It was managing receivables of US$ 9 million with Portfolio at Risk contained under 1.5% (includes portfolio associated with delinquencies exceeding 30 days). KB had successfully disbursed US$ 12 million and serviced over 70,000 loans since its inception.

ii. Develop a Framework for Institutional Diversity in the Microfinance Sector

As part of the MF sector policy, the institutional design and financial infrastructure created to support KB was used to develop a framework-legal, supervisory, and regulatory-to mainstream the attributes of the basic MF policy for entry of new MF institutions. The framework scope includes (i) definition and categorization of MF service providers into categories of MFIs and their licensing procedures; (ii) corresponding supervision and regulation standards and systems, including self-regulation; (iii) disclosure and reporting requirements; (iv) appropriate adjustment for entry threshold prescribed under the banking laws to enable entry of MFIs as licensed depository institutions; and (v) foreclosure and dispute resolution mechanisms. As a matter of due diligence prior to opening up the sector to a diverse range of institutions-the development of the enabling framework was sequenced after the dedicated systems for KB were operational and the supervisory capacity of SBP was developed.

Under this new legal and regulatory framework The First Microfinance Bank Limited (sponsored by the Agha Khan Foundation & IFC) was licensed in 2002. The bank has currently outlets in 3 urban centers and providing saving services to its clients. The bank is geared to setup 15 more branches by 2003.

SBP recently invited expression of interests for setting up MFIs from investors both local and foreign. A number of interests received are under processing at SBP.

iii. Support for Social Intermediation:

As part of the policy, the Microfinance Social Development Fund (MSDF) was established in SBP for provide intensive and sustained support MFIs for promotion of Community Organizations and capacity building for the poor, especially women, to effectively utilize MF services. The revenue earned from MSDF meets defined social preparation costs associated with community mobilization, skills development, social awareness, basic numeracy skills, and selection and management of IGAs for about 560,000 poor organized in about 24,750 COs. MSDF also funds women's empowerment through training in community management, capacity enhancement for specific identified skills, and leadership management. The duration of MSDF is for 25 years and the minimum outlay is US$ 40 million equivalent to generate sufficient revenues to support social development needs of the expected clients, contributed by the Government of Pakistan whereas KB has set aside 10% of its net profit in terms of KB Rules 2000 issued by the Central Bank.

iv. Enhancing Outreach of Basic Community Services:

To leverage the social mobilization through MSDF, the Community Investment Fund (CIF) was established in the SBP, with a term of 25 years, to increase the access of the poor to basic infrastructure and thus improve their livelihoods through efficient and productive use of local resources. The involvement of COs in identifying, planning, executing, and monitoring community-based infrastructure subprojects will empower them and serve as an incentive to mobilize and strengthen COs. This will help expand the MF market and maintain peer pressure as a substitute for physical collateral. The minimum outlay of CIF is US$ 20 million equivalent and the Government has contributed these funds.

MSDF and CIF support is to enhance social capital by creating a network of COs, strengthening COs, increasing social and economic interaction among the excluded, influencing norms of behaviors that govern interaction between genders, enhancing capacity and skills, and providing opportunities for economic development. The fund mechanism provides a clear basis for determining social costs associated with MF and has a built-in exit mechanism; as business volumes increase, MFI revenues will meet an increasing proportion of social costs. These funds are used only to provide services through NGOs, and nearly half the proceeds are targeted at poor women.

v. Pilot Risk Mitigation Mechanisms for the Poor as a Safety Net Measure:

As a safety net measure, the Risk Mitigation Fund (RMF) was established in SBP. RMF's objective is to reduce risks associated with failed IGAs, both farm and non-farm, of KB clients. RMF will assist KB borrowers, not KB per se, in case of loss of IGAs (acquired through KB loan) due to unforeseen circumstances beyond their control. RMF is expected to mitigate risks faced by about 27,000 poor during the six-year 2000-2006. Assistance from RMF is to be provided using a community-based participatory process where 75% of the CO members approve assistance from RMF to any individual. Experience with community-based risk mitigation mechanism gained by RMF will provide the basis for assessing the feasibility of actuarial-based insurance services for the poor.

vi. Protecting Deposits of the Poor:

Although small in absolute amount, the value of the savings of the poor relative to their income is considerable and therefore needs to be protected. KB is a deposit-taking institution, both from its (poor) borrowers and also from non-borrowers. Given substantial paid-up capital and viable operations, no immediate deposit guarantee is considered necessary. However, as a matter of precaution, the Deposit Protection Fund (DPF) was established in SBP to partially secure the savings mobilized by KB. This will provide assurance to the poor of the safety of their savings. At the end of year six (2000-2006), the DPF balance is expected to be about 50% of KB's deposits.

4. Conclusion:

Poverty is a multifaceted phenomenon that includes, but goes beyond lack of adequate income. The overarching objective of development in many countries has been and continues to be the eradication of all facets of poverty. Rapid as well as well distributed growth in income has always been viewed as an instrument for achieving this objective.

Pakistan has in the last 3 years initiated a bold reform program for accelerating growth as well as a focused third generation microfinance sector development program providing a conducive policy framework and support mechanisms to encourage private investments in the sector.

The framework allows everyone to contribute for poverty reduction according to their priorities and competency. The framework provides NGOs a long-term resource support for social services as well as microcredit in a transparent manner based on the quality of their outputs.

The State Bank of Pakistan provides for a regulatory framework allowing for the establishment of licensed MFIs, which can mobilize resources from local markets.

The Government has set up mechanisms for sharing social intermediation costs and risks of banking with the poor.

The Government will continue to play a catalytic role and it is now for the donors, private investors, civil society institutions and development organizations to take advantage of and make their contribution for poverty reduction, in a sustainable manner.