Prospects for Investment In South Asian Microfinance

2010

SAMN
South Asian Microfinance Network

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About SAMN

OVERVIEW

The South Asian Microfinance Network (SAMN) is a regional microfinance network aiming at enhancing capacity, financing and regional dialogue in the microfinance sector of south Asia. SAMN governance is composed of leading Apex Institutions from the countries of the region along with the Agency for Technical Cooperation and Development (ACTED). SAMN also partners with MFIs, Investors, Banks and other key microfinance stakeholders to fulfill its objectives.

SAMN was established in 2008 with a vision to improve financial inclusion for the low income population in the countries of south Asia. The early foundation of SAMN was laid by ACTED, a French INGO along with ACCESS Development Services and other regional and global microfinance stakeholders.

MEMBERS

SAMN membership now consists of the leading national microfinance apex institutions in six countries of the region who along with ACTED lead, manage and govern the SAMN activities with ownership towards the shared objectives. The current SAMN members, each represented with a seat on the SAMN Board of Directors, are:

- In Afghanistan: Afghanistan Microfinance Association (AMA)
- In Bangladesh: Credit and Development Forum (CDF)
- In India: ACCESS Development Services (ACCESS)
- In Nepal: Centre for Microfinance (CMF)
- In Pakistan: Pakistan Microfinance Network (PMN)
- In Sri Lanka: Lanka Microfinance Practitioner's Association (LMFPA)
- Host member: Agency for Technical Cooperation and Development (ACTED)

VISION

To enhance financial inclusion for low income population in the countries of south Asia

SAMN will achieve this through strong partnership with micro-finance stakeholders, especially with retail microfinance institutions that deliver a diversified range of sustainable financial services to the low income population to build their financial and social capital.

OBJECTIVES

To achieve its vision of enhance financial inclusion; SAMN has following overall and specific objectives.

a. To enhance the quality and outreach of microfinance in south Asia by building strong, sustainable and scalable institutions through technical assistance and financing facilitation inputs to growth oriented MFIs. Through SAMN partnership, each institution:

- improves and enacts key systems and policies
- meets financial and efficiency performance standards as per international benchmarks
- provides client-focused products and services
- reports accurately and transparently on its financial and social performance
- has access to a sufficient and diverse set of financing on a sustainable basis.

b. To promote best practices and exchange through the creation of a regional space for microfinance in south Asia. SAMN aims to become:

- a regional information hub for best practices, sector data, benchmark, regulation and investment among others
- a viable and sought after platform to facilitate exchange and establish linkages within the region

FOCUS AREA

SAMN works in three core focus areas and develops competencies around these.

TECHNICAL COOPERATION

The activities under this focus area target a select number of tier II MFIs that partner with SAMN to enhance their investment readiness, improving their practices, reporting and transparency, thereby making them more attractive for Investors. SAMN provides targeted and high quality technical cooperation through SAMN team, partnerships or outsourcing contract with external Technical Assistance (TA) providers and peer learning. Collation at national/regional level considerably reduces the cost and provides a more effective learning environment to participants through mutual exchange.

FINANCING FACILITATION

SAMN assists MFIs in linking with local and international financial institutions and investors to meet their financing need. Besides one to one contact, SAMN organizes Investment Fair during the year where partner MFIs have opportunity to make direct contact with the financial institutions and Investors. With its diverse pool of over 30 partner MFIs in the region and strong TA association with MFIs, SAMN offers investors and financial institutions different investment options to meet their financing criterion and services to reduce the cost and risk of the transaction. SAMN provides investors with all information pertinent for investment such as country context, country microfinance sector, details on partner MFIs and risks among other things and link investors with appropriate stakeholders to realize the investment.

REGIONAL EXCHANGE AND DIALOGUE

SAMN, through its membership of leading national microfinance apexes, is uniquely placed to provide platform for regional exchange and dialogue. Through this dimension SAMN aims to become a regional hub for collecting and widely disseminating information on microfinance, including best practices, sector data, benchmark, regulation, investment deals, contact information among others and a viable and sought after platform to facilitate exchange among microfinance stakeholders.

Regional exchange is facilitated through Knowledge Management Services such as Information Hub, Publication of Investment Guidelines, Investors and TA Providers Directory, Background and Focus notes, SAMN Bi-monthly Update, SAMN Quarterly Newsletter and Website. Additionally SAMN organizes regional events on different theme bringing together a diverse range of microfinance stakeholders from the region and beyond for meaningful exchange through small workshops and focus group discussions. When requested and necessary, SAMN focuses on building capacity of its member through direct inputs as well as through peer learning.

PARTNERSHIP WITH MFIS

SAMN partners with high potential MFIs in the countries of the region and closely work with MFIs to provide continuous support to meet their technical assistance and financing needs. SAMN focused on tier II MFIs.

PARTNERSHIP WITH INVESTORS, BANKS AND MICROFINANCE STAKEHOLDER

The SAMN continuously develops and welcomes strategic partnership with Investors, Banks and other microfinance stakeholders to bring various expertise and domain knowledge on board for comprehensive and cost effective services and to leverage its action.

SAMN Members

Agency for Technical Cooperation and Development (ACTED) is France based international relief and development agency operating in more than 25 countries. SAMN is one of the key global initiatives by ACTED to contribute to the development of the microfinance sector.
www.acted.org

Afghanistan Microfinance Association (AMA) was established in 2005 and is the national network of MFIs representing 13 MFIs. The key activities of AMA are Capacity Building, Advocacy and Information Dissemination to promote a sustainable and transparent microfinance sector in Afghanistan.
www.ama.org.af

Credit and Development Forum (CDF) represents over 1,500 NGO MFIs across Bangladesh. With objective to facilitate enabling environment for the microfinance operations, CDF works in core areas of Capacity Building, Research, Linkages and Advocacy.
www.cdfbd.org

ACCESS Development Services (ACCESS) aims to incubate new institutions to enable their self-sufficiency and self-sustainability. ACCESS assists the growing microfinance sector through streamlined and structured services to emerging MFIs and supports the enabling environment through the Microfinance India Platform.
www.accessdev.org

Centre for Microfinance (CMF) is the national focal point for microfinance in Nepal. CMF has 78 members as its shareholders, mostly MFIs and their associations and is owned by four types of MFIs operating in Nepal. The core services of CMF are Networking, Knowledge Management, Technical Assistance and Advocacy.
www.cmfnepal.org

The Pakistan Microfinance Network (PMN) is a network of 23 microfinance providers representing over 95% of client outreach and portfolio. To achieve its mission of 'Supporting the sector specially retail MFPs to enhance scale, quality, diversity and sustainability', it has three core function of Enabling Environment, Capacity Building and Information Hub.
www.microfinanceconnect.info

Lanka Microfinance Practioner's Association (LMFPA) aims to build the capacity of institutions engaged in microfinance to serve poor communities in a viable and sustainable manner. Presently LMPA membership consists of 86 members and LMFPA focuses on Advocacy, Research and Capacity Building.
www.lankamicrofinance.com

SAMN Partners

The Humanist Institute for Development Cooperation (HIVOS) is a Dutch non-governmental organisation that aims at structurally alleviating poverty, with an emphasis on civil society building and on sustainable economic development. The efforts of Hivos are focused on nine themes including financial services Hivos supports over 800 partner organisations in more than 30 countries through financial means and institutional support as well as the exchange of knowledge and experience.
www.hivos.nl

Oxus Development Network was founded by ACTED in 2005 to strengthen its microfinance intervention. It is a French company that provides technical backstopping and financing to MFIs.
www.oxusnetwork.org

Standard Chartered is a leading international bank operating in more than 70 countries. It has over USD 350 mn in credit and financial instruments to more than 52 partner MFIs in 14 countries of Asia and Africa impacting over 2.6 mn people.
www.standardchartered.com

This Publication

This is the second edition of the publication 'Prospects for Investment in South Asian Microfinance', covering six countries of the region – Afghanistan, Bangladesh, India, Nepal, Pakistan and Sri Lanka.

The publication is particularly targeted to potential investors in South Asian microfinance from four key perspective that shape an investment decision among others - Economy, Financial Sector, Status of the Microfinance Sector and Investment Options in the microfinance sector. The publication will also be useful for other microfinance stakeholders interested in knowing about the microfinance sector in the region and make cross-country comparisons.

We hope that readers find this publication useful and we look forward to reader's comments and suggestions to improve the publication in future.

Acknowledgement

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We especially thank our members, Afghanistan Microfinance Association (AMA), Credit and Development Forum (CDF) Bangladesh, ACCESS Development Services (ACCESS) India, Centre for Microfinance (CMF) Nepal, Pakistan Microfinance Network (PMN) and Lanka Microfinance Practioner's Association (LMFPA) for providing continuous support in getting most updated information on the sector and clarifying some aspects related to investment which are not very easily available in the existing literature and publications.

SAMN also thanks Luca Pupulin and Katherine Neumann of ACTED for providing valuable inputs to the publication.

Finally we are grateful to the HIVOS and Banking with the Poor Network (BWTP) for the funding support that allowed us to bring out this publication.

Abbrevations

ADB : Asian Development Bank
ADBN : Agriculture Development Bank of Nepal
ADRs : American Depository Receipts
AFS : Ariana Financial Services
AISA : Afghanistan Investment and Support Agency
AKAM : Aga Khan Agency for Microfinance
AMA : Afghanistan Microfinance Association
ANDS : Afghanistan National Development Strategy
AREU : Afghanistan Research and Evaluation Unit
AWDR : Average Weighted Deposit Rate
AWPR : Average Weighted Prime Lending Rate
BAB : BRAC Afghanistan Bank
BB : Bangladesh Bank
BFIA : Banking and Financial Institutions Act
Billion : bn
BIO : Board of Investment
BRAC : Bangladesh Rural Advancement Committee
CAGR : Compound Annual Growth Rate
CAR : Capital Adequacy Ratio
CBB : Chhimek Bikas Bank Ltd.
CDF : Centre for Self-help Development
CDNS : Central Directorate of National Savings
CGAP : Consultative Group to Assist Poor
CIB : Credit Information Bureau
CIBIL : Credit Information Bureau (India) Limited
CMF : Centre for Microfinance
CPI : Consumer Price Inflation
CRBs : Co-operative Rural Banks
CRIB : Credit Information Bureau
DAB : Da Afghanistan Bank
DBB : Deprosc Bikas Bank
DFIs : Development Finance
DSL : Deprived Sector Lending
DMFI : Deposit Taking Microfinnace Institutions
DSE : Dhaka Stock Exchange
ECB : External Commercial Borrowing
ECLOF : Ecumenical Loan Fund
EFU : Eastern Federal Union
EPF : Employee Provident Fund
ESOPs : Employee Stock Ownership Plans
EU : European Union
FATF : Financial Action Task Force
FCBs : Foreign Owned Commercial Banks
FDI : Foreign Direct Investment
FIBP : Foreign Investment Promotion Board
FIIs : Foreign Institutional Investors
FINGOs : Financial Intermediary Non-Government Organizations
FMBB-A : First Microfinance Bank Afghanistan (FMFB-A)
FSRP : Financial Sector Reform Program
FSS : Financial Self-Sufficiency
GB : Grameen Bank
GBB : Grameen Bikas Bank
GDP : Gross Domestic Product
GDP : Gross Domestic Products

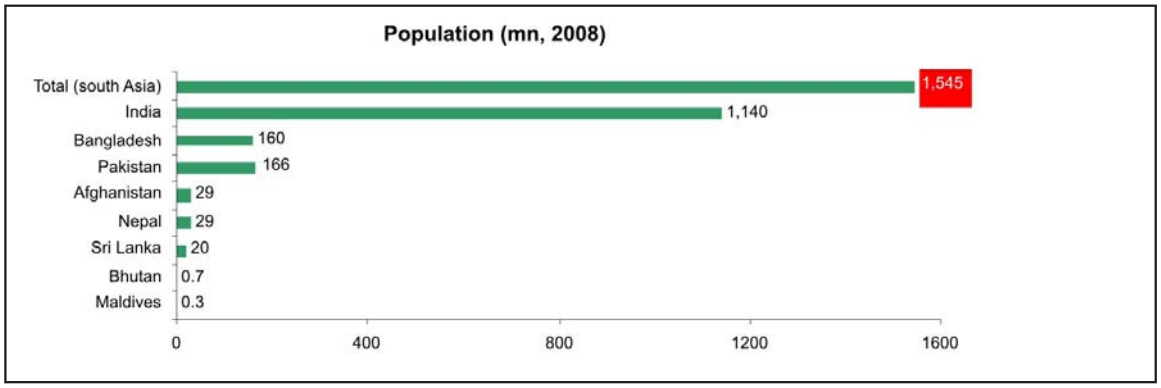
GDR : Global Depository Receipts
GNI : Gross National Income
HDI : Human Development Index
HDR : Human Development Report
HIPC : Heavily Indebted Poor Countries
HNB : Hatton National Bank
IBBL : Islami Bank Bangladesh Ltd
IBSL : The Insurance Board of Sri Lanka
IFC : International Finance Corporation
ILO : International Labour Organization
IMF : International Monetary Fund
INAFI : International Network of Alternative Financial Institutions
InM : Institute of Microfinance
IRDA : Insurance Development and Regulatory Authority
IRDP : Integrated Rural Development Programme
JLG : Joint Liability Groups
KfW : Kreditanstalt fur Wiederaufbau
KYC : Know Your Customer
LCBs : Licensed Commercial Banks
LEPR : Labour Force Participation Rate
LFSUS : Lanka Financial Services for Underserved Settlements
LIBOR : London Interbank Offered Rate
LOMC : Lanka Orix Microcredit Limited
LSBs : Licensed Specialised Banks
MFB : Microfinance Banks
MFDBs : Microfinance Development Banks
MFIN : Microfinance Institutions Network
MFIs : Microfinance Institutions
MFPs : Microfinance Providers
MIFA : Microfinance Association of Nepal
MIGA : Multilateral Investment Guarantee Facility
Million : mn
MIS : Management Information Systems
MISFA : Microfinance Investment Support Facility for Afghanistan
MIX : Microfinance Information Exchange
MoF : Ministry of Finance
MPCSs : Multi-Purpose Co-operative Societies
MRA : Microfinance Regulatory Authority
NABARD : National Bank for Agriculture and Rural Development
NAV : Net Asset Value
NBFCs : Non-banking Financial Companies
NBFIs : Non-Bank Financial Institutions
NCDs : Non-convertible debentures
NDTF : National Development Trust Fund
NEFSCUN: Nepal Federation of Savings and Credit Cooperatives Union Ltd
NGO : Non-government Organizations
NMBA : Nepal Microfinance Bank Alliance
NMDB : Nerude Microfinance Development Bank Ltd.
NPL : Non-performing Loans
NRB : National Rashtriya Bank
NSO : National Service Organization
OLB : Outstanding Loan Balance
OLP : Outstanding Loan Portfolio
OSS : Operational Self Sufficiency
PAMP : Poverty Alleviation Microfinance Project
PAR : Portfolio at Risk
PCBs : Private Commercial Banks
PDs : Primary Dealers
PKSF : Palli Karma Shahayak Foundation
PMFDBs : Private Microfinance Development Bank
PMO : Prime Minister's Office

ProMiS : Promotion of the Microfinance Sector
PSBs : Public Sector Banks
PSLM : Pakistan Social and Living Standards Measurement
PTCCS : Primary Thrift and Credit Societies
RBI : Reserve Bank of India
RDBs : Regional Development Banks
RDS : Rural Development Scheme
RFS : Registered Finance Companies
RLF : Revolving Loan Fund
RMDC : Rural Microfinance Development Centre
RMG : Ready Made Garments
ROA : Return on Asset
ROE : Return on Equity
RRDBs : Regional Rural Development Banks
RSP : Rural Support Programme
RSRF : Rural Self-Reliance Fund
SACCO : Savings and Credit Co-operative
SBA : Stand-By Arrangements
SBP : State Bank of Pakistan
SBPL : Self Help Group (SHG) Bank Linkage Programme
SBS : Samurdhi Bank Societies
SCBs : State Owned Commercial Banks
SDBs : Specialized Development Banks
SEBI : Securities and Exchange Board of India
SEC : Securities and Exchange Commission
SECP : Securities and Exchange Commission of Pakistan
SEEDS : Sarvodaya Economic Enterprise Development Services Ltd
SFCL : Small Farmers Cooperative Limited
SFDP : Small Farmers Development Project
SHGs : Self Help Group
SIDBI : Small Scale Industries Development Bank of India
SKBBL : Sana Kisan Bikas Bank Limited
SLCs : Specialized Leasing Companies
SME : Small and Medium Enterprises
TA : Technical Assistance
TCCS : Thrift and Credit Co-operative Societies
TMSS : Thengamara Mohila Sabuj Sangha
UAE : United Arab Emirates
UCBs : Urban Co-operative Banks
UK : United Kingdom
UNCTAD : United Nations Conference on Trade and Development
UNHCR : United Nations High Commissioner for Refugees
US : Unites States
USD : US Dollar
VAT : Value Added Tax
VDC : Village Development Council
VSSO : Voluntary Social Service Organizations

Microfinance in South Asia

POVERTY CONTEXT

Eight countries of South Asia, Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, has large combined population (1.5 bn[1]), second only to East Asia (2 bn). Over 460 mn among these are poor. Three countries India, Bangladesh and Pakistan together account for 95 % of the population as well as poor.



Source: World Bank

South Asia has great diversity in size and circumstance, India (1.13 bn) and Maldives 0.3 mn. Nearly 80%of the region's GDP originates in India, South Asia's fastest-growing and biggest economy, with Pakistan and Bangladesh accounting for another 10% and 7%, respectively, and with the remainder divided among the others. Although intraregional trade is the lowest in the world—about 5% percent of total external trade—informal and unrecorded border trade is significant[2].

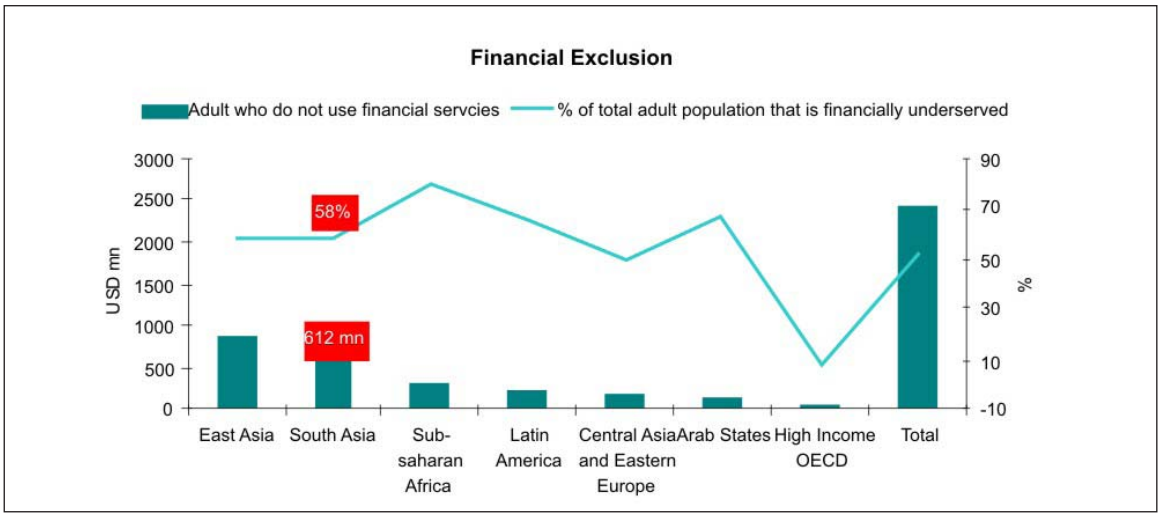
With an average per capita gross national income (GNI, by Atlas method) of USD 963 (2008), South Asia remains a low-income region that is on the verge of becoming middle-income—in contrast to a decade ago. The South Asia grew on an average 6.5% in 2000-07 and this economic growth has led to a decline in poverty and improvement in human development indicators[3]. However, still a large population of close of half a billion people continue to live under povery with low development indicators in education, health, gender among others. According to the World Bank, the poverty head count ratio in south Asia stands at staggering 40.3% and 73.9% of population at USD 1.25 (PPP, 2005) and USD 2.0 (PPP, 2005).

1 World Bank Data for 2008 available at http://data.worldbank.org/indicator/SP.POP.TOTL?display=default
2 Global Economic Prospects Summer 2010, World Bank and IFC, 2010
3 Human Development in South Asia – A Ten year review, Oxford, 2007

FINANCIAL EXCLUSION

A large section of the population, most notably the low income population, does not have adequate access to formal financial services. Over 58% of adult populating or 612 mn people do not have access to financial sevies.

A recent report from the World Bank shows a dismal picture, pointing out that countries of the region lag far behind the international benchmarks in key indicators for financial access such per person branches, ATMs, loan and deposit accounts.



Source : Honohan 2008, Human Development Index, World Bank

Access to Finance						
Indicators	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Benchmark
Branches per 100,000 people	4.73	6.37	1.73	4.96	7.69	9 - 28
ATMs per 100,000 people	0.29	1.93	0.28	1.25	5.67	39 - 167
Deposit accounts per 1,000 people	255.23	442.87	110.4	171.14	1117.82	976 - 2418
Loan accounts per 1,000 people	61.11	78	10.83	31.78	364.22	248 - 776
Branches per 1000 sq. km.	44.53	23.46	2.97	9.67	15.81	1 - 57
ATMs per 1000 sq. km.	2.71	7.11	0.48	2.44	11.65	3 - 252

Source : Getting Finance in South Asia Phase IV - 2008 World Bank

In a context of limited outreach of the formal financial sector, there is an enormous need and market opportunity for microfinance services. While the microfinance sector has grown rapidly in past few years, it still fails to meet the supply gap of financial services, in both qualitative and quantitative terms.

Currently, south Asian microfinance providers (excluding government banks and programs) reach approximately 50 mn clients in the region[4] and have a limited product range and mostly offer small size groups loans to women. This implies a huge untapped market in terms of clients and financial products and services.

4 Not including government program

MICROFINANCE

Since its origin in Bangladesh in 1970s. the sector has come a long way in terms of increased outreach, delivery models and diversity to demonstrate the role of microfinance in provision of financial services to poor. In the past few years, the microfinance sector has grown with impressive numbers. During 2006-07, the South Asia as a whole grew at 27%, Pakistan and India leading the pack with growth rates of 57% and 44% respectively. It is noteworthy that 14 MFIs from south Asia finds place among top 50 MFIs list published by Forbes and some of the largest MFIs with large outreach of over mn clients come from MFIs in Bangladesh (Grameen, BRAC, ASA) and India (SKS, Spandana, Share). However, all these achievements which are commendable without doubt can not dilute that facc that in four decades, since Grameen began in Bangladesh, the microfinance sector still does not serve more than 10% of poor population of the region.

Present Microfinance Outreach*		
	Poor Population (mn)	Total Borrowers** (mn)
Afghanistan	11	0.29
Bangladesh	71	30
India	312	22.6
Nepal	9	1.79
Pakistan	51	1.9
Sri Lanka	5	2.5
South Asia	459	59.08

* figures are for 2010 for Afghanistan and Pakistan, rest are for 2009
** the numbers does not account for multiple borrowings and hence total outreach is less than number given here

MARKETS GAPS AND CHALLENGES

While there are a number of challenges and opportunities in the countries, a few common, some difference, there are few worth highlighting from the regional perspective.

LIMITED AND SKEWED OUTREACH

The microfinance still reaches a very small portion of the market potential. The outreach gaps are also immense in terms of products diversification, geographical spread and more poor segment of population that remain excluded.

Geographically, we see that microfinance sector has very uneven spread within these countries and a large geographical area remain without effective coverage. For example, Afghanistan microfinance though has presence in 27 districts, 43% of the clients come from Kabul and surrounding urban area[5]. In Pakistan Punjab Province has around 70% share of outreach and portfolio[6] and in India four southern states dominate the sector with over 50% share in client outreach and portfolio[7]. If one looks at regional microfinance outreach, Bangladesh though has 16% share in the population of south Asia, it share in microfinance client outreach is 63%. Pakistan's population share in the region though is 11%, it share in microfinance client outreach is meager 2%. Further, it is worth mentioning that besides

5 MISFA Feb 2010, Sector Update
6 PMN, Microwatch Issue 14, Sep – Dec 2009.
7 N Srinivasan, 2009, State of the Sector Report 2009: Southern region has 54% share in client number and 58% share in portfolio.

these statistical asymmetry, there are skewed development along other factors such as practices of MFIs and financing among other things.

Microcredit products, based on Grameen model, targeting women overwhelmingly dominate the market. While there are small variations across MFIs in terms of repayment cycle, delivery model, amount, tenor and MFIs are increasingly focusing on product diversification, the portion of such microfinance products in total basket remain very small. The saving, insurance, remittances, leasing products remain mostly underdeveloped and have not mainstreamed as standard product offerings by microfinance providers. For example in India over 90% loan products of MFIs are standardized[8], In Pakistan 86% of loan portfolio comes from group methodology[9].

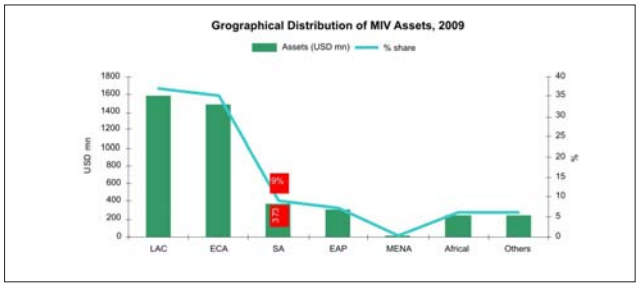
LIMITED POOL OF MFIS

A handful of tier-1 MFIs have an overwhelming share of market. For example in Afghanistan, two microfinance providers BRAC and First Microfinance Bank account for 63%[10] of total microfinance clients number and loan portfolio; in Bangladesh Grameen Bank, ASA, BRAC and Proshika account for 82%[11] of clients and in India top 20 large MFI (with portfolio over USD 11 mn) have 82% share in client outreach and 88% portfolio[12]. In Pakistan three microfinance providers National Rural Support Program(NRSP), Khushahli Bank, Kashf Foundation and First Microfinance Bank (FMFBL) account of 71% of the present client outreach and 67% of loan portfolio.

It is worth mentioning, that with the exception of Afghanistan, each of these countries have a large number of MFIs registered as Cooperatives, Societies, Trusts and other legal forms, however, their oureach remains small, confined to small geographical area and management and financial practices very basic.

FINANCING GAPS

Access to financing is one of the major obstacles to growth of microfinance in the countries of the region. However, the investment into microfinance sector compared with other region of the world is low and less than 10% of global investment comes to the region. While in last few years there has been growing investment in the region as a whole though and South Asia has achieved a compound annual growth rate of 82% from 2006 to 2009. Latin America and Caribbean (LAC) and Eastern Europe and Central Asia (ECA) continue to dominate MIV portfolios, comprising 72% of all microfinance investments[13].



Source : Micro Rate, 2010

8 Intellecap 2009
9 PMN, Microwatch Issue 14, Sep – Dec 2009
10 Figure calculated from MISFA Feb 2010 Microfinance Update
11 Country Brief Bangladesh, BWTP, 2009
12 Microfinance in India, State of the Sector Report, N Srinivasan, 2009
13 State of Microfinance Investment, A Microrate 2010 Survey, Microrate, July 2010

AFGHANISTAN

Population : 25.47 mn (2009)[1].
Main towns : Kabul (2.5 mn); Kandahar (0.45 mn); Herat (0.35 mn)
Currency : Afghani (Af)
Exchange rate : USD = 46 Af (as of August 2010 Kabul Market Price)
Fiscal Year : 21st March – 20th March

Development Indicators:

- Population below poverty line (National): 42% (2007)
- GNI per capital (Atlas method, USD): 370 (2008)
- Literacy Rate (15-24 years): 23.5% (2005)
- Mortality Rate (child<5 years): 257 per 1000 births (2008)
- Life expectancy at birth: 44 years (2008)
- HDI: 0.352, 181 rank in 182 countries[2] (2009)

Indicator[3]	2005-06	2006-07	2007-08	2008-09	2009-10*
Nominal GDP (USD bn)	6.5	7.7	9.7	11.8	14.5
Real GDP Growth (%)	16.1	8.2	14.2	3.4	22.5
Consumer Price Inflation (avg, %)[4]	11.6	7.3	8.5	30.6	-8.3
Exchange rate (avg vs USD)[5]	49.50	49.93	49.96	50.25	50.23
External Debt (year-end, USD bn)	n/a	n/a	1,654	2,041	n/a
External Debt (as a % of GDP)	n/a	155.0	20.7	19.2	10
FDI (USD mn)[7]	177	409	207	108	185
FDI (as a % of GDP)	n/a	3.1	2.5	2.5	1.4

*estimates

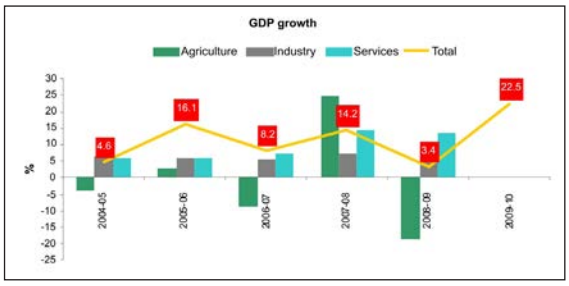
1 ADB Fact Sheet Afghanistan
2 Only Niger with HDI value of 0.340 is below Afghanistan
3 Figures taken from World Bank, April 2010, Afghanistan Economic Update, World Bank ; Afghanistan at a Glance 2009, and EIU Country Report Afghanistan July 2010
4 Economist Intellignece Unit (EIU) Country Report, July 2010
5 ibid
6 The external debt burden fell to 10% of GDP upon securing debt relief under the Heavily-Indebted Poor Country and Multi-lateral Debt Reduction initiatives, Source: Afghanistan Spring Brief April 2010, World Bank, 2010
7 Based on Foreign Investment registered with ASIA, AISA Annual Report 2008

ECONOMY

Afghanistan is the poorest country in the Asia and Pacific region. Despite significant economic and development gains since the ousting of the former Taliban regime in 2001, the people of Afghanistan continue to suffer widespread and growing insecurity; high levels of poverty, weak governance[8]; inadequate health care, education, and gender inequality. Foreign assistance is dominant in the economy and in the past few years, foreign assistance to Afghanistan reached around 40% of GDP (average of 5 years), of which, one third is provided through the core budgetary support and the remaining two third is outside the government budget system. In a recent move, the World Bank and International Monetary Fund (IMF) have announced USD 1.6 bn in debt relief for Afghanistan through the Heavily Indebted Poor Countries (HIPC) initiative, and range of donors have pledged USD 140 mn for the Reintegration Trust Fund[9]. Poor security[10], political environment and corruption remain big challenges for socio-economic growth.

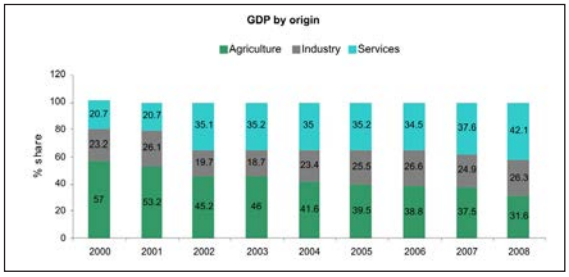
ECONOMIC GROWTH

Since 2001, the Afghan economy has grown steadily (13.8% per year on average in real terms between 2002-09)[11] on the back of foreign aid inflows. Gross Domestic Product (GDP)[12] growth is high but volatile with the economy buffeted by shocks of drought and commodity price hikes. A sectoral breakdown shows that while growth rates of Industry and Services are high, growth rate in Agriculture is marked by high volatility.



Source: World Bank and DAB

GDP growth in 2009-10 is estimated to have reached at 22.5%, after a sluggish previous year when real GDP growth rate was just 3.4% as economic output was curtailed by severe drought. Behind the surge in growth in 2009-10 is the strong performance of the Agriculture sector (53%), is boosted mainly by ample and well-distributed rainfall and greater spending by government and donors. The Service sector also continues to grow in double digits, led by government services, financial sector and transport services. With regards to the Industry sector, its growth is constrained by the poor performance of manufacturing and construction, which was much lower than the early years of reconstruction. As exception is mining, which has registered growth of nearly 30% in the last two years[13].



Source: World Bank and DAB

According to the IMF and Asian Development Bank (ADB), the GDP growth is likely to continue on the back of financial support for economic development from the international community with increasing emphasis by the donors for provision of basic services to the citizens of Afghanistan. ADB forecasts

8 Afghanistan has the second worst corruption ranking among the 180 countries surveyed in Transparency International's Corruption Perception Index

9 Afghanistan Spring Brief, Worldl Bank, April 2010

10 According to the World Bank, a 30% spike in security incidents in 2009, over the previous year, recording 960 incidents per month, was the worst since the fall of the Taliban in 2001

11 CSO Statistics 2008-09

12 According to Afghanistan, Asian Development Outlook 2010, opium economy is equivalent to about 20%–25% of legal GDP

13 Asian Development Outlook 2010, Afghanistan, ADB 2010

the GDP growth to be 7.6% and 6.8% for next two years.

ECONOMIC STRUCTURE

In 2008, the share of Agriculture, Industry and Services in Afghanistan's GDP was 31.6%, 26.3% and 42.1% respectively[14]. Since 2000, the share of Agriculture has declined from over half of the GDP to now less than one third of GDP while the Service sector has doubled in the same period. However, the Agriculture sector continues to be a key determinant of GDP growth as it generates 70% of employment in the country and has strong externalities associated with the manufacturing and service sectors and with exports.

The principle agriculture products are wheat, maize, barley, sugarcane, fruits, nuts and cotton. Cereal production accounts for 70-80% of total output but is susceptible to weather conditions. The northern province of Kunduz and the southern province of Helmand are the main areas of agriculture production. Agricultural output is volatile due to frequent droughts and lack of agricultural support systems such as irrigation, extension services and storage facilities. Only 10% of Afghanistan's land is arable and only half of that is cultivated[15] and less than 10% of arable land is being rrigated[16].

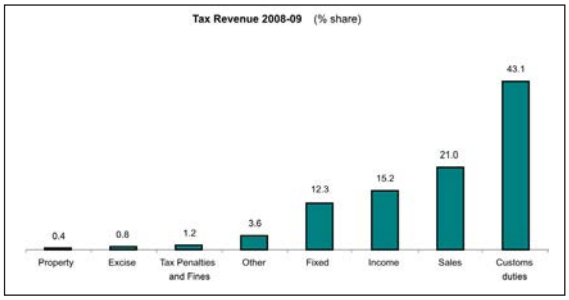
Within the Industry sector, the contribution of manufacturing to the GDP is 15.6% followed by construction at 9.2%. The manufacturing sector is overwhelmingly (approximately 95%) linked to the agriculture and agro-processing sector[17]. The industrial base has remained low and is concentrated in the few urban areas. The construction sector provides on an average 10% of industrial growth as a high portion of aid money continue to fund the country's infrastructure.

14 ADB, Key Indicators for Asia and Pacific 2009, Afghanistan

15 Central Statistic Office Key Statistics 2008-09

16 AISA Annual Report 2008-09

17 The construction sector is considered a part of the Industry sector in Afghanistan, whereas in rest of the countries of the world it is part of the service sector



Source: DAB

With the forecasted development of mining of Aynak copper deposits in Lowgar province in comi ng years, the mining sector is likely to become a main contributor to the economy in the coming years. According to a US Geological Service report, Afghanistan has untapped mineral wealth which is worth an estimated USD 1 tnr with iron ore reserves amounting to USD 423 bn and copper worth USD 273 bn being most abundant.

The Services sector mostly consists of government services (21.6%), financial sector (29.8%), transport (6%) and trade activities has benefited mainly from donor and government spending[18].

As per the available data on total investment (foreign and domestic) from the Afghanistan Investment and Support Agency (AISA)[19], the construction sector attracted about USD 1.4 bn during 2003 to 2008, accounting for about 35% of the total investment. In the same period, the Service sector registered investment worth USD 1.22 bn (29% of the total). Manufacturing industry with a total of USD 1.15 bn accounted for 28% of the total registered investment, while the agriculture sector attracted only USD 360 mn.

LABOUR

The latest labour figures for Afghanistan are not available. According to IMF 2004 data; the country has a labour force of over 8.2 mn. Among those employed, 70% are employed in agriculture, 6% in industry, 15% in services and the rest are classified as em-

18 CSO Key Statistics 2008-09

19 AISA Annual Report 2008-09

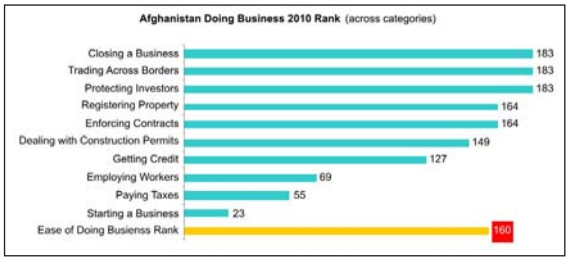
ployed in 'other' fields. Women account for around 65% of the agriculture workforce in rural areas[20]. It is important to note that 50% of population is below 15 years of age.

TAXES

The Afghan tax regime remains cumbersome and tax compliance is low in the country marked by a very low tax base. Some common features associated with a low tax base in the Afghanistan economy are; extremely low level of development; a large informal sector; the dominance of agriculture that is hard to tax, and capacity constraints hindering the ability of the government to collect taxes. Since 2001, the government with the support of international agencies has taken several steps to broaden the tax revenue base. However, total domestic tax revenues accounted for 7% of GDP which is well below the regional average[21]. More than 50% of the tax revenues comes from Kabul city and customs revenue account for over 40% of the total domestic revenues. In 2008-09, total revenue was USD 910 mn (up by 36% from 2007-08), tax revenue USD 575.5 mn and non-tax revenue was USD 334.7 mn.

BUSINESS ENVIRONMENT

The World Bank report 'Doing Business 2010 Afghanistan', which assesses the business environment in 181 countries through quantitative indicators, ranks Afghanistan in 160th position, improving slightly from the 2009 ranking of 168th position. While the country ranks reasonably well in starting business (23), employing workers (63) and ease of paying taxes (55), low ranking scores are found for protecting investors (183), ease of closing business (183); crossing borders (183) and registering property (164). Afghanistan is at the bottom of ranking for eight countries in south Asia.



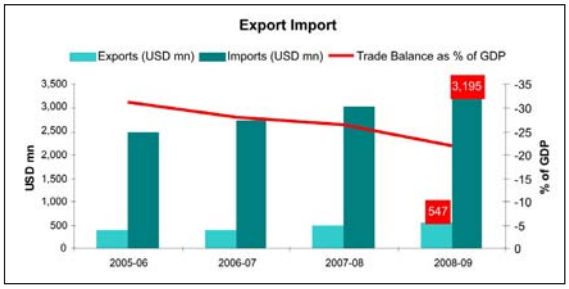
Source: IFC

EXPORT IMPORT

In 2008-09 Afghanistan's exports totaled USD 547 mn, dominated by food items such as fresh and dry fruits (almost USD 258 mn) and carpets and rugs (almost USD 152 mn). Together, food items, carpets and rugs account for 80% Afghanistan's exports. In 2009-10 there was a 40% decline in exports

Imports mostly consist of machinery and equipment, food, household items, metal and petroleum products and are largely driven by donor and military spending. Imports of almost USD 3,195 mn were dominated by capital goods (USD 1,527 mn).

Pakistan is the most important trading partner, accounting for 46.5% of exports and 13.6% of imports in 2008-09[22]. Other important trading nations are India (16% of exports in 2008-09), China (12% of imports) United States of America, Tajikistan, Russia and Germany.



Source: DAB

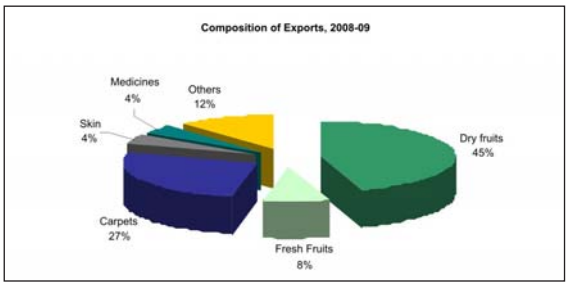
In the coming years, the mining sector could be the main driver of export and import growth, provided infrastructure and the security climate improve to allow extraction of these untapped reserves. An estimate from

20 ADB, Key Indicators for Asia Pacific, 2009, Afghanistan

21 While in industrialized countries the revenue to GDP ratio is typically around 45-55 %, for the least developed countries it is closer to 20 %, Afghanistan is an outlier in this group as well

22 DAB Annual Report 2008-09.

USAID suggests that annual export of marble could reach USD 700 mn within a decade. Potential for an increase in Afghanistan's traditional export of carpets and dry fruits is limited.



Source: DAB

FOREIGN INVESTMENT

Despite a positive government law on foreign investment that provide for 100% foreign investment, tax incentives, custom benefits and freedom to repatriate profits, foreign direct investment (FDI) has been slow because of reasons of insecurity, governance, the regulatory framework and property rights.

Source: AISA

According to the Afghanistan Investment Support Agency (AISA), the government nodal agency to register and track investment, total initial capital inflow registered by AISA since its establishment in 2003 up to the end May 2009 was USD 4.9 bn. Out of this about 34% i.e. USD 1.62 bn, is foreign investment. The foreign direct investment in Afghanistan has been falling continuously from the level of about USD 483 mn achieved in 2003 to USD 108.6 mn achieved in 2008. Most of the FDI which comes into Afghanistan is by those companies which are providing logistics or act as contractors of the United Nations, USAID, foreign NGOs or other donor agencies. The Agriculture and Industry sector have not seen much investment.

Foreign Investment Flows (2003-08)		
	USD mn	Share (%)
Construction	551	34
Industry	146	9
Services	629	39
Agriculture	294	18

Source: AISA

Turkey is the largest supplier of FDI with 19% followed by UAE (17%), USA (16%) and Canada (16%). Joint ventures have been a preferred arrangement of bringing FDI into Afghanistan with about USD 294 mn has come through this route[23].

REMITTANCES

So far, neighboring Iran and Pakistan have been the major recipients of mostly illegal and unskilled migrant laborers from Afghanistan. Some 4 mn Afghans are living in Iran and Pakistan. This figure takes into account the 2.1 mn Afghan refugees in Pakistan and 920,000 in Iran. According to a joint UNHCR and ILO report in 2008, Afghans working in Iran remit approx. USD 500 mn annually, equivalent to 6% of Afghanistan's GDP.

COPING WITH THE GLOBAL FINANCIAL CRISIS

According to Da Afghanistan Bank (DAB) Annual Bulletin 2008-09[24], the impact of the global recession on Afghanistan has been low and unobservable. However, if the recession deepens and continues, Afghanistan can be affected through trade, foreign direct investment (FDI), foreign aid and finally through the region, especially through Pakistan which is its major trading partner.

The report says that Afghanistan – as an oil importing country – has benefited from the global decline in fuel and food prices. The only item which has seen a drop in its exports is the

23 AISA, 2008, Annual Report
24 DAB, 2009, Annual Bulletin 2008-09

Afghan carpet. Afghan carpets are usually categorized as luxury goods due to their excessively high price and their distinct quality. In 2008-09, export of Afghan carpets declined by around 30%. This is also reflected in the private capital FDI into Afghanistan which has come down to USD 108.6 mn in 2008 compared to USD 207.4 mn in 2007. The banking sector in Afghanistan has been safe from the financial turmoil in western countries since they had not invested their funds abroad.

FINANCIAL SECTOR

REFORMS

In late 2001, the financial and banking systems of Afghanistan were devastated. The banking system was then comprised of six state owned commercial banks that were entirely Kabul-based and largely inactive. The legal basis for Da Afghanistan Bank (the future Central Bank), operations was deficient, without prudential norms and enforcement mechanisms.

The new Banking Act and Da Afghanistha Bank act were passed in 2003-2004 stipulating Da Afghanistan Bank (DAB) as the Central Bank with authority to register, regulate and monitor commercial banks. However, in 2010, the financial market continues to face deficiencies resulting from a still weak legal framework, notably in terms of formal mechanisms for contract enforcement. As part of the Afghanistan National Development Strategy (ANDS) 2008-2013, the Government of Afghanistan has committed to strengthen both the legal and regulatory framework by implementing four pending laws on secured transactions, mortgages, leasing and negotiable instruments and by enforcing prudent regulations in the banking sector. The GoA also plans to restructure and privatize two state-owned banks (Bank Millie and Pashtany Bank), to launch a credit information bureau and a financial dispute resolution tribunal as well as to establish an adequate insurance law.

In the latest development in June 2010, DAB has announced a moratorium on licensing of new commercial banks to allow for a cooling-off period so that banks could achieve full operational efficiency and consolidate their finances. The cooling-off period would also provide the Central Bank with sufficient time to train its staff in sophisticated risk-based supervision techniques.

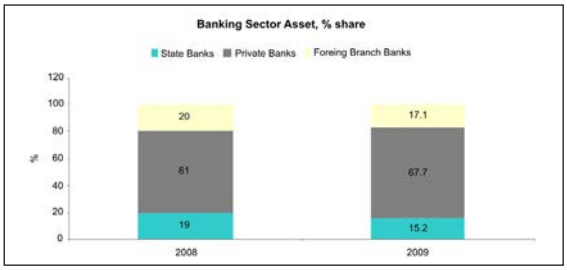
Implementing regulations for the secured-transaction and mortgage laws (passed in mid-2009) have been drafted and are expected to be finalized by the Supreme Council of DAB by mid-2010. Additionally, DAB is currently undertaking a review of both the Banking Law (2004) and the Law of Da Afghanistan Bank (2004). It is also likely that the reforms will, in general, increase DAB's powers of supervision and enforcement with respect to the financial sector.

COMPOSITION

Afghanistan's financial sector can be considered as a success when looking at the total system assets of about 18.3% of GDP and at an annual growth rate of 57%. However, the dominance of a few major players and the concentration of a number of risks within the narrow banking sector inhibit competition.

The financial sector is dominated by commercial banks. By the end of 2009, Bank assets as a share of GDP has risen to an all-time high of 23%. According to DAB, the banking sector has grown at an impressive rate since 2003 with banking assets increasing from USD 300 mn in 2002 to USD 2.2 bn in 2009. Total loans amounted to USD 981 mn and deposits stood at USD 2.28 bn in 2008-09. Deposits were largely denominated in USD (55%) and deposit growth continues to outpace loan growth, indicating the difficulty of lending in a constrained private-sector environment. The loan to deposit ratio has fallen below 50%.

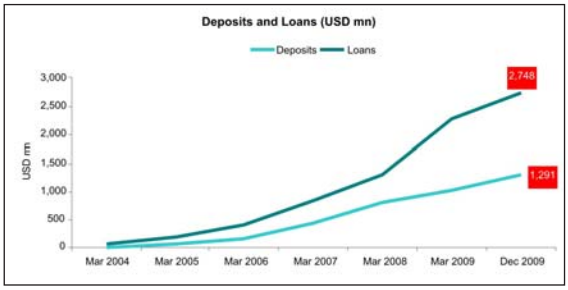
At present the banking system consists of 17 licensed commercial banks with 347 braches in 34 provinces. Of there 2 are state-owned, 9 private and 5 foreign banks.



Source: DAB

No information is available regarding the location of branches and presumably, most banks have their branches spread in the corridor between Kabul and Mazar-e-Sharif and in other major Afghan cities like Herat and Jalalabad. As of March 2008, the two largest domestic private banks accounted for almost 50% of total banking system assets. The combined loans of these two banks were 70% of total commercial bank lending.

Non performing loans (NPLs) continue to decline (the banking system's NPL consist of 1.2% of gross loans in 2008-09) and the capital ratio of most banks is above the minimum regulatory threshold of 12% of risk weighted assets an an exception for two banks [25]. The ratio of liquid assets to total assets averages 45%, well above that of other countries of the region. Overall the banking sector was profitable earning a net profit of USD 34.5 mn since the beginning of 2008-09. The overall return on asset (ROA) decreased to 1.69% in 2008-09, compared to 1.80% in the previous year. Branches of foreign banks and private banks are the most profitable groups. State-owned banks as a group are at loss.



Source: DAB

According to an IMF study, foreign banks are not lending in the domestic market while local privately owned banks are the main drivers of domestic lending. The private banking sector is the leading creditor accounting for 82% of total loans. By far the major component of loan portfolio is commercial loans (87%) to the exclusion of all other types of lending[26].

Credit to the private sector stands at only 10% of GDP, and access to financial services, especially credit and payments, is extremely limited. In Afghanistan, there is virtually no amount of long term financing available from commercial banks as most banks offer terms of a year or less with maximum tenure of three years, contributing to the persistence informal economy.

In addition to the banking sector, there are several financial intermediaries in addition to the commercial banking system. These typically include Microfinance institutions (MFIs), Corporate no-depository institutions (Finance Companies, Mortgage Companies, and Leasing Companies), Insurance Companies, Private Pension Plans, Foreign Exchange Dealers (total 332) and Money Service Providers (100 of them).

Capital markets are limited to primary issuance of short-term Capital Notes (a security of the Central Bank) which are electronically traded between the DAB and commercial banks. Other non-bank financial institutions like stock markets and bond markets are not yet developed.

The insurance sector is weak and poorly supervised with one state owned company and is poorly supervised. The single state-owned pension firm is largely restricted to a public pay-as-you-go system and which provides coverage to a small segment of the population.

INTEREST RATES

According to DAB, the Central Bank had steered interest rate from about 18% in 2008 to about 3% to date. In response to the decline in interest rate the DAB Supreme Council had decided to narrow the interest rate corridor from +/- 3.5% to +/-1% around the 28 day capital

25 World Bank, Afghanistan Economic Update, April 2010

26 DaB Strategic Plan 2009-14, Feb 2009

note yield. This action was taken to ensure that commercial banks had ready access to liquidity for their operations and received real rates of return on required reserves.

The interest rate spread between deposit and lending rates ranges from 7% to 15%. The magnitude of the spread was said to be due to high costs for security, electricity, communications and salary.

FINANCIAL EXCLUSION

Although the financial system has grown quickly, it is still under-developed and its role in the economic activity of the country remains very limited. While exact numbers are not available, only a small segment of the population has access to formal financial services and the banking sector is mainly based in urban areas, offering basic services. According to a World Bank survey, only 30% of businesses have bank accounts and many use hawala[27] transfer systems[28]. Informal moneylenders and exchange dealers continue to be active players in the financial system and provide both cash and non-cash payments.

The number of savers as of December 2008 were almost 1 mn, while there were less than 43,000 borrowers. In spite of the growth among bank depositors, the number of people not covered by these financial institutions is staggering. Only 2.6% of the Afghan population has a savings account[29].

MICROFINANCE SECTOR

HISTORICAL EVOLUTION

The microfinance sector in Afghanistan came into existence in 2003, when the Government of Afghanistan, together with the World Bank, the Consultative Group to Assist the Poor (CGAP), the Department for International Development (DFID), Sida, USAID, Novib and the Governments of Denmark and Canada established the Microfinance Investment Support Facility for Afghanistan (MISFA) – an apex institution to pool diverse donors' funding mechanisms and to offer a streamlined flexible support to MFIs in Afghanistan. In 2006 MISFA was transformed into a company owned by the Ministry of Finance (MoF) and governed by an independent board of directors elected by donors.

To date, these donors have provided more than USD 100 mn to MISFA and the World Bank has further committed USD 30 mn in June 2008 to improve the microfinance sector in the country. Overall the initiative has proven to be very successful. 15 MFIs have emerged to render the much needed financial services to the low income population, supported by MISFA funding and capacity building programs. It is important to note that most of these MFIs come from NGOs background.

Amongst the MFIs, the Bangladesh Rural Advancement Committee (BRAC) Afghanistan is the largest player in the market with 152,671 active microfinance borrowers which is 52% of total borrowers and 31% of Outstanding Loan Balance (OLB) as of May 2010.

The Afghanistan Microfinance Association (AMA) acts as a network of MFIs operating in Afghanistan. It aims at promoting a sustainable sector through capacity building of MFIs, advocacy, lobbying and awarenes raising, to establish itself as a voice of the sector. Registered in 2007, AMA currently

27 Hawala is a system of money transfer where customers entrust money to hawala bankers or operators (hawaladars), who facilitate money movement worldwide through personal connections, leaving a minimal paper trail

28 EIU Country Profile 2008

29 Assessing the demand for saving services among microfinance clients in Afghanistan, 2010, MISFA

has 13 permanent members and 2 associate members.

MFIs have about 12 times more credit clients than all commercial banks combined; however, unlike banks, they do not have depositors. In clear contrast, banks have about 23 depositors for every borrower.

TYPES OF MFIS

There is no comprehensive legal framework for the microfinance sector in the country and there are no prudential regulations for MFIs. Currently, while a majority of MFIs are incorporated as limited liability companies and registered under the Ministry of Commerce; other institutional forms are present as well.

The types of institutions active in the microfinance sector are:

Deposit taking Microfinance Institutions (DMFI): Registered and regulated by the DAB under DMFI license. These can take two forms: Limited liability companies and Corporation/ Companies. Both types are registered under the Afghan Investment Support Facility (AISA) and are not regulated except under normal company law according to the Commercial Code of 1955. To date no MFI has applied for this license.

MFIs registered as general companies/corporations: They do not take deposits and can take two forms: Limited liability companies or Corporation/Companies. Both forms are registered under the AISA and are not regulated except under the normal company law according to the Commercial Code of 1955. All MISFA partners are registered under these legal forms.

Credit Unions: They are registered with AISA but are not regulated. There are currently 20 Islamic Investment Financial Cooperatives supported by World Council of Credit Unions (WOCCU) with funding from MISFA and others.

Commercial Banks: Among commercial bank, there are currently two banks in the country that focus on microfinance clients. Both of them are MISFA partners and have received significant financial support from MISFA via loan facilities:

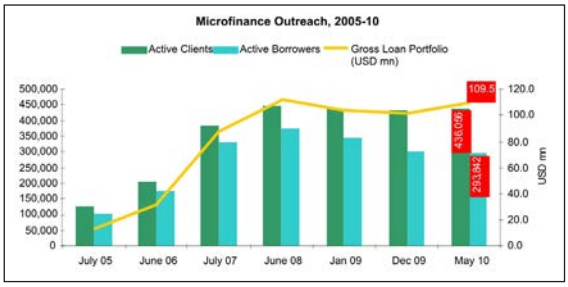
- The First Microfinance Bank Afghanistan (FMFB-A) is promoted by the Aga Khan Development Network. FMFB-A was the first private commercial bank to be licensed and incorporated in Afghanistan in 2003. Since its inception, the Bank has grown rapidly and is now operating 13 branches in 7 provinces. The bank is currently the largest microfinance institution in Afghanistan in terms of outstanding portfolio size. The bank's microfinance portfolio was valued at USD 39.8 mn at the end of 2009. Of the total portfolio, 22% benefited rural clients. Women constitute 13% of the bank's client base. The bank also provides micro-savings, allowing individuals to open an account with as little as USD 1. The continued increase in deposit activity has brought the number of clients up to 37,342. The value of deposits climbed to USD 10.8 mn.
- BRAC Afghanistan Bank (BAB) is a commercial bank registered with the DAB offering financial services to small enterprises in Kabul and other major cities. BRAC Bank is incorporated in Afghanistan and is an international bank with institutional shareholdings by BRAC, the International Finance Corporation (IFC) Shore Cap International (based in Chicago, USA) and Triodos Bank of The Netherlands. It has one branch and three sub-branches in Kabul. During its operation, the Bank has disbursed more than USD 35 mn in loans to no fewer than 6,000 small and medium entrepreneurs.

It is important to note that all MFIs that are financed by MISFA have to register with AISA. The most common legal form for MFIs in Afghanistan is under the status of a Corporation. The role of MFIs outside the MISFA network is insignificant.

MAJOR HIGHLIGHTS OF THE SECTOR

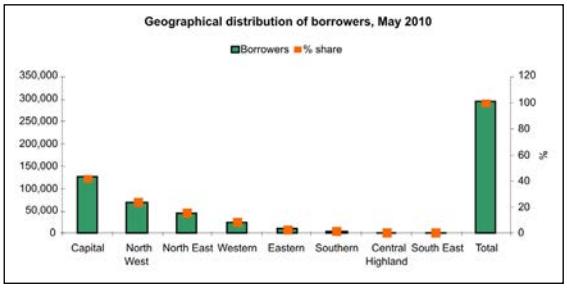
OUTREACH

Since its inception, the microfinance sector has made substantial growth in terms of active borrowers, loans disbursed, size of loans as well as provinces and districts covered.



Source: MISFA

According to a research study from the Institute of Development Studies, the growth of the sector has led to increased business activity, employment opportunity and assets as well as improved socio-economic status for women.



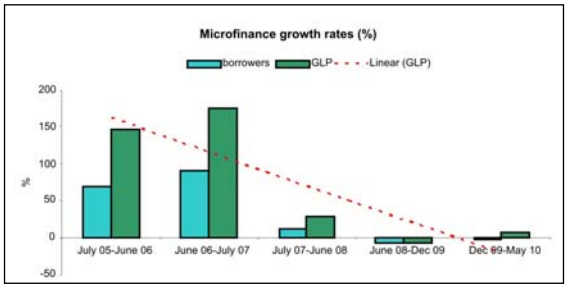
Source: MISFA

As of May 2010, 15 MFIs registered with MISFA operate in 109 districts of 26 provinces reaching 436,056 clients and 293,842 borrowers, and have Gross Loan Outstanding of Af 5,364 bn (USD 109.5 mn). Among the borrowers 43% are women and 72% are urban[30].

However, outreach is mainly concentrated in Kabul and surrounding areas where close to 43% of borrowers come from these regions. So far the cumulative total loan disbursed by MISFA partners amounts to Af 35,159 mn (USD 717mn)[31].

GROWTH

The microfinance sector in Afghanistan grew at a very fast rate since its start as pilot in 2003-04 led by MISFA. Between 2006-08 the microfinance sector achieved considerable growth in terms of the number of MFIs, outreach and loan outstanding, but then dropped considerably in growth rates from 2007–08.



Source: MISFA

According to AREU study looking at problems of the sector, this growth trajectory clearly brings out the fundamental problems of the sector that seriously undermine the viability of MF in the medium to long term. The key reason for problems besetting the sector is a push towards scale and operational sustainability while ignoring important dimensions of putting in place sound internal systems and ensuring quality. This had far reaching implications on how MFIs approached clients and eventually led to systematic problems at the sectoral level that are reflected in the downward trend seen since 2008.

PRODUCTS

Credit services are the main products for all the MFIs with variations in characteristics such as lending methodology, amount and purpose across the MFIs and provinces. According to a MISFA impact study[32], 89% of the loans were used for productive purposes. 53% of surveyed households used their loan to expand their business and 28% for start-ups. Generally interest rates on loan products offered by MFIs depending on terms and type of product/guarantee or lack thereof

30 In terms of OLB, share of urban is 75%

31 USD = 49 Af

32 Microfinance in Afghanistan: A Baseline and initial impact study for MISFA, September 2007

range from 1.4% – to 2% flat per month or 17% to 24% flat per annum. There has been some downward pressure on pricing, particularly in Kabul due to competition among the MFIs. In almost all cases loan repayment starts almost immediately and repayments are on a weekly, biweekly or monthly basis.

Voluntary savings are forbidden by law to MFIs that are not registered as DMFIs. However, savings products are offered by a few MFIs and made compulsory by others. Eight of the current 15 MFIs include some kind of savings product for members of the groups. None of the MFIs have offered an insurance product.Voluntary savings are forbidden by law as only mandatory savings can be mobilized, otherwise MFIs fall under DMFI regulation.

MISFA considers Islamic microfinance as a great opportunity and is paying close attention to its development. Currently 4 out of 15 MISFA partners offer Sharia compliant products and consider them as very promising not only for clients but also for community leaders and authorities.

Active banks in the microfinance space, i.e. FMB-A and BAB, are targeting micro and small business owners. Other services such as micro-leasing, micro-insurance and micro-remittance are not practiced in the country.

According to a recent study by Afghanistan Research and Evaluation Unit (AREU)[33], on the microfinance sector in Afghanistan, the MFIs developed a simple and limited range of credit products that are easy for new loan officers to introduce. Such standardized product portfolio is easy for the MFI to monitor, but did not necessarily meet a clients' desire for loan products fitting their specific livelihood activities. The mismatch with client interests could have been particularly the case in rural areas, where cash flows are irregular, returns low and risky and come after a significant maturity period. Therefore, product simplicity, while meeting the short term interests of MFIs, eventually backfired for not being more concerned with client needs.

The First Microfinance Bank Afghanistan piloted a habitat improvement product in 2008 to improve the housing stock of individuals, increase construction standards and organise communities around community infrastructure. These loan products will be bundled with technical assistance on seismic and disaster mitigation, energy efficiency, sanitation, crowd reduction and proper ventilation. This is the first step taken in Afghanistan in the housing finance sector. At the end of 2009, 2,280 microloans were disbursed for housing improvements valued at USD 1.6 mn.

SUSTAINABILITY

In the beginning of 2009, the Operational Self-Sufficiency (OSS) figures for the sector stands only at 79%. It is suggested that MFIs in the country have achieved growth at the expense of profitability and sustainability. The MFIs incur high operational costs due to the security environment, small size of loans, poor infrastructure and high costs of top management, all contributing to limit their ability to achieve sustainability.

Another cause for concern for the sustainability of MFIs is the recent trend in rising Portfolio at Risk (PAR). Broadly, PAR>30 increased from 3% in September 2007 to 10% in October 2008. In January 2009 the PAR>30 is 11%[34] for the sector as a whole. This has further deteriorated in recent months for many MFIs, however, the updated data for the sector as a whole is not available. Some explanations given for the increase in PAR are due to the lack of human resource capacity, deteriorating national security, lack of internal control and unconsolidated growth.

The high operating costs and unstable security situation continue to pose major challenges for MFI sustainability.

33 AREU, Jan 2010, Building a viable microfinance sector in Afghanistan

34 There are significant differences among MFIs in relation to figures such as PAR>30 and OSS

The recognition of problems within the sector has lead to a considerable internal review both by MISFA and MFIs with the aim of improving performance and long term viability. MISFA has initiated a number of reforms through its report card system that are meant to institutionaliseg MFI reviews against key performance and capacity indicators to understand trouble spots and MFI ways of addressing them. There are four categories against which MFI's are assessed: governance and management capacity, sustainability and income, data management capacity, and impact and product.

In addition to this, the MFIs have also made their own changes to their practices. Many of these relate to downsizing of operations, greater emphasis on Human Resource training, establishing internal control systems and capacity building programs to reduce risk of fraud targeting loan officers, reducing cash transactions, changes in recruitment policy and experimenting with loan products and methodology including piloting Islamic products.

Source: Building Sustainable Microfinance Sector in Afghanistan, AREU, Jan 2010

MESO LEVEL INFRASTRUCTURE

The meso-level infrastructure is still under developed and continues to rely on overseas consultants and agencies for Technical Assistance, ratings etc. However, a noteworthy development is the transformation of the Afghanistan Microfinance Association (AMA) into a network of MFIs leading advocacy and technical service provision to MFIs. AMA has also developed manuals in local languages and provides training to MFIs in local languages. Presently AMA provides training in Financial Ratio Analysis, Accounting, Delinquency Management, Training of Trainers and Basics of Microfinance among others.

At a sectoral level, there are not many specialized TA providers, independent rating agencies or valuation agencies. MISFA has played an important role in building the sector and indeed conducts a variety of capacity assessments, ratings and portfolio audits among other things through independent consultants and agencies as well as by MISFA's Technical Support Department.

COMPETITION

There is no study or data available to know competition within the sector. However, considering that sector is concentrated in Kabul and surrounding areas and other relatively secure regions, it is indeed quite probable that MFI are chasing same set of clients.

Consolidation in Microfinance sector in Afghanistan

The Afghanistan microfinance sector is currently experiencing consolidation and merging process. It essentially means that some weak-performing MFIs are now getting merged with stronger MFIs to ensure a sustainable existence of microfinance in the country.

According to MISFA, the week performance of number of MFIs is critical factor in Afghan context for merging and consolidation. Diverting limited resources even to a few ailing MFIs would deprive the more successful ones of the resources to improve their products and services, as well as their outreach. Ultimately, this will have an impact on the poor Afghans being served by the sector as a whole.

MISFA, as an apex organization of the microfinance sector in the country has explored all available options and conducted number consultations before reaching this decision. To address all those concerns, MISFA has widely circulated a message assuring the MFIs staff that the process is not a cause for alarm but it is a step forward towards reaching sustainability and help the microfinance sector become more vibrant and stronger.

Source: AMA and MISFA Newsletter

RISKS

The key external risk is related to the increase in insecurity and general instability throughout the country, which this report will not dwell on. Besides this, a number of other factors pose risks to the microfinance sector. Among them are political risk stemming

form negative religious sentiment, complete reliance of MFIs for financing and capacity building support on MISFA. As the support from MISFA has met their funding requirements, MFIs are giving less priority to external funding and therefore lack diversified funding sources and investment preparedness.

Internally, frauds among credit officers and staff in the guise of ghost clients have already damaged the sector. According to AREU study, 'rapid MFI expansion without concurrent investments in staff training or the establishment of monitoring and internal audit systems has led to fraud within the sector that often happens through the creation of so-called "ghost client". Many MFIs have also been slow to computerise their operations at the branch office level which may lack the infrastructure to support it. The lack of oversight and management information systems, whether computerized or manual, coupled with rapid loan officer recruitment to meet scale targets but with little investment in training, set up an environment ripe for fraud.'

These consequences combined with external factors such as a deteriorating security environment, drought, internal and regional migration, high food prices and devaluation of the Pakistan rupee put further stress on MFI business models and client's repayment capacity and as a result MFI repayment rates started to decline leading to declining rates of operational sustainability due to loan losses and fraud.

REGULATIONS

The only microfinance specific regulation is applicable to DMFIs. Any MFI that mobilizes voluntary deposits is required to register and be regulated under the DMFI articles form published by the DAB. However, it is important to note that no MFI has applied for a DMFI licence to date.

The two commercial banks with a focus on microfinance come under the DAB regulation and supervision is as applicable to commercial banks.

In the absence of any specific regulatory authority for the MFIs, MISFA is taking the lead role in not only funding the MFIs, but also in guiding them in reporting, governance structure etc. MISFA monitors and reviews the performance of MFIs in a very proactive manner. MISFA regularly takes detailed reports from member MFIs on indicators such as number of clients, outstanding loan balance, rural and women ratio, geographical spread and staff among others and publishes them on its website. MISFA is also instrumental in enhancing transparency in the sector and encourages MFIs to report on the Microfinance Information Exchange (MIX) market.

FINANCING

The majority of MFIs currently depend on MISFA funding. Aiming at building the equity and fund base of MFIs, MISFA provides debt on soft terms to finance their portfolio and grants to cover operating expenses, purchase of fixed assets and expenditures for training and technical assistance. Since its inception and learning from other countries, MISFA's financing strategy has been clearly designed and oriented to gradually reduce the proportion of grants and substitute them by debt financing, while MFIs stabilize their financial positions and gain the ability to raise commercial funding from various other sources.

Over the last five years (2003-08) it has provided approximately USD 717 mn as loan funds to partner MFIs. The loans are priced at 5% for old partner MFIs. However, for new MFIs like ASA the interest rate is 8%. The minimum loan amount is USD 100,000, with term period of one year, with the option of roll-over to another term after written consent from MISFA management and based on satisfactory performance[35].

35 Microfinance in Afghanistan, InM, 2009

MARKET GAPS AND CHALLENGES

Despite the considerable growth of the sector, a 2006 study from the World Bank [36] shows a large market potential for continuing expansion. Considering the economically active population living below the poverty line, only 5% of their financial service demand was covered by MFIs in the country and only 8% of the projected credit requirements were met by the MFIs.

	Households	Households Demanding Credit	Credit Demand (USD mm)
Rural	3,300,000	1,386,000	970
Urban	985,000	492,500	345
Total	4,285,000	1,878,500	1,315

Source: Microfinance in Afghanistan, InM, 2009

The present client outreach of 436,056 (May 2010, with 293,842 borrowers), is still only 8% of the approximately 2 mn households living under the poverty line in the country. This leaves a major scope for expansion. In addition it is concentrated in the central and north-western regions and urban areas, leaving the eastern region and specifically many parts of the southern regions and rural areas underserved leaving a great potential for increasing the outreach.

Estimated credit demand in Afghanistan is estimated to be much higher than current supply. Gaps also exists in availability to financial products and most MFIs offer more or less similar credit products.

MICROFINANCE INVESTMENT

GENERAL INFORMATION

The Government of Afghanistan has taken significant steps in reforming the banking, legal and tax systems to create an investor-friendly business environment. It has enacted a liberal policy on domestic and foreign investment in 'Law on Private Investment in Afghanistan' – amended on December 6, 2005. Based on the provisions of this law and the Commercial Law, qualified domestic or foreign entities may invest in all sectors of the economy, including MF. Both domestic and foreign investments are treated equally in the country.

The High Commission on Investment is the Government's focal point and highest administrative authority on policy and implementation related to private investment. The High Commission on Investment has established AISA as a limited liability company assisting it in carrying out its duties. Another important agency from the investment perspective is the Government Office of Private Investment having authority to grant various tax waivers.

All investors, whether foreign or domestic, have the right to avail the banking facilities in Afghanistan, including opening accounts in foreign currency and collecting loans and credit to advance investment in the country. The State does not have the right to confiscate or to seize domestic or foreign investment without due process of law and a court order from the appropriate level of jurisdiction.

As far as the transfers of funds are concerned, private foreign investors are allowed to transfer distribution of capital and profits out of the country, with a notification to the central bank, in any currency at the prevailing exchange rate.

There is no tax exemption for interest earned on debt investment. The tax rate is 20% on

36 Microfinance In South Asia, World Bank 2006

net income and currently interest earnings are subject to 5% value added tax (VAT).

DOMESTIC DEBT INVESTMENT

LEGAL FRAMEWORK

The legal framework for domestic investment remains the Commercial Law and the Law on Private Investment in Afghanistan. All legal forms of MFIs can take debt investment from domestic financial institutions.

PRESENT SITUATION

MISFA is the biggest player in domestic debt investment, giving debt to its member MFIs at an annual interest rate of 5% in the local currency[37]. Over the last five years (2003-08) it has provided approximately USD 717 mn as loan funds to partner MFIs.

The commercial market for domestic debt is very weak for the microfinance sector. With the availability of soft loans from MISFA, the commercial rates offered by the banks are not very attractive for MFIs.

The first commercial debt agreement in the sector was between Bank Alfalah and BRAC Afghanistan in June 2008, worth USD 1 mn, with MISFA providing a First Loss Default Guarantee of 25% to Bank Alfalah against a perceived default by BRAC.

DOMESTIC EQUITY INVESTMENT

LEGAL FRAMEWORK

The legal framework for domestic equity investment remains the Commercial Law and the Law on Private Investment in Afghanistan – amended on December 6, 2005. All legal forms of MFIs can take equity investment from domestic financial institutions. However, as MFI growth has been largely funded by grants, the government is seeking to ensure that MFIs do not distribute dividends to investors gained through these. Most of the MFIs have the status of Corporation and as per their statutes, until they have refunded all grants received from MISFA, they are not authorized to distribute dividends. According to their statutes, their entire surplus income at the end of the year must be converted to reserve funds in order to reinvest the funds in the company and to meet unforeseen contingencies. None of the assets or funds belonging to the company is permitted for transfer out of Afghanistan in any shape or form.

PRESENT SITUATION

The equity market is non-existent in the country and only recently a domestic equity fund (Afghan Growth Finance) mandated to invest in local business has been established. In the case of many MFIs some equity is provided by a parent organization. MISFA has no equity investment in MFIs and has only supplied grants for fixed assets, capacity building and operating expenses.

The recipient MFI must approach AISA for approval for any equity investment. For such companies, while nothing prevents them to pay dividends, all MFIs financed by MISFA are forbidden to distribute dividends until all grants are refunded. This is not a law but can be found in the statutes of all MFIs. The transfer of grants to a for-profit institution and the creation of dividends related to grant funding to entities outside of Afghanistan is illegal. There is no tax waiver for equity investment.

FOREIGN DEBT INVESTMENT

LEGAL FRAMEWORK

The legal framework for domestic investment remains the Commercial Law and the Law on Private Investment in Afghanistan. All legal forms of MFIs can have debt investment from foreign financial institutions.

37 Earlier loans by MISFA were in foreign currency but they were later converted into local currency and the new repayment schedule was signed with all the member MFIs in the year 2007

PRESENT SITUATION

Despite the liberal policy and low tax environment, not many foreign investments, commercial or social, have come forward to MFIs except for soft loans provided by a few international agencies through MISFA.

An MFI, Ariana Financial Services (AFS), has received loan support from KIVA. AFS has 350 KIVA clients with a portfolio of Af 12 mn (USD 240,000). On average, AFS disburses Af 900,000 (USD 18,000) via KIVA to 50 borrowers each month.

The foreign debt investment market has a low demand from MFIs and investors/banks. For foreign investors active in the microfinance space, MFIs in Afghanistan are still not an attractive option as their balance sheets have high PAR>30 and low level of OSS amongst others. At the retail level, with low cost debt available from MISFA, most MFIs do not have much incentive to approach foreign debt investors in the short term.

FOREIGN EQUITY INVESTMENT

LEGAL FRAMEWORK

The legal framework for foreign equity investment remains the Commercial Law and the Law on Private Investment in Afghanistan – amended on December 6, 2005. All legal forms of MFIs can take equity investment from Foreign Financial Institutions.

PRESENT SITUATION

To date, no foreign investment, social or commercial has come to MFIs. As mentioned above, for most company MFIs, equity is provided by the parent organization. To date MISFA has only supplied grants for fixed assets, capacity building and operating expenses.

The commercial banks with focus on microfinance have had some equity investments. For example, FMB-A has equity investment from Aga Khan Agency for Microfinance (AKAM), Kreditanstalt fur Wiederaufbau (KfW) and the International Finance Corporation (IFC)[38].

BAB also has equity investment from the IFC, ShoreCap International and Stichting Triodos Doen. The Multilateral Investment Guarantee Facility (MIGA) of the World Bank has issued a guarantee to ShoreCap covering its equity investment in BAB. An additional amount of USD 112,500 is being guaranteed by the MIGA-administered trust fund, the Afghanistan Investment Guarantee Facility. The coverage is for a period of up to ten years against the risks of transfer restriction, expropriation, war and civil disturbance.

The recipient company has to approach AISA and obtain approval for any equity investment. For such companies, while nothing prevents them from paying dividends, all MFIs financed by MISFA are forbidden to distribute dividends until all grants are refunded. This is not a law but can be found the statutes of all MFIs.

KEY CONTACTS

Afghanistan Microfinance Association (AMA)

www.ama.org.af

Afghanistan Investment Support Agency (AISA)

www.aisa.org.af

Da Afghanistan Bank (DAB)

www.centralbank.gov.af

Microfinance Investment and Support Facility (MISFA)

www.misfa.org.af

38 IFC has provided USD 3.5 mn standby revolving loan facility to FMB-A to fund its loan portfolio

BANGLADESH

Population : 144.2 mn[1] (2009)
Main towns : Dhaka, Chittagong, Khulna, Sylhet, Rajshahi, Bogra
Currency : Bangladesh Taka (Tk)
Exchange rate : 1 USD = 69.06 (average for 2009-10)
Fiscal Year : 1st July – 30th June

Development Indicators[2]:

- Population below poverty line (National): 40.5% (2005)[3]
- GNI per capita (Atlas method, USD): 520 (2008)
- Adult Literacy Rate: 53.5% (2007)
- Mortality Rate (child<5 years): 61 per 1000 live births (2007)
- Life Expectancy at birth: 66.6 years (2007)
- HDI: 0.543, 146 rank among 182 countries (2009)

Indicator[4]	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10***
Nominal GDP (USD bn)	61.9	68.4	79.6	89.4	99.5
Real GDP Growth (%)	6.6	6.4	6.2	5.9	6.1
Consumer Price Inflation (avg,%)	6.48	7.16	7.20	6.66	6.78
Exchange rate (avg, vs USD)	67.2	69.1	69.1	68.8	69.5
External Debt (year-end, USD bn)	17.8	18.5	21.0	21.5	22.2
External Debt (as a % of GDP)	28.7	27	26.4	24.1	22.3
FDI (USD mn)	745	793	748	961	636
FDI (as a % of GDP)	1.34	1.20	1.16	0.967	1.07

*estimates

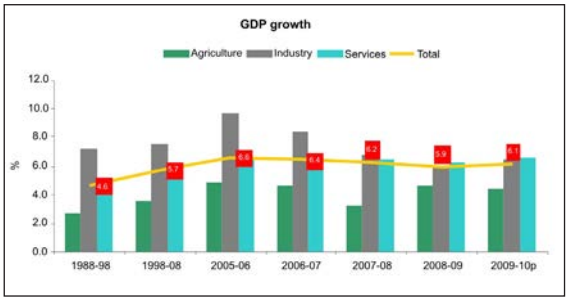
1 Bangladesh Economic Review 2010, Ministry of Finance, Government of Bangladesh
2 Bangladesh Bureau of Statistics and ADB Bangladesh Fact Sheet http://www.adb.org/Documents/Fact_Sheets/BAN.pdf
3 According to ADB, 49.6% of population lives on less than USD 1.25/day in 2005
4 Figures taken from South Asia Economic Update 2010, World Bank and Major Economic Update, Bangladsh Bank, August, 2010

ECONOMY

The high poverty levels, poor human development indicators, rising income inequality and inadequate social sector expenditures continue to pose serious challenges in achieving socio-economic goals for Bangladesh. The poverty figure remains high at 40%[5] and underlying the national poverty story are vast differences between regions. Dhaka, Chittagong, and Sylhet divisions in the eastern part of the country experienced rapid poverty reduction. In the West, gains were much smaller for Rajshahi and nonexistent for Barisal and Khulna[6]. Adult illiteracy remains at a high of 50% and child malnutrition and maternal mortality rates are among the highest in the world.

ECONOMIC GROWTH

Bangladesh has registered an average Gross Domestic Product (GDP) growth of 5-6% in the last ten years, led by trade, fiscal, industrial, agricultural and financial policies is supported by export-oriented manufacturing, inward remittances and the service sector. A notable feature of economic growth in Bangladesh has been its broad-based nature and contribution of private investment.

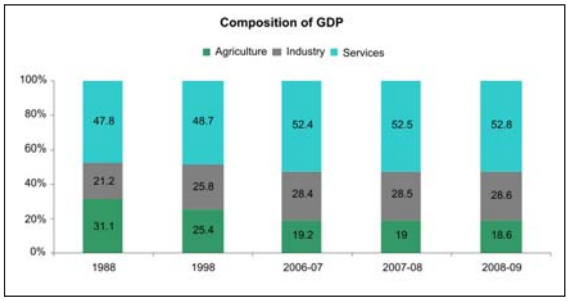


Source: World Bank and Bangladesh Bank

On the expenditure side, external demand has been instrumental in the expansion of industrial production and contributed to about one quarter of incremental GDP growth over the past decade, which leaves three quarters of the GDP growth to be explained by domestic demand.

ECONOMIC STRUCTURE

The economic structure is changing with Industry and Services gradually increasing their share at the expense of Agriculture[7]. Despite these changes in the sector wise composition of GDP, more than 60% of the population is dependent for their livelihoods on agriculture and related farm and non-farm activities[8].



Source: World Bank and Bangladesh Bank

Presently Services account for over half of the GDP. The share of the Manufacturing sector is increasing at a slow rate. Apart from sluggish external demand, performance of the industry sector has been held back by inadequate power and energy supply. Small and Medium enterprises (SMEs), which are unable to install their own generators, have been most seriously affected by power shortages [9].The Ready Made Garments (RMG) sector currently has 17% share of GDP while construction accounts for 8% of GDP.

Two metropolitan cities of Dhaka and Chittagong have emerged as the main centers of economic activity of the country, concentrating employment and manufacturing outputs. Dhaka alone accounts for 80% of the country's RMG output and half of manufacturing sector employment. Complementary business services, particularly finance and real estate account for a much higher share

5 From 1991 to 2005, the national poverty incidence fell from 59% to 40%
6 Poverty Assessment for Bangladesh: Creating Opportunities and Bridging the East-West Divide, World Bank, Oct 2008

7 Bangladesh at a Glance, World Bank, 2009
8 Bangladesh Quarterly Economic Update, ADB, March 2010
9 ibid

of total employment in Dhaka relative to the rest of the country (World Bank, 2007).

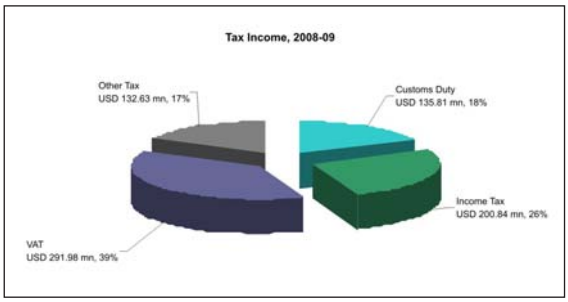
LABOUR

Bangladesh has a total labour force of about 70 mn, 80% them being employed in the informal sector. Daily wage labor accounts for about a third of all workers; self-employed outside of agriculture – about 20% of all employed – consist of individual own-account workers, employers, and those engaged in family enterprises. Finally, the self-employed in agriculture account for about a quarter of all workers.

A 2005-06 labour survey found that 23% of labor lived in urban and 77% in rural areas. The labor force lacks skill for market needs and the average education of the workforce is only 4 years. A significant number of labour migrate out of the country [10].

TAXES

In the last few years, Bangladesh has made efforts to widen the base of tax without increasing the rate of tax. The tax system in Bangladesh is progressive in nature with lowest individual income tax rate being 10% and highest 25%. For companies, minimum and maximum tax rate is 27.5% and 45% respectively. A uniform VAT rate of 15% is applicable for both goods and services. However, Tax as a percentage of GDP is low at 9% of GDP in 2008-09.

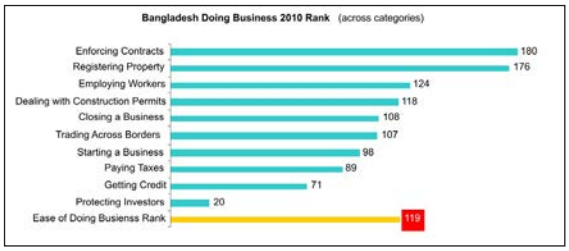


Source: Bangladesh Bank

BUSINESS ENVIRONMENT

In Doing Business 2010 Report, Bangladesh is ranked 119 out of 183 economies. The best raking comes in protecting the Investors while worst ranking comes in registering the property and enforcing contracts.

According to the World Economic Forum's Global Competitiveness Report for 2007-08, the three most problematic factors for doing business are corruption, inadequate supply of infrastructure and inefficient government bureaucracy. Similarly, according to the Enterprise Surveys (2007), electricity, access to finance and political instability rank as the top three constraints to firm investment.



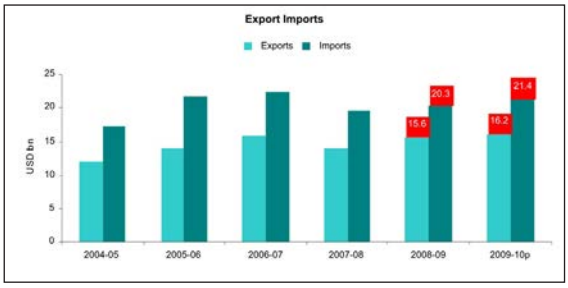
Source: IFC

EXPORT IMPORT

From 2003 to 2007, Bangladesh achieved annual export value growth of 19.6%. The competitiveness of Bangladesh comes from the fact that the country provides significant benefits to exporters with liberal Foreign Direct Investment (FDI) regime (no prior approval requirements or limits on equity participation and repatriation of profits and income in most sectors and tariff-free access to the European Union (EU), Canada, Australia and Japan. However, along with weak governance[11] and infrastructure inadequacies finance, e.g. the cost of borrowing, represents a significant obstacle to stronger export performance.

10 Poverty Assessment for Bangladesh: Creating Opportunities and Bridging the East-West Divide, World Bank, Oct 2008

11 Bangladesh has consistently ranked among the most corrupt countries by Transparency International with the Corruption Perception Index latest ranking being 162 out of 180



Source: Bangladesh Bank

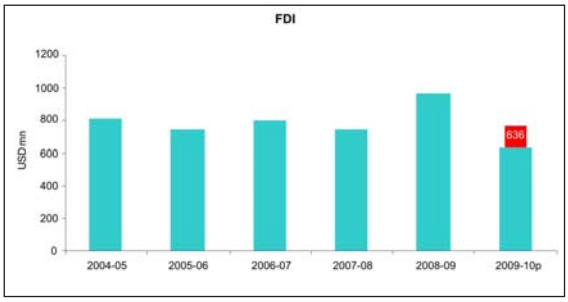
The contribution of trade (export and import) remains high at 43% of the GDP as of the end of 2009. However, external trade depends on a narrow export basket. More than 80% of export earnings are derived from clothing, the Unites States (US) and EU markets accounting for more than 85% of total exports[12].

Imports have grown at a lesser pace than exports over the last decade. They comprise mainly raw materials, intermediate and capital and consumer goods and roughly 60% of imports are sourced from 10 countries.

Exports and Imports as a % of GDP stood at 17.4% and 22.7% respectively in 2008-09.

FOREIGN INVESTMENT

The Foreign Investment Act of 1980 guarantees the right of repatriation of capital, profits, capital gains, post-tax dividends, and approved royalties and fees. Despite the liberal FDI regime, governance and infrastructure problems and week banking system have curtailed its expected flow.

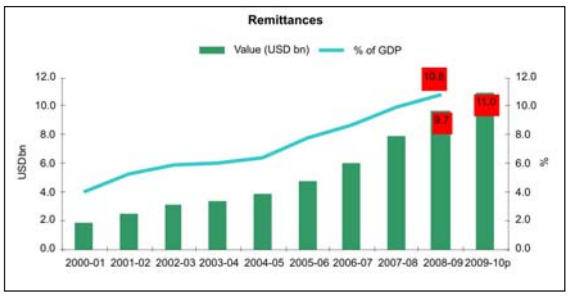


Source: Bangladesh Bank

FDI flows into Bangladesh have increased consistently from 1990s rising from an annual average of USD 217 mn in the period 1990-2000 However, Bangladesh remains an underperformer regarding FDI inflows, ranking 121 out of 141 countries on the UNCTAD inward FDI Performance index. Sectorally, FDI has played a critical role in the start-up of the RMG industry in the country and inward flows continue to be directed towards the RMG sub-sector in particular as well as the power, energy, telecom and manufacturing sector more broadly.

REMITTANCES

It is estimated that about 140,000 people per year, mostly skilled and semi-skilled labour emigrated abroad from 1976 to 2004. Over the past two years, a record number of Bangladeshi workers (1.7 mn) left the country in search of jobs abroad. The total number of migrant workers is estimated at about 6.1 mn at present, over 10% of the total labour force; they are estimated to have sent about USD 11 bn in 2009-10, equivalent to 12% of GDP. Of these remittances, 25% were from the industrialized countries in the West and 75% come from the Middle East.



Source: IMF and Bangladesh Bank

A key feature of Bangladeshi migrant workers is that they are mostly unskilled and semi-skilled. From 1976 to 2009, about 70% could be classified as unskilled and semiskilled; the remaining 30% are classified as skilled and professionals[13].

12 Bangladesh Quarterly Economic Update, ADB, March 2009

13 ADB, Mar 2010, Bangladesh Quarterly Economic Update

COPING WITH THE GLOBAL FINANCIAL CRISIS

The Bangladesh economy has increasingly integrated with the global economy over recent years, through trade, remittance flows and foreign direct investment. Export accounts for 17% of GDP and remittances equivalent over 10% of GDP. The degree of openness of the Bangladeshi economy was about 43.4% towards the end of 2007-08, with the extent of globalization equivalent to 56.6% of GDP[14].

The global financial crisis resulted in a deceleration of trade and migration flows although remittance flows remained high. In response, the Government of Bangladesh has expanded its social safety net system designed to address transient food insecurity. Substantial effort is also made to support productive sectors through stimulus packages, investment in infrastructure and agriculture, interest rate cuts and improved macro-economic monitoring. This has enabled Bangladesh to avoid some of the consequences. Job losses in the export-led sectors were contained to around 100,000 against the forecast of 300,000. However, the adverse impacts have started to be transmitted through various channels to the domestic economy due to slowdown in export growth, lower number of workers leaving for jobs abroad, declining industrial growth, negative growth of import of capital machineries, slow growth of term loans and lower domestic resource mobilization[15].

FINANCIAL SECTOR[16]

REFORMS

Considerable progress has been made in strengthening the financial sector in Bangladesh since implementation of the Financial Sector Reform Program (FSRP) introduced in 2003. The FSRP in the last few years has focused on the liberalization of interest rates; implementation of capital adequacy requirements of commercial banks; modernization of the banking sector; revision of the legal structure of the financial sector; development of a capital market; improving the Central Bank's supervision and improvement of overall management of the banking sectors with special emphasis on credit management among others.

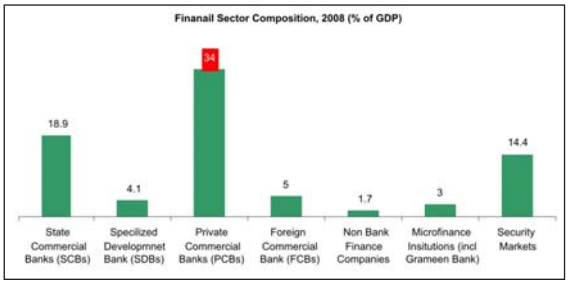
While the reforms continue, presently focusing on the introduction of BASEL II, raising the quality of banks' capital, and strengthening Central Bank's in-house capacity for stress testing, key concerns remain in areas of: finances of state commercial banks; implementation of accounting practices; unified and broadened regulations to cover MFIs and NBFIs and improving efficiency in the financial markets.

Banks and NBFIs may borrow in foreign currency on the condition that effective interest rates do not exceed LIBOR plus 4% and term does not exceed 7 years. NBFIs however, face additional restrictions such as repayment of interest in foreign currency is prohibited though repayment of loan principle in foreign currency is allowed[17]. In a recent development, the Central Bank has asked banks to dedicate a minimum 40% of total budget allocation tp small businesses; establish dedicated SME functions and report on SME portfolio on a quarterly basis.

COMPOSITION

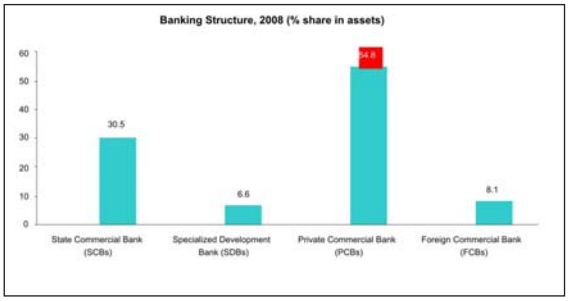
In Bangladesh, commercial banks dominate the financial sector with banking assets of around 65% of GDP in 2008.

14 Global Financial Crisis Discussion Series, Bangladesh, Mustafizur Rahman et al, ODI, May 2009
15 ibid
16 All figures in this part are taken from different documents made available on the website of Bangladesh Bank, ADB and World Bank
17 IFC/KfW, 2009, Bangladesh: microfinance and financial sector Diagnostic study



Source: IMF

The banking system that consists of the Central Bank, known as the Bangladesh Bank (BB); 4 state owned commercial banks (SCBs); 5 government owned specialized development banks (SDBs) ; 30 domestic private banks (PCBs), 9 foreign owned commercial banks (FCBs) and 29 Non-banking Financial Institutions (NBFI). PCBs now hold a majority of banking assets owning 55% of bank assets, compared to 35% in 2002 and the role SCBs and SDBs has correspondingly declined. However, SCBs still have commanding position in the banking sector four SCBs together account for more than 30% of deposits and operate 3,383 branches (50% of the total) as of 30 June 2008[18].



Source: IMF

The banking sector has grown at annual growth rates of between 11% to 23% in 1995-2005 with PCBs providing the fastest growth. The weak performance of nationalized and specialized banks with high Non performing loans (NPL) at around 30%; high interest rates and negative return on equity continue to cripple the financial system in the country[19].

In Bangladesh 119 cooperative banks are operating, of which 64 are central cooperative banks, 48 are land mortgage and the remaining 7 are other cooperative banks. Central Cooperative dominate with 90% of assets, 85% of deposits and 90% of loan advances. Cooperatives are regulated under the Cooperatives Societies Act and under the Ministry of Local Government and Cooperatives.

29 NBFIs consists of investment, finance, leasing companies etc. Of these one is government owned, 15 are local (private) and the other 13 are established under joint ventures with foreign participation. Leasing companies (11 of them) are showing strong performance with asset growth, innovation and profitability and portfolio quality.

Key Indicators for Banks 2008				
	NPL	RoA	RoE	Interest rate spread (year end)
SCBs	28	1.1	68.5	5.85
SDBs	11.7	-0.6	-9.5	2.88
PCBs	5.1	1.4	46.4	5.36
FCBs	3.7	2.9	46.1	9.02
All Banks	11.2	1.3	20.3	5.75

Source: IMF & ADB

The insurance sector is regulated by the Ministry of Finance. A total of 62 insurance companies have been operating in Bangladesh, of which 18 provide life insurance and 44 are in the general insurance field. The industry is dominated by two large state owned company's accounting for most of the total assets of the insurance sector[20]. The total premium income to GDP of Bangladesh reached a mere 0.6% in 2004, compared with 0.7% in Pakistan, 3.1% in India, and 1.6% in Sri Lanka[21].

The capital market is regulated by the Securities and Exchange Commission and consists of stock exchanges in Dhaka and

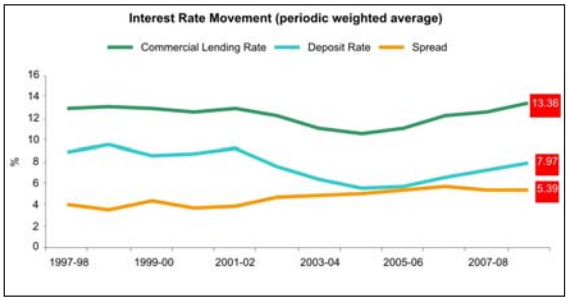
18 Bangladesh: Financial System Stability Assessment, IMF, Feb 2009
19 Bangladesh: Financial System Stability Assessment, IMF, Feb 2009
20 Bangladesh Financial Sector Agenda for Further Reforms, Syed Ali-Mumtaz H. Shah, ADB, 2009
21 ibid

Chittagong. The capital market is underdeveloped and equity oriented. In terms of stock market capitaliztion, the market capitalization of the Dhaka Stock Exchange (DSE) stood at 17.8% of GDP at the end of financial year 2008. The debt securities market in Bangladesh is very small and government debt securities overwhelmingly dominate the market. The bond market is underdeveloped and dominated by government issues. The corporate bond market remains largely undeveloped. Long-term financing is scarce, which impacts on infrastructure financing, especially power investment and housing investment.

The gross domestic savings rate in Bangladesh is low (20.5% in 2007) for the purposes of stimulating economic growth. The low level of saving is associated with a high consumption pattern, a low level of financial intermediation, and low disposable income. Bangladesh intermediates a reasonable proportion of its deposits to the private sector, equivalent to 37% of GDP.

INTEREST RATES

The cost of financial intermediation is well reflected in high interest rates. Overall lending rates remain high within the South Asian context.



Source: Bangladesh Bank

FINANCIAL EXCLUSION

According to a 2007 World Bank study, financial penetration in Bangladesh is adequate for its current level of development. Further, Bangladesh has the highest microfinance penetration rate in the world: 13% of Bangladeshis have a microfinance loan. The Central Bank data as mentioned in the table, also points to the fact that over 78% of adult population is financially included in 2008. However, it is important to note that it does not account for multiple or redundant accounts (such as membership of cooperatives) and picture would be quite different if such factors are included in data.

Further, despite the fact that the market is well served, not all sub segments of this market are served. Hard core poor and graduating microfinance clients (the so called missing middle) continue to face challenges in getting appropriate financial services.

Status of Financial Inclusion in Bangladesh

Year	Adult Population (mn)	Population pe bank branch (mn)	Number of bank deposit A/Cs (mn)	Deposit A/Cs as % of adult population	Number of members in MFIs (mn)	MFI members as % of adult population	Numbers of members in co-operatives (mn)	Cooperaive members as % of adult population	Financial Inclusion** as % of adult population
1999	73.16	18669	27.30	37.32					
2000	75.16	18347	28.40	37.79					
2001	77.18	19886	30.10	39.00			7.65	9.91	
2002	79.59	20753	30.90	38.82			7.67	9.64	
2003	80.80	21406	31.30	38.73	14.63	18.11	7.57	9.37	66.21
2004	82.25	21443	31.60	38.42	14.40	17.51	7.76	9.43	65.36
2005	83.80	21420	33.10	39.50	18.82	22.46	7.92	9.45	71.41
2006	84.60	21171	34.50	40.78	22.89	26.95	8.03	9.45	77.33
2007	84.95	20920	35.70	42.02	20.83	24.52	8.22	9.68	76.22
2008	85.78	20566	37.60	43.83	20.90	24.36	8.44	9.84	78.04

Source: Scheduled Bank Statistics, Bangladesh Bank and Statistical Year Book of Bangladesh, BBS

* Adult population is defined by BBS as population 15 year and above
** Financial Inclusion is measured here as
(No. of bank deposit A/Cs + No. of MFI members + No. of members in cooperatives) / Adult population *100.
Post offices and government savings bureaus not included as these offer no credit services.

MICROFINANCE SECTOR

HISTORICAL EVOLUTION

Given its low developing status, economic and labour landscape which is concentrated in the informal economy, the country is a natural market for microfinance services and there is no wonder that microfinance originated in Bangladesh in the 1970s.

A BWTP research, conducted in 2009, identifies that the Bangladesh microfinance sector evolved through four distinctive stages[22]. These are:

- Action research phase in the 1970s
- Microcredit development phase in the 1980s
- Consolidation phase in the 1990s
- Expansion phase from 2000 onwards

Post liberation, Bangladesh's development sector started implementing programmes broadly in the areas of health, education, agricultural diversification and development, relief and rehabilitation and small scale income generating activities to help the poor have alternative sources of income. With the huge success of Dr. Yunus's Jobra experiment, other NGOs started getting interested to offer microfinance services to their target clients. The government, through Bangladesh Bank and a few other ministries, also took up microfinance as a poverty alleviation tool.

A decade later, Non Government Organizations (NGOs) started developing new products, slightly deviating from the traditional Grameen approach of microfinance to meet the diverse financial needs of the clients. Slowly, with success and growing competition, for many NGOs microfinance became the most prominent program, fading out other social development programs.

During 1990s, with funds from the World Bank, the government established Palli

22 BWTP, 2009, Microfinance Industry Report Bangladesh

Karma Shahayak Foundation (PKSF) as an apex funding agency for facilitating wholesale funds to the MFIs. PKSF started providing low interest refinancing along with technical supports to strengthen the systems and policies of the MFIs. PKSFs also focused on improving efficiency of the MFIs towards attaining self-sufficiency and to reduce dependence on donor funding. ASA achieved self-sufficiency in the late 1990s and started operating microfinance using its own funds, mobilized from retained earnings, client deposits and grants converted to equity. BRAC, Proshika, Grameen Bank along with ASA demonstrated that microfinance can be operated without dependence on donor fund and can be run in sustainable manner. These four organizations are commonly known as the 'big four' of Bangladesh microfinance industry.

In recent years, the sector is experimenting with product design and delivery mechanisms to reach untapped markets like urban markets, small business and enterprises and insurance and remittances products.

TYPES OF MFIS

At present, the main direct providers are microfinance institutions (MFIs), which are basically non-governmental organizations (NGOs) labeled here as `MFI-NGOs', Grameen Bank (GB), Palli Daridra Bimochon Foundation (PDBF), Rural Development Scheme (RDS) of Islami Bank Bangladesh Ltd (IBBL), among others.

PDBF is a transformed public sector MFI in Bangladesh. This is the only public sector MFI in Bangladesh. IBBL replicates Grameen model and directly implements RDS at the field level. The IBBL is the only commercial bank that implements group-based microfinance program directly.

According to Credit and Development Forum (CDF) unpublished Statistic Report for 2009, by end of Dec 2009, 744 NGO MFIs serve 72.44%% of members, while GB's share is 20.82%.

The NGO MFIs are mostly registered as NGOs; Societies; Not-for-profit Companies; Cooperative Societies; Trusts. They are supervised by NGO Affairs Bureau, Prime Minister's Office (PMO); Ministry of Social Welfare; Ministry of Finance; Department of Cooperatives and Registrar of the Joint Stock Companies depending on their registration type. GB is an exception case who is registered as a Specialized Bank. However, with the passage of Microfinance Regulatory Bill, the Microfinance Regulatory Authority (MRA) now has the supervision and regulatory power and all NGO MFIs are required to be registered with MRA to provide microfinance services. As of now over 500 MFIs are registered with MRA.

MAJOR HIGHLIGHTS OF THE SECTOR

OUTREACH

According to Microfinance Information Exchange (MIX) Market data for 2007, Bangladesh has 274 MFIs, with 24.8 mn borrowers[23]. The total population count was 142 mn, 50% (71 mn) of whom were poor. The MFIs penetration of borrowers reported in the Benchmarking Report was 17% of the total population and 35% of the poor population.

As per latest data available with CDF for Dec 2009, the microfinance sector has over 38 mn clients served through 17,777 branches and a staff of 361,764. However, it is difficult to estimate the unique number of microfinance borrowers as there is no detail data to know the extent of multiple borrowings among clients.

A striking 90% of MFIs clients are women and 89% rural. The average size of loan outstanding per borrower was Tk 6,521 (USD 94). In 2008, of the total portfolio, ASA (22.50%), BRAC (28.81%) and GB (27.96%) account for about 79.26%. The remaining 20.74% is under about 700 smaller MFIs. The NGO-MFIs as a whole (including ASA and

23 MIX, 2008, Asia Microfinance Analysis and Benchmarking Report

BRAC) occupied 72.44% of the sector's total members in 2009 and Grameen Bank's share as a single agency was at 20.82% in 2009. According to CDF, 126 MFI NGOs out of 744 that reported for latest CDF survey account for 85% of the members.

Geographically underserved groups are scattered throughout the country, the majority of the poorest of the poor live in northern Bangladesh, in particular near the Jamuna river basin and in rural or urban slums.

Outreach of Microfinance Sector as on Dec 2009					
	Branches	Cumulative Members (mn)	Cumulative Borrowers (mn)	Net Savings (USD mn)	OLB (USD mn)
NGO MFIs* (N=744)	14,845	27.73	58.91	696	2058
Grameen Bank	2,562	7.97	7.97	645	787
PDBF	226	1.39	1.22	20	51
RDS (IBBL)	144	1.19	1.19	23	54
Total	17,777	38.29	69.29	1,384	2,950

Source: CDF

GROWTH

The aggregate time series data between 2003 and 2009 shows that the sector has hugely expanded as reflected by memberships, borrowers and portfolio: membership has increased by 186%, borrowers by 199% and portfolio by 302.4%. The savings balance has also proportionately increased by 362%. A further insight about the growth pattern shows that growth has actually come from the three very large organizations. Grameen has expanded 2.45 times in membership, 2.46 times in borrowers and 2.77 times in portfolio size. ASA has expanded 3.1 times in membership, 2.75 times in borrowers and 3.09 times in portfolio size. Similarly, BRAC has expanded more 2 times in membership, 1.82 times in borrowers and 2.77 times in portfolio size. The rest of the sector could only manage to grow by 1.2 times in membership, 1.52 times in borrowers and 2.44 times in portfolio.

The table here shows growth indicators for 137 NGO MFIs for the last three years. The microfinance sector is expected to grow 25% annually over the next three years (2009-2012) as a result of growing demand for lager loan size[24].

Annual Growth Rate of Key Microfinance Indicators, (%)*			
	2009	2008	2007
Net Savings	17.83	22.87	22.81
Cumulative Borrowers	11.83	13.98	19.64
Current Borrowers	-8.51	5.27	18.18
Cumulative Loan disbursement	28.82	22.22	28.31
Loan Outstanding	2.65	24.36	28.4
Revolving Loan Fund	10.54	46.49	36.83
* for 137 NGO MFIs based on CDF Survey 2009 (unpublished)			

Source: CDF

PRODUCTS

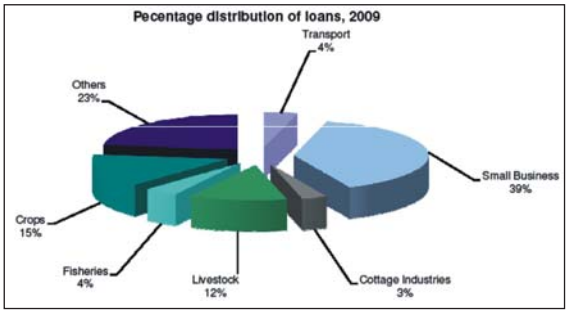
The products that are currently offered by the sector are mainly loan and savings products.

The average size of loan outstanding per borrower was Tk. 6,521 (USD 93) in 2009 for 126 NGO MFIs. Loans are repayable over an agreed timeframe, generally over 45 equal weekly installments. The loan size depends on the MFIs' product design and savings deposited by clients. In many MFIs in Bangladesh, loan size is determined as a multiple of savings. Neither PKSF nor MRA restricts the amount of a first time loan to be given to any client. However, PKSF puts an interest cap of 12.5% (calculated on a flat basis) for all MFIs that borrow from PKSF. The Bangladesh Microfinance Statistics 2009 (unpublished) shows that approximately 37.50% MFIs charge 12.5% interest per annum with another 57.76% MFIs charging 15% interest per annum. Also an overwhelming 97% of MFIs charge flat interest rate.

Group-based lending methodology is the main system of delivery of microfinance services, although commercial banks and a

24 Bangladesh: Microfinance and financial sector Diagnostic study, IFC, 2009

number of MFIs offer loans to individual clients. As shown in chart here, small business, crop production and livestock account for majority of loans



Source: CDF

The Bangladesh Microfinance Statistics observed that typical savings products are compulsory savings, voluntary savings, deposit pension schemes, time deposits and fixed deposits with monthly income. More than 81% of the reporting MFIs paid interest on savings in the range of 5% to 8% in 2009. The deposit mechanism in most cases is through group meetings with the frequency depending on the type of savings a client is accessing. MRA has stopped collection of time deposit, that is, deposit of small savings per week to receive a lump sum at the end of 3 to 5 years. MRA requires that MFIs have a minimum equity of USD 7 mn in order to offer certain saving products such as contractual or long term savings and deposit pension schemes, therefore these products are offered only by large MFIs and GB given its exceptional status. MFIs can collect savings only from group members. Only Grameen Bank in Bangladesh can mobilize savings from non-members and about 23% of Grameen Bank's net savings come from non-members[25]. The amount of net savings per member in 2009 was Tk. 1,744 (USD 25) for 126 NGO-MFIs as per CDF Statistics 2009.

Micro-insurance and remittance services are recent offerings in the microfinance product portfolio and the sector is consistently increasing outreach through micro-insurance and remittance services. MFIs introduced micro insurance products basically to reduce risks related to delinquency and non-performing loans in case of clients' death. Most of the NGOs/MFIs collect premium during loan disbursement and offer insurance policy for the loan period only or for a year. Proshika has the most diverse range of insurance products, offering clients insurance facility for life, property, housing, education, health and livestock[26]. International Network of Alternative Financial Institutions (INAFI), Bangladesh's study on Micro insurance in Bangladesh, conducted in 2007, reported that a total of 20.69 mn clients are covered by micro insurance services provided by the NGO-MFIs. The total client coverage is reported to be female dominant, with 85% of the total clients being female. Average premium charged by the NGO-MFIs for micro insurance products is Tk 8 per thousand Tk loan. The study mentions that the reported 61 MFIs/NGOs are offering total 81 insurance schemes of different products i.e. loan (71%), life (16%), health (6%), livestock (5%) and property insurance (2%).

NGO MFIs are prohibited from engaging in transfer services. Among MFIs only BRAC through its sister BRAC Bank provides remittance transfer through an agreement with Western Union. Apart from this, there are lots of other MFIs working in collaboration with commercial banks and money transfer agencies. UDDIPAN has signed a contract with Al-Arafah Islami Bank Ltd., Shakti with Trust Bank Ltd., Padakhep with Dhaka Bank Ltd., Thengamara Mohila Sabuj Sangha (TMSS) with National Credit and Commerce Bank Ltd. and ASA with National Bank Ltd.

SUSTAINABILITY[27]

During the 2003 to 2007 period, the overall operating efficiency of the sector as a whole declined (members per credit officer have declined from 320 to 221), borrowers per credit officer have declined from 233 to 180

25 Microfinance Industry Report, Bangladesh, BWTP, March 2009

26 Ibid

27 This section is heavily adopted from the report "Microfinance in SAARC Region: Bangladesh Country Report, 2009"

and portfolio per credit officer has remained almost the same in nominal terms, increased slightly from Tk 798,510 to Tk 889,772. This has been mainly due to rapid horizontal expansion, that is, enrollment of 'new' members/clients in new geographical areas.

The recovery rate of loans has remained high, with more than 99% recovery since 2005. Similarly, overdue loans have declined as a percentage of outstanding loan since 2004. However, the decline could be because of a sharp rise in portfolio size between 2004 and 2007. The portfolio quality in more recent times has actually declined. Based on InM Study in 2009, major MFIs (ASA, BRAC, Grameen and a few other large MFIs) shows that the portfolio quality has remained good except in Sidr and severely poverty stricken districts. In 2009 recovery has remained above 97% and the overdue as percentage of outstanding loan was 2.65%.

The very large and large MFIs have been historically very profitable. In three case (ASA, BRAC and BURO) the profitability has reduced, which can be linked with massive expansion financed by high cost loans (BRAC and BURO) and increase in management cost (all three cases). Portfolio quality also seems to be in decline as reported by ASA, BURO and other sources (Bangladesh Bank 2008). With the passage of time smaller MFIs have expanded their operations and reached financial viability. The factors that made most contributions are economies of scale (expanding portfolio), staff efficiency (management cost control) and reasonable cost of capital, especially subsidized funds from PKSF and low cost savings.

MESO LEVEL INFRASTRUCTURE

The meso level infrastructure of the Bangladesh microfinance sector is not very strong. Though there are a number of national and international level TA providers, the sector is yet to have a strong information flow and credit bureau. There are a few MFI networks, of which Credit and Development Forum (CDF) is by far the only vibrant one. Palli Karma Shahayak Foundation (PKSF), Institute of Microfinance (InM), CDF, INAFI, Anukul Foundation and Stromme Foundation are among the major TA providers in Bangladesh. Among other meso level players, rating agencies (Credit Rating Information & Services Limited (CRISL) & Credit Rating Agency of Bangladesh (CRAB), 97 PKSF listed audit firms.

There are a number of commercial banks, who are becoming increasingly interested in financing the MFIs. These commercial banks form a strong portion of the existing meso level infrastructure as they are key borrowing source for MFIs. There is no credit bureau in a context where client overlap is estimated at 40%.

COMPETITION

The microfinance industry in Bangladesh reached its maturity in the late 1990s. It was observed that in the case of more accessible and populated areas of Bangladesh, considerable double counting of membership (of the poor) in multiple organizations existed. It is common in Bangladesh that one client borrows from more than one creditor at the same time. The fierce competition among the MFIs resulted in such overlapping. The general consensus from a March 2002 gathering of microfinance industry leaders in Dhaka sponsored by Women's World Banking was that the national average for overlapping was about 15%, with much higher overlap in some rural areas (such as Tangail), ranging from 25% to 40%[28].

The level of saturation is high in case of Bangladesh microfinance industry. Saturation of the microcredit market resulted in a high number of over-indebtedness and clients tend to borrow from one MFI to repay loans of another. Given that in a densely populated area, there are on an average 7-10 MFIs operating, including the big MFIs, clients have a good number of alternative sources to access loans from. Absence of a credit bu-

28 S. Charitonenko & S. M. Rahman in 'Commercialization of Microfinance in Bangladesh', 2002, p 11-12

reau contributes to non-tracking of default borrowers among the MFIs working in the same locality.

Switching costs incurred by clients when changing providers appear set to decline as competition increases and MFIs vie for clients by reducing the transaction costs of participation. While it is impossible to know how accurate the estimates of double counting and overlapping are, it is clear that these two factors are causing overstatement of total microcredit outreach figures[29].

Competition in terms of product diversification i.e. leasing, savings, insurance, money transfer and delivery mechanism, open savings, individual lending, targeting male clients, loan not tagged with savings, etc. is not very prominent.

RISKS

High inflation, natural disaster and increasing cross-indebt ness are some of the major risks to the sector. For example after recent cyclones (Sidr and Aila) the bigger MFI's balance sheets noted an increase in bad loans.

Although no systematic study is available, practitioners in the sector report that loan recovery in the 2008-09 period is in decline and portfolio quality is under stress due to economic slowdown, reduced employment opportunities in rural areas, price hikes of 2008 and probably institutional weakness created due to over-expansion. Overdue loans as a percentage of loans outstanding has increased for ASA, BRAC and Grameen between 2006 and 2008.

A large number of MFIs remains unregulated though The Microfinance Regulatory Act has been approved by the Parliament in 2006, and MFIs are regulated and supervised by the Microfinance Regulatory Authority (MRA). The rules required to enforce the Act is still being drafted and the supervision function of MRA have not yet started.

29 Commercialization of Microfinance in Bangladesh, S. Charitonenko & S. M. Rahman in , 2002, p 12

REGULATIONS

The government, with the close cooperation of the Bangladesh Bank, undertook efforts to establish a regulatory framework which culminated in the enactment of the Microcredit Regulatory Authority Act, 2006 with a view to ensuring transparency and accountability of microcredit activities of the MFIs in the country. The Microcredit Regulatory Authority (MRA) has been established under the act, which is now empowered and responsible to implement the said act and to bring the microcredit sector of the country under a full-fledged regulatory framework. The main responsibilities of the authority include issuance and cancellation of the license for microcredit, overseeing, supervising and facilitating the entire activities of MFIs.

According to the Act, no MFI can carry out microcredit activities without obtaining a licence from MRA. Accordingly 4,236 NGO-MFIs have applied to MRA for license as of 26 February 2007. It was decided by the Authority that among these organizations, only those organizations who can fulfill minimum criteria (have equal to or more than 1,000 borrowers or equal to or more than Tk 400 mn loan outstanding) will be considered for a license. The remaining organizations will be allowed time until June 2009 to reach the above mentioned minimum criteria. If they are unable to meet those criteria within the specified time they will have to close their microcredit operation after that date. Up to 31 December 2009, the Authority has issued around 500 licenses to different NGO-MFIs and the licensing procedure for other NGO-MFIs is under process.

Under the Act, MFIs are allowed to provide loans, accept deposits from members, provide insurance services and other social development oriented services and receive financing. MRA is also working to prepare detailed rules and policies to monitor and supervise licensed NGO MFIs that will cover governance issues, financial transparency, mode of operations and other related issues

to ensure transparency and accountability in operation.

The Act, however, limits two potential sources of MFI funding which are equity and deposits. Equity investments in MFIs are directly prohibited as is dividend distribution. Further, it specifically prohibits MFIs from accepting deposits other than from a member of the MFI. MFIs are prohibited to transform into banks or NBFI. They may however establish sister banks. BRAC Bank, though being a separate entity, largely focuses on SME lending. The SME clients of BRAC Bank are mostly graduated members from BRAC MFI. Almost all branch offices of BRAC around the country have a SME service center of BRAC Bank. Through BRAC Bank, BRAC had been successful in retaining significant amount of its graduate clients, who otherwise would not have been served either by MFIs or by formal financial institutes.

FINANCING

Microfinance in Bangladesh has started with funding from the donor agencies in the form of grants. Gradually, with the growth of the sector, the funding sources also experienced diversification. The primary sources of refinancing for MFIs are equity, deposits and PKSF funding. Other funding sources include loans from local NGOs or international organization such as Anukul, Stromme, Plan etc. International financial institutions currently represent only a small source of funding for MFIs. The sector has successfully reduced its dependence on donor funding and is steadily accessing commercial fund sources.

Bangladeshi MFIs mobilize a significant amount of compulsory member savings, however, the debt financing in Bangladesh's microfinance industry is constantly growing.

Financing Sources for NGO MFIs*				
Sources	2009		2006	
	USD mn	% share	USD mn	% share
External Sources	129	11	74	11
Members' Savings	510	44	350	54
Own Fund	42	4	42	7
Borrowing	468	41	180	28
Total	1,148	100	647	100
*Based on 137 NGO-MFIs smaller NGO excluding big 4 MFIs				

Source: CDF

PKSF had played a key role in facilitating low-cost funds to the MFIs for the last 15 years. It now lends to almost all prominent MFIs in the country through its two lending windows: Bipool (window for large MFIs) and Pushpo & Usha (window for medium & small MFIs). At the end of 2008, PKSF has 197 active partner MFIs which have mobilized 11.35 mn (PKSF-funded part) members, that is, about one third of the whole sector. Loans outstanding from its partner MFIs is Tk 44,231 mn. PKSF puts an interest cap of 12.5% flat per annum on all loans the partner MFIs may charge from the end-users.

Partnership category	No. of POs	Interest charged	Loan term
Usha & Pushpo (small and mid level MFIs)	233	4.5%	3 years with 6 months grace period. Payable over 10 equal quarterly instalments
Bipul (large MFIs)	10	7%	4 years with 1 year grace period. Payable over 12 equal quarterly instalments

Source: PKSF

The commercial banks came up vibrantly as an alternative financing source, reducing the monopoly of PKSF as the only wholesale funding agency. A recent deal signed by BURO Bangladesh with Citibank N. A. can be sought as an example. Under this deal, BURO mobilized BDT 1,500 mn through a syndicated loan. A total of 13 commercial banks formed the syndicate, with Citibank N. A. as the arranger, agent bank, security bank and

account bank. This is the country's first ever syndicated agricultural term financing, to be used by BURO for agricultural lending to its clients. The loan term is for 5 years, with the first year as a grace period. The launching interest rate was 13% with floor rate at 12.5%. The repayment would be done through quarterly instalments through a mechanism known by the bankers as 'quarterly rest'. The portfolio generated by using this fund would work as collateral against the loan.

Among the locally available sources of funding, besides PKSF, the commercial banks are significantly gaining their market share by down-scaling interest rates and bringing in flexibility in the terms and conditions. As many as 15 commercial banks are currently providing funds directly to roughly 100 MFIs. Commercial banks have been providing loans to MFIs in mainly three different modes: a) individual bank develops its own policies and programs and lends to individual MFIs; b) syndicated loan where a number of commercial banks band together led by one bank to finance microcredit operations in one MFI; and c) securitization. All three modes have been applied in Bangladesh market. The typical terms and conditions include no collateral. MFIs are required to submit corporate guarantee, sign promissory notes, guarantee forms and get clearance from the Credit Information Bureau (CIB) of the Central Bank. In some isolated cases, however, MFIs are required to give collateral.

Funding source	Maturity Period	Interest Rate
PKSF	For Large MFIs: 4 year with 1 year grace period For small-medium MFIs (3 years with a 6 month grace period	For large MFIs: 7% per annum For Small and Medium MFIs: 1 – 4.5 % per annum
Banks and NBFIs	1 -3 years	10% - 14 % per year
INGOs and others	1-3 years	0 % - 10% per year

Whosale lending to microfinance under linkage program, Dec 2009			
	Loan Disbursement (USD mn)	Outstanding (USD mn)	Number of NGOs Financed
PKSF	1,119.45	402.41	257
Stately-owned Commercial Banks (SCBs)	160.69	66.52	116
Privately-owned Commercial & Overseas Banks (PCOBs)	288.30	117.13	40
Specialized Banks (SPs)	43.92	23.46	82
Total	**1,612.35**	**609.53**	**238**

Source: CDF

MARKET GAPS AND CHALLENGES

According to IFC Report in 2009, based on calculations for poor and ultra poor and factoring for need at 10%, credit worthy poor clients are estimated 20.9 mn or 37% of the population of the country. Industry data points to a generally well-served retail microfinance market. This does not however, preclude the existence of specific gaps within the market. The present coverage of MFIs, about 70% of poor households, suggests little room for further growth in market depth through Grameen-style microcredit. However, there is potential to fuel further expansion of the microfinance industry by increasing the breadth of outreach, and by expanding areas of service and types of products and services offered. These approaches may be especially important for MFIs trying to make their operations commercially viable by exploring profitable market niches

Despite good supply, the poorest of poor and graduating microfinance clients remain under-served. Under regulatory constrains, there is a lack of appropriate savings, insurance and remittances products. The second round of Impact Assessment Study of BRAC's Rural Development Programme (RDP) carried out by BRAC's Research and Evaluation Division (RED) revealed that 41% of the eligible poor did not participate in any NGO (microfinance and other activities) activities,

which alarmingly testifies that in Bangladesh extreme poor are left out of traditional microfinance activities.

MFIs have been concentrating on horizontal expansion. Considerable scope remains on vertical expansion in areas of sophisticicated product services, financing strategy, technologies, reporting and transparency, among other.

As of now, the sources of refinancing are overwhelmingly domestic and exclusively in local currency. This might constrain the future growth of the sector.

MICROFINANCE INVESTMENT

GENERAL INFORMATION

Banks and NBFIs may borrow in foreign currency but repayment of interest in foreign currency is prohibited.

For NGO MFIs foreign currency financing is effectively prohibited given MFIs are allowed to accept foreign currency loans only at zero percent. Further MRA regulations prohibit a dividend distribution that discourages equity investment. Therefore all external funding is in local currency.

The legal framework for investment in MFIs in Bangladesh is regulated under several laws. Among the most common ones are the Societies Registration Act 1860, Voluntary Social Welfare Agencies (Registration and Control) Ordinance 1961, Foreign Donations (Voluntary Agencies) Regulation Ordinance/ Rules 1978, Microcredit Regulatory Authority Act 2006, Cooperative Society Act 1956. Apart from these, the respective government offices also issue various circulars from time to time in regard to regulating the microfinance sector.

Investment in MFIs in Bangladesh is mostly done by PKSF, commercial banks and non bank financial institutions. There are few INGOs who also invest in microfinance, but mostly in the form of grants and non-interest bearing loans repayable in local currencies to the local franchises of the INGOs. Some of the commercial banks also directly implement microfinance programs. Anukul Foundation, a spin-off entity of CARE Bangladesh's INCOME project, also has some investment in microfinance sector of Bangladesh. The current amount of funds available for investment with Anukul is around Tk 3.8 bn. Anukul Foundation's focus of investment is to micro-entrepreneurial activities, promoting wage and self-employment in the urban and semi urban areas. Stromme Foundation also has some investment in microfinance.

Any form of foreign investment in the form of loan is restricted by the existing legal framework. However, negotiation to ease the legal restriction is going on with the concerned authorities. CDF, as the largest MFI network, is constantly liaising and advocating with the Central Bank, Ministry of Finance, MRA and Board of Investment in this area.

DOMESTIC DEBT INVESTMENT

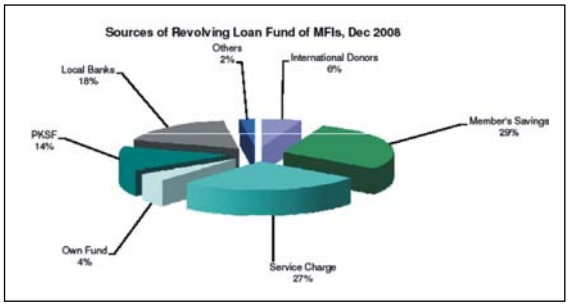
LEGAL FRAMEWORK

There is no specific regulatory requirement for domestic debt investment in microfinance activities. MFIs can borrow from numbers of sources including the commercial banks and PKSF. The options to borrow money from local fund sources are commonly guided by MFIs' legal documents like Memorandum of Association and Articles of Association.

PRESENT SITUATION

The Bangladesh Microfinance Statistics 2008 shows that sources of Revolving Loan Fund (RLF) of the reporting MFIs in the area of external sources shrank by 1.91% to 5.99% during 2007-08. It is important to note that the share of external sources in RLF has been declining consistently over the last few years. This demonstrates that microfinance activities are no longer dependent on donors. Of the total RLF of the reporting MFIs, more than half constituted members' savings and service charges in 2008. Greater involvement of the local banks through the MFIs is a sign of gradual integration of microfinance with the formal monetary system.

It has been often assumed that MFIs in Bangladesh can maintain their growth rates based on current re-financing options. However, it will be difficult for them to do so. As the demand for larger loans increases and refinancing sources of savings decreases, it would be difficult to meet demand. Existing financing sources are thus not adequate to help MFIs serve the growth of existing clientele.



Source: CDF

Though PKSF is still the only apex funding source with a relatively lower interest rate, many MFIs remain out of PKSF's coverage. PKSF started lending to the MFIs operating in the urban areas very recently.

DOMESTIC EQUITY INVESTMENT

The current legal framework does not allow any kinds of domestic equity investment in the field of microfinance in Bangladesh. The MFIs build their equity base through grants or retained earnings.

FOREIGN DEBT INVESTMENT

The current legal framework does not allow any kinds of foreign debt investment in the field of microfinance in Bangladesh.

Generally, investment is restricted under the Foreign Exchange Regulation Act. Any investment in foreign currency requires approval from the Board of Investment of Bangladesh. Given that PKSF is established to facilitate financing in microfinance sector, the authorities are reluctant to encourage foreign investment. Growing interest from the commercial banks to invest in microfinance also is another factor to restrict foreign investment.

FOREIGN EQUITY INVESTMENT

The current legal framework does not allow any kinds of foreign equity investment in the field of microfinance in Bangladesh.

KEY CONTACTS

Bangladesh Bank
www.bangladesh-bank.org

Board of Investment
www.boi.gov.bd

Credit and Development Forum (CDF)
www.cdfbd.org

Institute of Microfinance (InM)
www.inm.org.bd

Microcredit Regulatory Authority (MRA)
www.mra.gov.bd

Ministry of Finance
www.mof.gov.bd

NGO Affairs Bureau
www.ngoab.gov.bd

Palli Karma Shahayak Foundation (PKSF)
www.pksf-bd.org

INDIA

Population : 1.17 bn (2008)
Main towns : Chennai (6.5mn), Delhi(12.8 mn), Kolkata(13.2 mn), Mumbai(16.3 mn)[1]
Currency : Indian Rupee (INR or Rs)
Exchange rate : USD = Rs 47 (average 2009-10)
Fiscal Year : 1st April – 31st March
Development Indicators[2] :

- Population below poverty line (National): 27.5 %[3] (2004-05)
- GNI per capital (Atlas method, USD): 1,070 (2008)
- Adult Literacy Rate (15 years and above): 66% (2007)
- Mortality Rate (child<5 years): 69 per 1000 live births (2008)[4]
- Life expectancy at birth: 64 years (2008)
- HDI: 0.612, 134 out of 182 countries (2009)[5]

Indicator[6]	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Nominal GDP (USD bn)	922.9	1131.9	1329.1	1512.4	n/a
Real GDP Growth (%)	9.5	9.7	9.2	6.7	7.4
Consumer Price Inflation (avg,%)	4.2	6.4	6.2	9.1	11.3
Exchange rate (avg, vs USD)	45.3	41.3	43.5	50.4	45.8
External Debt (year-end, USD bn)	138.1	171.3	222.4	229.5	247.3
External Debt (as a % of GDP)	17.0	18.8	19.2	19.9	19.3
FDI (USD bn) (net)	3	7.7	15.4	17.5	19.7
FDI (as a % of GDP)	1.9	1.5	1.4	1.3	n/a

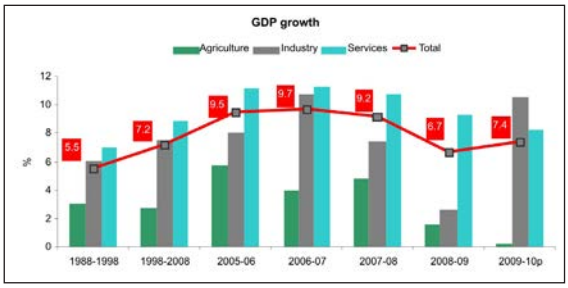
1 Based on 2001 Census, available at http://censusindia.gov.in/towns/town.html
2 Figures taken from Human Development Report 2009, UNICEF Country Statistics and ADB Fact Sheet 2009
3 According to the World Bank, 41.6% of populaiton lives under global povery line of USD 1.25 (PPP)
4 According to UNICEF, India accounts of 21% of under five mortality deaths in the world
5 HDR 2009
6 Figures taken from India Economic Update, World Bank 2010, Economic Survey, Ministry of Finance, 2010 and Central Bank Annula Report 2008-09

ECONOMY

With a population of over 1 bn, India is home to 17% of the global population and is the 11th largest economy by GDP (4th largest by Purchasing Power Parity or PPP) in the world. Howeve, chronic poverty in many parts of the country, low socio-development indicators including health, education, un-even spread of economic growth, lower growth in agriculture and infrastructure bottle necks, continue to pose challenges to inclusive growth in India. Over 300 mn poor remain vulnerable to economic and natural shocks.

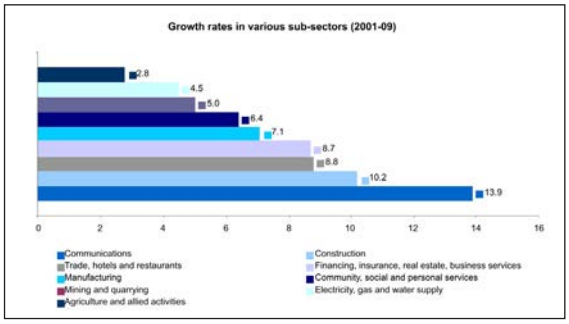
ECONOMIC GROWTH

Since the 1990s, on the back of progressive economic reforms, the country began to experience rapid economic growth, as various sub-sectors were opened for private competition and investment, including international investment. The economy has been growing at an impressive rate of 8.9% during 2003-08. The Service and Industry sectors have been the main drivers of growth, in particular manufacturing is one of the key drivers of economic growth trajectory. An important feature of growth in the past decade has been the broad based nature of growth.



Source: World Bank and RBI

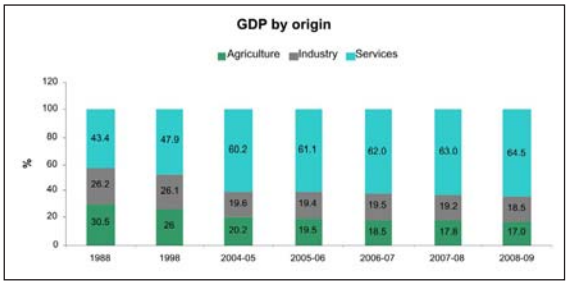
The year 2008-09, saw a considerable slowdown in the growth rate of India's Gross Domestic Product (GDP) to 6.7% following the global recession and financial crisis. However, in the financial year 2009-10, GDP growth improved to 7.4% on the back of domestic demand despite a poor monsoon and continued global recession. A strong recovery in the Industry sector combined with the Services sector muted the impact of a deficient monsoon on overall output. The contribution of the Industry sector to the overall growth increased sharply from 9.5% in 2008-09 to 28% in 2009-10. The International Monetary Fund (IMF) and the Indian Central Bank, the Reserve Bank of India (RBI), project the GDP growth rate at 8.7% for 2010-11 and 9% for 2011-2012.



Source: RBI

ECONOMIC STRUCTURE

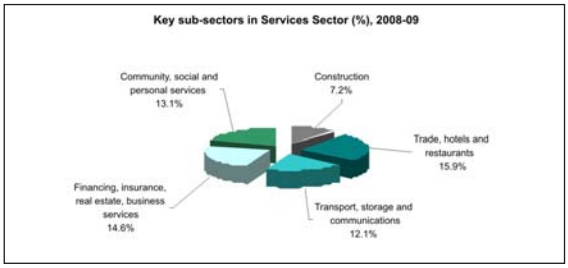
Over the years the structure of the economy has become increasingly dominated by the Services sector. However, despite a steady decline in the share of Agriculture and allied activities in GDP, Agriculture continues to employ 52% of the work force, and remains critical from the point of view of achieving the objectives of food security and price stability. Continued heavy dependence on the monsoon has resulted in a high degree of variability in agricultural production leading to demand-supply mismatches that exert pressure on commodity prices, particularly food prices. However, inter-linkages between the Agriculture and Industry sectors are weakening. As per the latest input-output matrices, the share of agro inputs in manufacturing has declined from 20% in 1993-94 to 5% in 2006-07.



Source: World Bank and RBI

Manufacturing is the major sub-sector in the Industry Sector accounting for over 15% of GDP. Major industries include telecommunications, textiles, chemicals, food processing, pharmaceuticals, steel, transportation equipment, cement, mining equipment, petroleum, machinery, information technology enabled services and software.

The Services sector, is fairly distributed between construction, financial services, transport/trade, communications and community services accounting.



Source: RBI

LABOUR

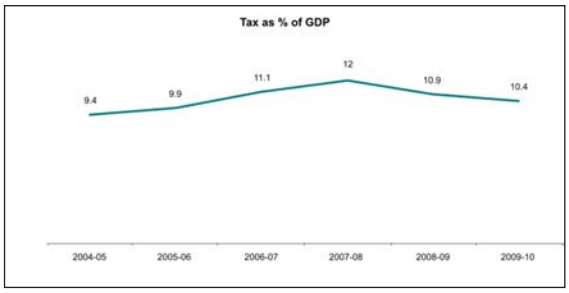
India has a labour force of 457 mn and currently has a demographic dividend where more than 50% of its population is below the age of 25 and more than 65% are below the age of 35.

The Agriculture sector accounts for 52% of workforce, while the Service sector makes up a further 34% and the Industry sector around 14%. India's textile and clothing sector currently employs 35 mn people and is the second largest provider of employment after agriculture.

A high 86% of people are employed in the informal sector and self-employment as a group still constitutes the single largest share in the employment category. Female workers in the informal sector constituted about 91.38 % of total female workers.

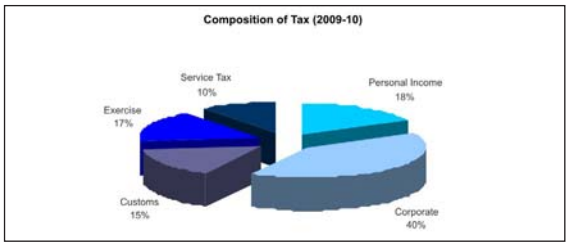
TAXES

India has a tax structure whereby the authority to levy taxes is divided between the central government and the state governments. The central government levies direct taxes such as personal income tax and corporate tax and indirect taxes like customs duties, excise duties and central sales tax. The states are empowered to levy sales tax and various other local taxes.



Source: RBI

In the last few years, the tax system in India has been subjected to significant reforms including revision of tax rates and laws. However, the share of tax as a percentage of GDP has only slightly improved and was at 10.4% of GDP in 2009-10.

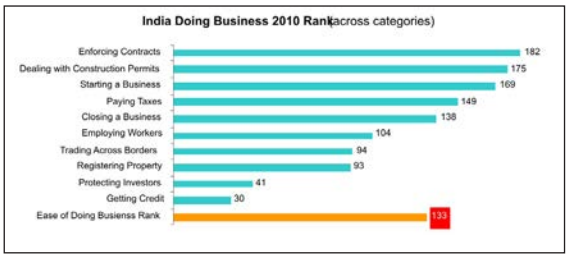


Source: RBI

In 2009-10, direct tax account for 57.7% of total tax and this has increased progressively in the last five years on the back of increased corporate tax whose share of total tax has increased from 27% in 2004-05 to 40% in 2009-10.

BUSINESS ENVIRONMENT

According to the IFC Doing Business 2010 Report, India is ranked at the 133rd position among 183 economies of the world. From the regional perspective, India has the 7th position among 8 countries of south Asia[7].

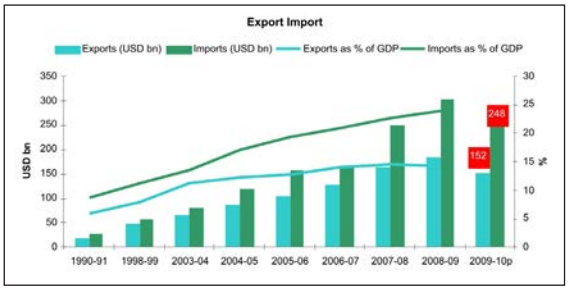


Source: IFC

However, the Global Competitiveness Index by the World Economic Forum ranks India at more favorable position, 49th position among 133 nations for 2009-2010.

EXPORT IMPORT

Since the 1990s, after the economy was opened, merchandise trade has grown at a fast pace.



Source: IMF and RBI

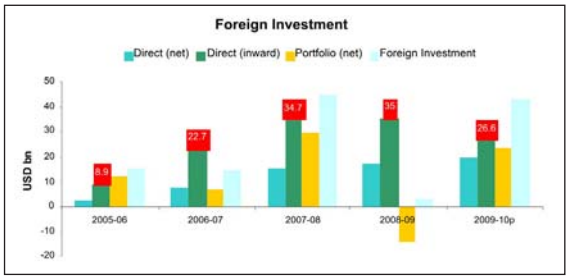
In India, sustained growth in merchandise exports has been accompanied by structural shifts in both commodity composition as well as product and market diversification. Export growth reached an average of about 25% during the period 2002-03 to 2007-08. However this declined to 11% in 2009-10 due to the global financial crisis. India holds the 22nd position among leading exporters in 2009, with its share in world exports at 1.2%. The main exports are agriculture and allied products[8] notably, tea and rice, and manufactured products including mainly leather, pharmaceuticals, manufacturing, chemicals, textiles, gems and jewellery. In fact, human capital and technology-intensive manufactured exports have grown fast in India since 1990. Until then, more than 80% of exports were based on natural resources and unskilled labor, arguably in line with India's natural endowments. However, by 2008 this share had declined to 63%.

India holds the 15th rank among leading importers in 2009, with a share of 1.9% of world imports. Key imports are petroleum products, electronic goods, gold, silver and machinery.

India's main trading partners are the United States, the United Arab Emirates, China and the United Kingdom while main import partners are China, the Unites States, Germany and Singapore.

FOREIGN INVESTMENT

India has been ranked at the third place in global foreign direct investments (FDI) in 2009. It will continue to remain among the top five attractive destinations for international investors during the next two years, according to the United Nations Conference on Trade and Development (UNCTAD) in a new report on world investment prospects titled, 'World Investment Prospects Survey 2009-2011'.



Source: RBI

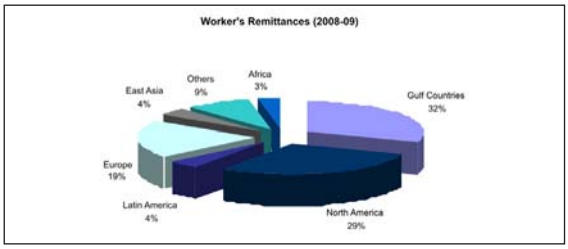
7 Afghanistan has the lowest rank in south Asia and Pakistan has best ranking

8 Agriculture counts for 10.4% of exports in 2008-09

The sectoral shares of FDI inflows have fluctuated significantly in recent years. However, services, housing and real estate, telecommunications, construction, computer software and hardware and automobiles have been attracting the largest FDI. Country-wise, investments routed through Mauritius remained the largest component of gross FDI inflows to India during 2009-10, followed by Singapore and the USA. During 2009-10, FDI was mainly channeled into the manufacturing sector (22.9%), followed by the construction sector (15.7%), financial services and real estate sectors (9.8%)[9].

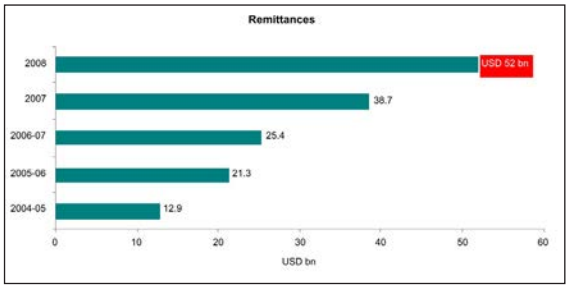
REMITTANCES

India is at the top of the remittances receiving countries as of 2008. The funds received through remittances were around USD 52 bn for the year 2008. India's diaspora is the second largest in the world after China and the Overseas Indian Facilitation Centre's Report (2008) estimates that over 30 mn Indians live overseas in over 130 countries.



Source: Overseas Indian Facilation Centre

An easing of regulations and controls and introduction of new technologies and products by Indian and international banks and reduced transfer costs[10] have shifted remittance flows to formal banking channels and has resulted in higher remittance transfers to India over time.



Source: World Bank

COPING WITH THE GLOBAL FINANCIAL CRISIS

India's integration with the global economy has increased over the years. Export/import as a percentage of GDP has increased from 19.6% in 1998-99 to 40.7% in 2008-09. Similarly, two way capital and current flows were only 44.1% of GDP in 1998-99 but have increased to over 111.9% of GDP in 2008-09.

Consequently, India faced a number of negative impacts on the economy such as the drying up of overseas financing, capital outflows, a slump in demand for exports and service export deceleration. The deepening of the global financial crisis made it increasingly difficult for companies to raise resources in 2008-09. On the external front, there was a sharp decline in the flow of funds from American/global depository receipts (ADRs/GDRs) and external commercial borrowings; however, the inflows of foreign direct investment (FDI) continued. A major problem faced by Indian banks was the unusual tightening of liquidity caused in part by portfolio investment outflows by Foreign Institutional Investors (FIIs).

However, India has coped with the global financial crisis reasonably well and was still less affected than other counties in the region as India's growth emanates from domestic demand. India's exports are less than 15% of GDP. Also financial integration with the global economy is limited, as Indian banks do not have direct financial exposure to the US sub-prime assets. All indicators of financial strength such as capital adequacy,

9 Economic Review 2009-10, RBI and Macroeconomic and Monetary Development 2009-10, RBI, April 2010

10 According to the central bank, between July 2006 and November 2009, the cost of money transfer through SWIFT has declined from being in the range of 2.5%-8.0% to 0.1%-5.0%. Cost of transfer of funds through other modes like draft and cheque has also come down from 0.5%-2.0% to 0.25%-2.0% and 0.4%-2.0% to 0.1%-0.1%-2.0% respectively.(Reserve Bank of India, 2010)

ratios of non-performing assets (NPA) and return on assets (ROA) for Indian commercial banks, which account for 88% of banking assets, are robust. The overall capital adequacy ratio (CAR) of commercial banks in India is 12.7%, well above the regulatory minimum of 9% and the Basel Accord requirement of 8%.

FINANCIAL SECTOR

REFORMS

Since the 1990s, major reforms were initiated in the financial sector to make it market-based, competitive, profitable and increase private investment. Since then, there have been enormous changes in the function of the financial sector, though public sector banks continue to dominate.

One of the important policy implementation was change the framework governing public sector banks (PSBs) in 1994 to enable them to raise capital funds from the market by way of public issue of shares. Many public sector banks have accessed the markets since then to meet the increasing capital requirements. The government has initiated legislative process to reduce the minimum government ownership in nationalized banks from 51% to 33%, without altering their public sector character.

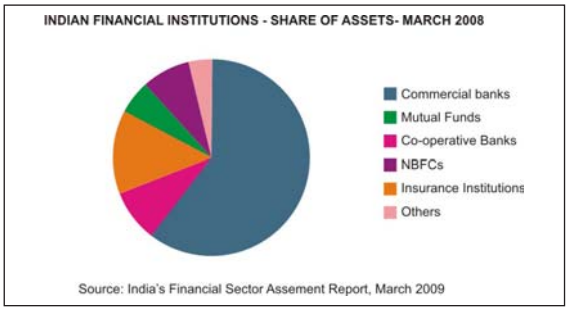
Reforms have altered the organizational forms, ownership patterns and domain of operations of financial institutions (FIs) on both the asset and liability fronts. Drying up of low cost funds has led to an intensification of the competition for resources among both banks and FIs. At the same time, with banks entering the domain of term lending and FIs making a foray into disbursing short-term loans, the competition for supply of funds has also increased. Furthermore, FIs have also entered into various fee-based services like stock-broking, merchant banking, advisory services and the like. At present, the RBI holds shares in a number of institutions. The further reform agenda is to divest the RBI of all its ownership functions.

The Reserve Bank of India (RBI) is the central bank and regulator for financial and banking systems.

In contrast to other South Asian countries, India has a developed capital market (bond market as well as equity market) and commercial banking system. The Indian banking system plays an important part in economic growth. Banking assets account for more than 80% of total financial assets and 64.81% of GDP.

COMPOSITION

India's financial system is comprised of financial institutions and financial markets. While financial institutions comprise scheduled banks, cooperative and rural banks, non-banking finance companies, housing finance companies, development finance institutions and insurance companies, the financial markets include equity markets and foreign exchange markets.

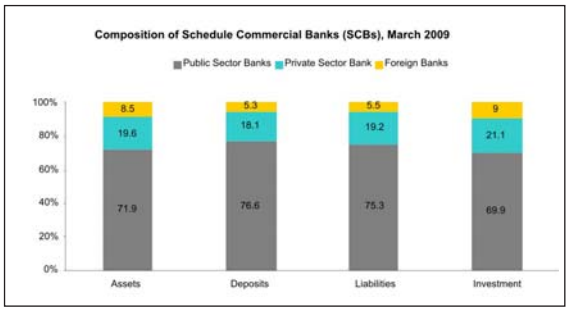


Other components of financial sector insurance, capital markets, bond markets and pensions are growing at a fast pace but still represent a small portion of the total financial sector.

Key Banking Institutions in India, March 2009	
Type of Institution	Number
State-owned commercial banks (including SBI and 7 associates)	20
Private commercial banks	22
Foreign banks	31
Regional rural banks	86
Urban cooperative banks	1,721
Rural Cooperatives	96,061
Nonbank finance companies (NBFCs)	12,740
NBFCs licensed to accept deposits	336

Source: RBI

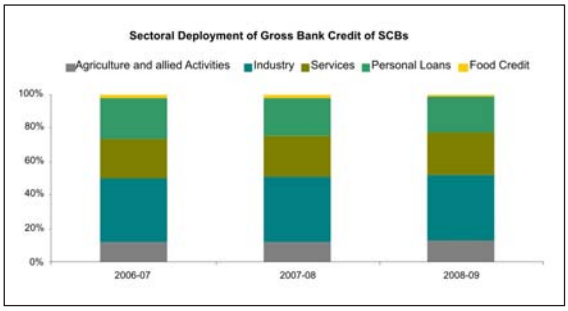
The banking sector is the largest component of the financial sector accounting for over 60% of total financial sector assets. The total asset value of the entire banking sector in India is nearly USD 270 bn (65% of GDP) and deposits total nearly USD 220 bn.The banking sector is classified into Scheduled Commercial Banks (SCBs), Cooperative Banks, Rural Banks and Non-banking Finance Companies (NBFCs) which are further subdivided into numerous sub-categories. There are 80 SCBs as on March 2009. Their total assets combined are 98.5% of GDP. In the public sector there are 27 institutions (State Bank of India and its six associates plus 20 others.); in the private sector there are 7 new private sector banks, 15 old private sector banks and 31 foreign banks. Though public sector banks, account for around 70% of commercial banking assets, competition in the banking sector has increased in recent years with the emergence of private players as also with greater private shareholding of PSBs through listing of PSBs on stock exchanges[11].



Source: RBI

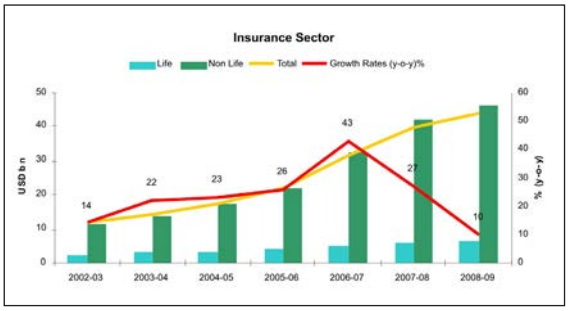
The co-operative banking structure in India comprises urban co-operative banks and rural co-operative credit institutions. The size of co-operatives and the rural financial sector in India remains small compared to commercial banks. Urban co-operative banks (UCBs) form an important part of the Indian banking sector, representing 10% of banking business.

11 Nine public sector banks, including the State Bank of India, the largest Indian bank are listed; private ownership has become close to 40%



Source: RBI

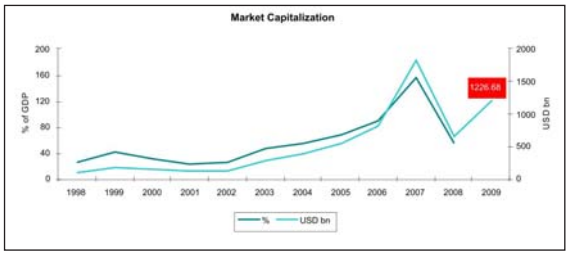
Non-banking financial companies (NBFCs) were initially created to cater to the needs of small savers and investors, but over time have developed into institutions that can provide services similar to those of banks. The NBFCs are distinct from banks in that their regulation and supervision is much lighter. These entities operate in the financial market and there are two broad categories of NBFCs : Deposit taking and Non Deposit Taking. The NBFCs as a whole constitute 9.1% of assets of the total financial system. Among NBFC groups, asset finance companies held the largest share in total assets/liabilities (70.3%), followed by loan companies (28.9%) in 2008-09.



Source: IRDA

The insurance sector, before 2001 when the sector was liberalized, was monopolized by state companies accounting for over a 97% share which has come down to 65% in 2009-10. By the end of March 2009, there were 44 insurance companies operating in India; 22 of which were in the life insurance business and the remaining 21 were in the general insurance business and 1 national re-insurer. Of these 44 companies, 36 are private sector companies. Premium income as a percentage of GDP has increased from 3.3% in 2002–03 to 7.6% in 2008–09. The total premium of the insurance industry has grown at a Compound Annual Growth Rate (CAGR) of 24.6% from 2002–03 to 2008–09 to reach USD 52.6 bn in 2008–09. The latest Swiss Re [12]report reveals that the insurance penetration in India was 4.6% in 2008 consisting of 4.0% in life business and 0.6% from non-life business. FDI up to 26% is permitted in the insurance sector. The Insurance Development and Regulatory Authority (IRDA) is the regulatory authority in the insurance sector under the Insurance Development and Regulatory Authority Act, 1999.

The Indian stock market is a mature market with many players, however, as shown by the top 10 stocks turnover ratio declining over the period from 72.9% in 2001 to 32.36% in 2006. The market capitalization of listed companies was USD 1,227 bn in 2009. The Securities and Exchange Board of India (SEBI) established under the Securities and Exchange Board of India Act, 1992, is the regulatory authority for capital markets in India. Similar to other South Asian countries, government securities accounted for nearly 79% of the total bond market.

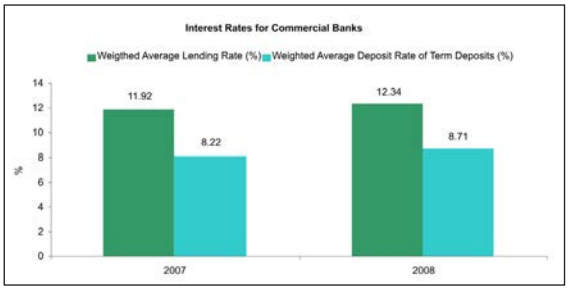


Source: World Bank

INTEREST RATES

The RBI, through various policy measures and policy rates has a strong influence over interest rates in the country, though the commercial banks have the freedom to determine their own rates and the market is becoming increasingly competitive.

12 http://media.swissre.com/documents/sigma2_2010_en.pdf

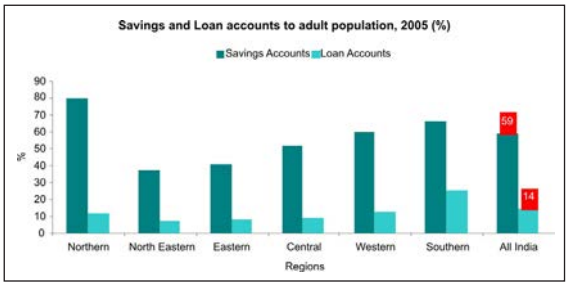


Source: RBI

The rate at which the Central Bank lends money to commercial banks in India is called the Repo Rate while the Reverse Repo is the rate at which RBI borrows money from banks. As of September 2010, the key policy rates are the Bank Rate (6.0%), Repo Rate (5.75%) and Reverse Report Rate (4.5%).

FINANCIAL EXCLUSION

Un-banked population is estimated to be at least 300 mn in India. Going by the available data on the number of savings bank accounts[13], 41% of the population is un-banked. In rural areas bank services have a coverage of only 39% against 60% in urban areas. The extent of exclusion from credit markets is much more, as number of loan accounts constituted only 14% of adult population. In rural areas, loan services cover 9.5% of the population against 14% in urban areas. Regional differences are significant with credit coverage at 25% for the Southern Region of India and as low as 7% in the North Eastern Region.



Source: RBI

Out of 203 mn households in the country, 147 mn are in rural areas of which 89 mn are farmer households. 51.4% of farm households have no access to formal or informal sources of credit while 73% have no access to formal sources of credit[14]. An high 78% of banking business comes from urban and metropolitan areas[15].

Extent of Financial Exclusion	States
> 75%	Meghalaya, Arunachal Pradesh, Mizoram, Manipur, Assam, Uttaranchal, Jharkhand
50 to 75%	Bihar, Chattisgarh, Orissa Himachal Pradesh, J & K, UP, Nagaland, Tripura, Sikkim
25 to 50%	Karnataka, Kerla, MP, Maharashtra, Punjab, Tamilnadu, West Bengal,
< 25%	Andhra Pradesh,

Source: RBI

According to the Report of the Committee on Financial Inclusion 2008[16], nearly three-quarters of farm households have no access to formal sources of credit and lack instruments to insure against adverse events but this problem is not limited to rural areas. Further, the report stresses that 'apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.'[17]

In the last few years, the government has taken a number of steps including creation of 'no frills' accounts[18], introduction of business correspondent and agent models as a branchless banking initiative, simplifying Know Your Customer (KYC) norms for small accounts, allowing larger transaction limits for mobile banking and the use of technology to promote financial inclusion. Other recent measures include promoting bank branch openings in under-served areas. The RBI recently announced that a point of ac-

13 assuming that one person has only one account, which assumption may not be correct as many persons could have more than one bank account

14 Similar data are not available for non farm and urban households.
15 Taken from RBI website http://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=522
16 Report of the Committee on Financial Inclusion, Jan 2008
17 ibid
18 Over 30 mn such no-frill accounts are opened by March 2009

cess to a bank's services should be provided to every village or locality with a population exceeding 2,000, which would require an additional 60,000 points of sale or access across the country.

MICROFINANCE SECTOR

HISTORICAL EVOLUTION

The evolution of Indian Microfinance sector can be broadly divided into four distinct phases:

Phase 1:

The cooperative movement (1900-1960)

During this phase, credit cooperatives were vehicles to extend subsidized credit to villages under government sponsorship.

Phase 2:

Subsidized social banking (1960s – 1990)

With failure of cooperatives, the government focused on measures such as nationalization of Banks, expansion of rural branch networks, establishment of Regional Rural Banks (RRBs) and the setting up of apex institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small Scale Industries Development Bank of India (SIDBI), including initiation of a government sponsored Integrated Rural Development Programme (IRDP). While these steps led to reaching a large population, the period was characterized by large-scale misuse of credit, creating a negative perception about the credibility of micro borrowers among bankers, thus further hindering access to banking services for the low-income people.

Phase 3:

SHG-Bank linkage program and growth of NGO-MFIs (1990 – 2000)

The failure of subsidized social banking triggered a paradigm shift in delivery of rural credit with NABARD initiating the Self Help Group (SHG) Bank Linkage Programme (SBLP), aiming to link informal women's groups to formal banks. The program helped increase banking system outreach to otherwise unreached people and initiate a change in the bank's outlook towards low-income families from 'beneficiaries' to 'customers'.

This period was thus marked by the extension of credit at market rates.

The model generated a lot of interest among newly emerging Microfinance Institutions (MFIs), largely of non-profit origin, to collaborate with NABARD under this program. The macroeconomic crisis in the early 1990s that led to introduction of the Economic Reforms of 1991 resulted in greater autonomy to the financial sector. This also led to emergence of new generation private sector banks that would become important players in the microfinance sector a decade later.

Phase 4:

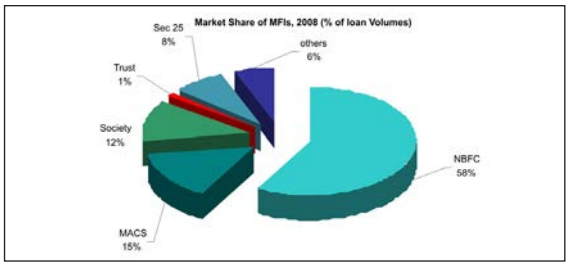
Commercialization of Microfinance: The first decade of the new millennium

Post reforms, rural markets emerged as the new growth drivers for MFIs and banks, the latter taking interest in the sector not only as part of their corporate social responsibility but also as a new business line. On the demand side, NGO-MFIs increasingly began transforming themselves into more regulated legal entities such as Non Banking Finance Companies (NBFCs) to attract commercial investment. MFIs set up after 2000 saw themselves less in the developmental mould and more as businesses in the financial services space, catering to an untapped market segment while creating value for their shareholders. This overriding shift brought about changes in institutions' legal forms, capital structures, sources of funds, growth strategies and strategic alliances.

The microfinance sector as it exists today essentially consists of two predominant delivery models – the SBLP and MFIs. As of March 2009[19], SBLP has over 4.4 mn loan accounts with outreach of over 54 mn[20]. By 31st March 2009, the MFIs reported a total client base of 22.6 mn. The overall coverage of the sector (outstanding accounts of members of SHGs and clients of MFIs) is estimated to have reached 76.6 mn as on March 2009. After adjusting for overlaps the net client base of the microfinance sector is estimated at 70 mn with outstanding micro-credit portfolio of about USD 4.4 bn However, approximately 90 mn low income households remain under-served. Four out of five microfinance clients in India are women[21].

TYPES OF MFIS

The different legal forms under which MFIs registered are Societies, Trusts, Section 25 (Not-for-Profit) companies, Non-Banking Finance Companies (NBFCs), Cooperative Societies and SHGs Federations.



Source: Microfinance State of Sector Report, 2009

Of these only NBFCs are for profit, rest fall under non-profit categories. The overwhelming majority of MFIs are Societies and Trusts, followed by Cooperative and Section 25 companies. Among the large MFIs, most are NBFCs[22]. The share of NBFCs in portfolio outstanding has grown from 50.5% (2005) & 71.3% (2007) to 76.0% currently[23]. As per estimations, the top 20 MFIs account for 80% of the total portfolio.

There is no centralized database on the number of microfinance institutions that operate in the country, however, estimates have put it anywhere between 800 and 1,200.

19 State of the Sector Report, 2009
20 The total has been reduced by 15% of MFI-figure, assumed to be the overlap with SBLP

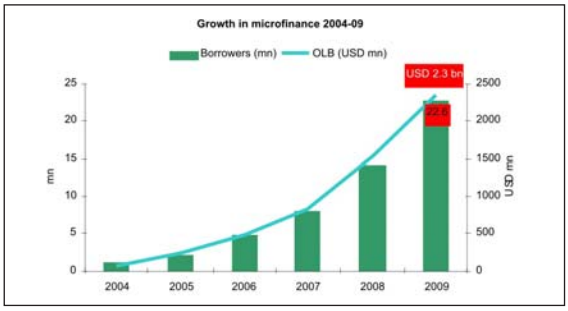
21 According to State of the Sector Report 2008, in addition to SBPL and MFIs, approximately 65 million clients are reached by commercial banks, RRBs and primary cooperatives
22 Practically promoter of other legal forms acquire a new NBFC and sell their MF portfolio to it as registering new NBFC is a very time consuming and uncertain process
23 State of the Sector Report, 2009

MAJOR HIGHLIGHTS OF THE SECTOR

OUTREACH

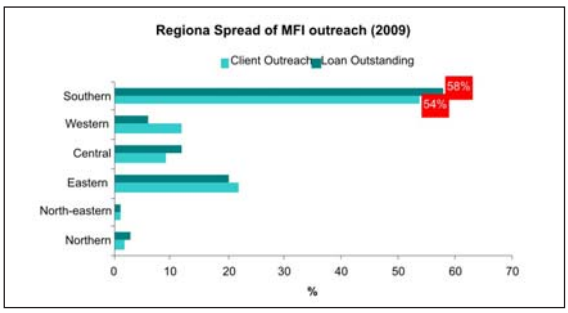
As of March 2009, the MFIs in India reported a client base of 22.6 mn with an outstanding portfolio of more than USD 2.3 bn.

The MFIs at the end of March 2009, served 13.2 mn rural clients and 16.8 mn female borrowers. Of the total borrowers 7.6 mn are from social disadvantages groups.



Source: Microfinance State of Sector Report, 2009

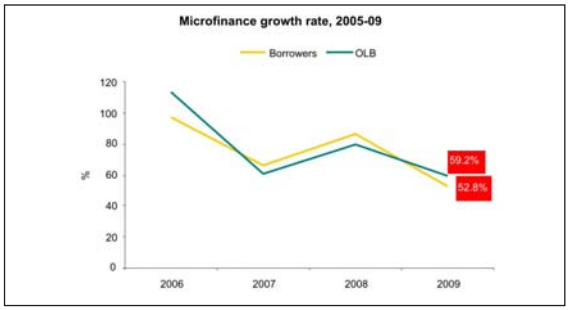
In terms of region the southern region continue to dominate and one out of every two MFI clients still from the southern states[24]. However, eastern and northern regions are expanding. Andhra Pradesh, Karnataka, West Bengal, Tamil Nadu and Orissa are the top five states in terms of total client outreach.



Source: Microfinance State of Sector Report, 2009

GROWTH

Over the past five years, the sector has delivered a Compounded Annual Growth Rate (CAGR) of 86% in the number of borrowers and 96% in portfolio outstanding. In the 12 months from March 2008 to March 2009, the microfinance industry experienced a 59% growth in its client base from 14.2 mn to 22.6 mn and 52% growth in its portfolio outstanding which increased from USD 1.5 bn to USD 2.3 bn.



Source: Microfinance State of Sector Report, 2009

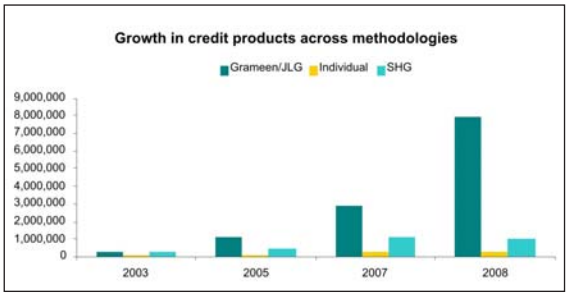
PRODUCTS

Given the fact that NBFCs and other forms of MFIs are not legally allowed to offer savings and there are regulatory and practical hurdles in offering other services such as insurance, the product basket is concentrated on provision of loan. 'Plain vanilla' loans for income generation purposes constitute 95% of an average MFI's portfolio. Credit-linked life insurance is another standard offering of MFIs, though provision is to mitigate credit risk while earning commissions from insurance companies. In terms of methodology, most large MFIs use the Grameen methodology and Joint Liability Groups (JLG). Over the years, lending based on Grameen and JLG has increased at a very fast pace compared to other forms of lending.

Most MFIs under JLG and Grameen have weekly or fortnightly repayment while SHG model has monthly repayment structure. The average loan size for Individual loan, JLG and SHG loans are Rs 8,307 (USD 187), Rs 5006 (USD 11) and Rs 3,412 (USD 76) in 2009[25].

24 State of the Sector Report, 2009, N Srinivasan, 2009

25 Ibid, USD = Rs 45



Source: InM Report, 2009

Based on the Sa-Dhan Study (2008), SHG lending model comes at the least cost to the customers and individual lending at the maximum cost.

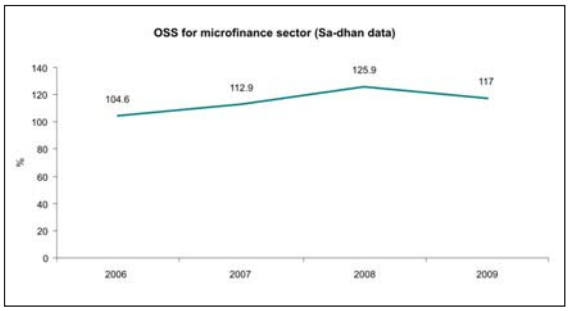
Model	Average loan size (Rs)	Average interest and other charges paid by customers (Rs)	Cost as % of loan
Individual	8,307	1,821	22
JLG	5,006	1,244	25
SHG	3,412	596	17

Source: Microfinance State of Sector Report, 2009

With increasing competition and demand for other financial services, MFIs are now piloting on a range of financial products including pensions and savings[26]. There is also a growing interest from the corporate sector in leveraging the MFI's established delivery channels to seek entry into rural and urban low income customer segments. As a result, many strategic alliances are being forged between MFIs and corporate players to offer non-financial products like which can be mutually beneficial by reducing transaction costs, augmenting institutional profitability and creating better access to products.

SUSTAINABILITY

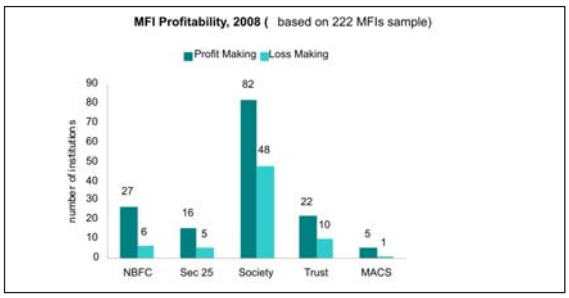
The data from 190 MFIs in Sa-dhan Side by Side Report 2009, show that Operational Self Sufficiency (OSS) has been improving over the years. The data also shows that OSS tends to increase with portfolio size and operational years of the MFIs. The further break down of data according to legal form for 2009 shows that MFIs registered as trusts have highest OSS.



Source: Sa-dhan Side by Side Report, 2009

Another study by CRISIL based on sample of 50 MFIs also shows OSS to be above 100% across various legal types and lending methodologies.

Of the 222 MFIs that reported information in State of the Sector Report 2009, 70% MFIs were profit making. Profits were reported by 84% of the large MFIs and 80% of medium MFIs. Only 58% of small MFIs were profitable.



Source: Microfinance State of Sector Report, 2009

The microfinance business model in India typically generates a Return on Equity ("ROE") of between 20% and 30%, driven by financing from commercial banks, strong operating efficiency and high portfolio quality.

MESO LEVEL INFRASTRUCTURE

In line with the growth of retail institutions, the meso level infrastructure as also developed in the country.

There are a number of TA providers like Microsave, EDA Rural Systems, ACCESS Development Services, Centre for Microfinance-Institute for Financial

26 Only cooperatives are legally allowed to mobilize saving from members

Management and Research, Bankers Institute of Rural Development, Micro Insurance Academy, Tata-Dhan Academy, M2i consulting, Sambodhi, BASIX and Intellelcap among others offering a range of technical services. With increasing focus on Investment, the capital advisory services are much in need and a few agencies are finding niche in them, most notably Grameen Capital India, Intellecap and Unitus, which has extensive presence in India.

Among the rating agencies, M-CRIL, CRISIL and SMERA are most notable. More MFIs are being rated as they approach bank and other commercial investors to meet their debt and equity needs. Out of 233 MFIs reporting to Sa-dhan 2008 report, M-CRIL rated 43, CRISIL rated 56 MFIs and all other rating agencies carried out ratings for 38 MFIs.

There is also a considerable interest in various aspects of technology contributing to the microfinance sector. An integrated MIS, mobile devices, smart-card solutions and score-cards are some examples of such technological innovations, which are increasing becoming popular among MFIs and many technology firms are offering products and solutions to growing needs of the MFIs.

Sa-dhan is national network of over 200 MFIs, playing a key role in policy advocacy and addressing issues such as code of conduct among members, data collection and transparency for the sector. Recently a new network of NBFCs, Microfinance Institutions Network (MFIN) is created by leading NBFCs to cater to the policy advocacy and other needs of this group of MFIs. At present 34 MFIs are members of MFIN.

At present, there is no Credit Bureau; however, MFIN is working in that direction with leading MFIs who are its members. MFIN has partnered with Credit Information Bureau (India) Limited (CIBIL) to start a Microfinance Credit Information Bureau.

COMPETITION

In the past few years, Indian microfinance has seen unprecedented growth with large MFIs expanding their active borrower base by about 110% making the sector one of the fastest growing worldwide. This trend was reinforced by and in turn further accelerated the commercialization of the industry. Commercialization is characterized by increased competition for the clients with an objective to seek profitability. The above reasons have lead to competition for the same clients in many parts of the country including Andhra Pradesh, Karnataka, Madhya Pradesh, West Bengal, Uttar Pradesh, Orissa, Tamil Nadu and Chhattisgarh. This leads to multiple memberships, over-indebtedness by the microfinance clients. According to Sa-dhan, 3 or 4 out of 10 MFI/SHG clients are multiple borrowers.

However, the competition has not led to MFIs distinguishing themselves by geographic areas or by differentiating products to different client segments.

RISKS

Externally, the sector is always under scrutiny due to perceived 'high interest rate' by the political class and many policy makers. Populist policies such as waiver of loans and capping on interest rate MFIs can charge, continue to bring credit and reputation risk for the MFIs. However, in last few months, there has been move by few MFIs to decrease the interest rate to counter some of these allegations and pass on gains of efficiency brought by higher volumes to the clients.

A rapid increase in global commercial investments in microfinance has also surfaced an array of associated risks for investors and microfinance institutions to manage. The investment landscape is marked with challenges like potential changes in regulatory statutes, portfolio dependence on a single product offering, political challenges to profitability, high regional concentration and the

near total dependence by Indian MFIs on local banks for debt capital.

REGULATION

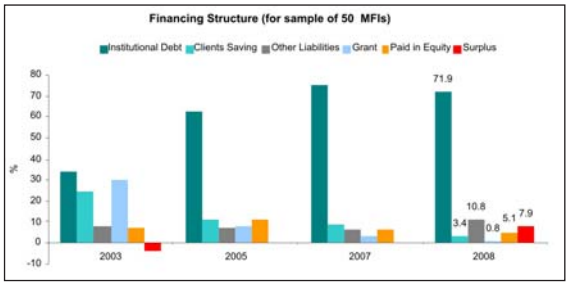
At the policy level, MFIs have achieved greater legitimacy with the government as an important mechanism for financial inclusion, and increasingly MFIs are mentioned in relevant policy documents.

However, at present, only MFIs registered NBFCs are regulated, implying 75% of the institutions involved in microfinance are unregulated though by loan volumes 77% of microfinance sector is regulated by the central bank[27].

The Microfinance Sector Development and Regulation Bill 2007 was tabled in the Parliament. The Bill, forms the first legal document that defines 'microfinance', sets down exclusive guidelines for the Indian microfinance industry and a promotional and regulatory framework for MFIs, especially those carrying out MF in a non-profit form. The bill has, however, lapsed now and according to the sector experts, the bill in its present form might not secure the objectives of regulation of the sector in a broad way by excluding NBFC and Section 25 companies out of its purview. .

FINANCING

With the increasing commercialization of microfinance sector in the country, the financing structure is changing. The share of client savings and grants has reduced over the years.Grants are becoming scarcer and savings as source of financing is also decreasing as more and more MFIs transform into regulated structure of NBFC and the central bank does not allow these institutions to raise deposit.



Source: InM Report, 2009

Concomitantly, debt has become the dominant source of finance for Indian MFIs. The share of debt in top 10 MFI finances is very high at 71.9% in 2008. The commercial banks along with government apex institutions like SIDBI are major sources of debt funding to MFIs[28]. Debt funding requirements are high due to the restriction to raise funds through savings[29]. It is important to highlight that borrowing from the commercial banks is an important source of financing to MFIs. As per the central bank regulation domestic and foreign commercial bank are required to lend 40% and 32% of fund to priority sector and lending to microfinance qualifies as priority sector lending[30]. This policy has been a key factor in commercial banks lending to MFIs. However, most banks continue to lend only to top tier institutions[31]. As of March 2009, banks and financing institutions had a total exposure to MFIs of USD 2.45 bn. This represents an almost 150% increase from the exposure in March 2008 of USD 984.8 mn and a 200% increase from the exposure in March 2007 of USD 805.6 mn[32]. Besides term loans, there has been a rise in non-traditional products such as non-convertible debentures, securitizations and portfolio

27 The volume of credit (which is four times the estimated volume of savings in the microfinance sector) is less than 0.5%t of the total credit flow of commercial banks and is thus not significant from a systemic point of view

28 NABARD Act does not permit refinancing to NBFCs or other MFIs – a serious limitation as many MFIs can have limited access to market capital

29 Among all legal forms only cooperatives are legally allowed to mobilize savings

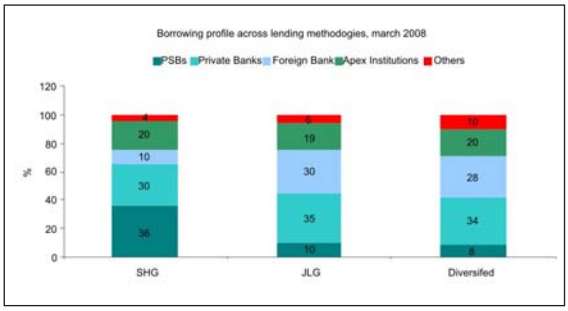
30 The RBI stipulates that domestic banks and foreign banks operating in India must direct 40% and 32%, respectively, of their advances to certain "priority sectors," including agriculture, small-scale industries, small road and water transporters, small business, microcredit, education software, and housing. The definition of what constitutes a "national priority" is adjusted from time to time. Since 2000, the RBI has allowed commercial banks to lend to MFIs as part of the priority sector rule, which has significantly facilitated the access of Indian MFIs to commercial funding.

31 India: microfinance and financial sector diagnostic study, IFC, June 2008

32 Microfinance Industry in India, Lok Capita, March 2010

buyouts available to MFIs through domestic as well as foreign debt funds. As a result, today, larger MFIs have adequate and easy access to debt financing. However, smaller and emerging MFIs are still struggling to find adequate funds as they have unproven business models and present a higher default risk to banks. Alternative debt providers are emerging in an attempt to fill this gap with subordinated-debt, guarantees and pooled securitizations.

Another study by CRISIL[33] for the sample of top 50 MFIs gives the sense of borrowing profile across lending methodologies clearly showing Public sector banks inclination towards SHG model.



Source: CRISIL

MARKET GAPS AND CHALLENGES

Despite the rapid expansion of microfinance, large areas of India continue to be underserved. The penetration potential of the existing microfinance model is between approximately 90 mn households, out of which 22.6 mn are existing customers. This implies an large unaddressed demand. Currently, as many as 54% of all microfinance clients are concentrated in the southern states: Andhra Pradesh, Karnataka, Kerala and Tamil Nadu. The fact that many states and regions of the country are not served by the MFIs present an opportunity for future growth.

Services	Demand (USD bn)
Credit	**59.8**
Credit among Below Poverty Line	5.7
Credit among Small and Marginal Land Owners	27.1
Credit among Agriculture Labour	15.0
Credit among Microentrepreneurs	8.8
Credit among Urban Low Income Population	3.2
Savings	**3.0**
Insurance	**0.5**
Remittances	**9.5**
Micropensions	**0.5**
Total	**73.2**

Source: 'Inverting the pyramid, the changing face of Indian microfinance', Intellecap, 2007

In terms of financing gaps, the Indian microfinance industry is expected to reach 110 mn borrowers and USD 30 bn loan portfolio by 2014 and will require a huge capital inflow both in debt and equity, according to a latest report by Intellecap[34]. A survey by research firm Venture Intelligence reveals that the microfinance sector would need USD 3-5 bn over the next 4-5 years[35].

There are also gaps and challenges at institutional level. While some of the leading MFIs, such as SKS, Share, Spandana, Ujjivan, Equitas and BASIX are setting the pace for the sector with innovations in products, processes and funding structure, there are hundreds of medium and small MFIs which are operating on a small scale with great need for training in building their institutional capacity to run microfinance on sound financial principles. The MFIs face enormous challenge in finding and retaining skilled human resources[36]; Sa-Dhan has estimated the human resource requirements at 2,40,000[37]. It is estimated that manpower constitute 70% of operating costs for the MFIs.

33 India Top 50 Microfinance Institutions, CRISIL, Oct 2009

34 Invesrting the Pyramid, Intellecap, 2010
35 http://www.ventureintelligence.in/pepulse-fs.pdf
36 CSFI, Microfinance Banana Skins Report 2008
37 Access Development Services, State of the Sector Report 2008, 2009

MICROFINANCE INVESTMENT

GENERAL INFORMATION

The MFIs in India are getting increasingly exposed to raising various forms of debt and equity investment from both domestic and foreign investors and the MFIs are gradually tapping other funding avenues apart from the traditional ones such as raising funds form high worth individuals, securitization of portfolio, Non-convertible debentures (NCDs) and latest being Initial Public Offerings (IPO) by the largest MFI in India.

However, constraints remaing in accessing different sources of funds. These include regulatory hurdles, lack of investor confidence and limited publicly available information about MFIs.

DOMESTIC DEBT INVESTMENT

LEGAL FRAMEWORK

There is no regulatory hurdle for any legal form of MFIs registered as Society, Trust or Section 25 company or NBFCs, leveraging their market position to obtain debt finance from domestic capital markets. Societies/ trusts need to incorporate the power to borrow from commercial sources explicitly in their memorandums of association/trust deeds along with the specific inclusion of provision of microfinance services.

PRESENT SITUATION

The ability to leverage for these institutions depends largely on the appetite of the lenders for risk and also on the creditworthiness of the institutions. The commercial institutions also evaluate the net worth of these institutions before lending. The NBFCs have the capital adequacy norms (10-15%) stipulated by RBI to delimit the leverage capacities of such legal forms.

At present, most of the banks are offering term loan for 2-3 years 12%-14%. However, as mentioned in the section on Financing above, while larger MFIs have adequate and easy access to debt financing, smaller and emerging MFIs are still struggling to find adequate funds as they have unproven business models and present a higher default risk to banks.

Alternative debt providers are emerging in an attempt to fill this gap with subordinated-debt, guarantees and pooled securitizations. The commercial banks are also having new debt instruments such as portfolio buyouts and purchase of securitized debt. NCDs are another form of debt investment which is used more by larger MFIs.

An issue in domestic debt investment is crowding of loan sanctions and disbursements especially in March every year to meet the target by commercial banks which leads to high un-allocated funds among a large number of MFIs raising the risk of misapplication of funds and possible misuse.

DOMESTIC EQUITY INVESTMENT

LEGAL FRAMEWORK

Only NBFCs falls within the realms of domestic equity investment since other legal forms of MFIs are an unattractive propositions to equity investors owing to their not-for-profit constitution that prohibits them from sharing dividends. According to a latest RBI circular, the NBFC have to have minimum of Rs 25 mn (USD 0.6 mn) as domestic equity to qualify to take foreign equity levels above 50%.

PRESENT SITUATION

While the microfinance sector in India has seen a large number of equity investment, most of it comes from foreign equity. Refer to section on foreign equity investment later.

While there are a lot of domestic equity players in India, they do not have much exposure to microfinance sector. Most transactions are in the form of private placements, dominated either by individual players as promoters

or by equity raised through Employee Stock Ownership Plans (ESOPs) and by the Trusts of employees or community created by the MFIs.

Among institutional investors, SIDBI has a few investments in MFIs notably in Bandhan and BASIX for over 10% stake. Catamaran Venture Investment Fund worth USD 129 mn is a recent entrant that have invested in SKS in Jan 2010 for over USD 6 mn.

The recent circular of RBI on foreign equity, compounded increase in capital adequacy requirement for NBFCs to 15% in April 2010 (from previous 12%) has led to rush to raise domestic equity. According to the estimates, growth targets and capital adequacy requirements together create an annual equity need of approximately USD 200 mn for the top ten MFIs until 2013.

Please note that International investors that set up local semi-independent funds for investing in India (e.g., Blackstone, Sequoia Capital) possess foreign origins, and therefore fall under the above restrictions for foreign capital.

In a recent move the finance ministry in India has the state-owned banks to ensure that MFIs they lend to, do not charge beyond 24% interest from final borrowers. The finance ministry has also asked banks to ensure that MFIs do not resort to evergreening of loans, that is deals in which they give fresh loans to help borrowers repay the old, sticky loans.

FOREIGN DEBT INVESTMENT

LEGAL FRAMEWORK[38]

The set of rules that govern foreign investment in form of borrowings is called External Commercial Borrowing (ECB) Regulations. The investment in non-convertible or partially convertible preference shares and debentures or any instrument with no definite period for conversion in equity also come under the purview of ECB Guidelines. Moreover any investment as commercial loans in the form of bank loans, buyers' credit, suppliers' credit, and securitized instruments (e.g. floating rate notes and fixed rate bonds) availed from non-resident lenders with minimum average maturity of 3 years also come under the purview of ECB Guidelines.

ECB has detail guidelines in terms of amount such as USD 500 mn limit per company per financial year under the automatic route, eligible borrower, recognised lender, end-use, all-in-cost ceiling[39], average maturity period, prepayment, refinancing of existing ECB and reporting arrangements among others. There has been some end use restrictions also such as utilisation of ECB proceeds is not permitted for on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate. Further ECB proceeds is not permitted to be used for investment in real estate, working capital, general corporate purpose and repayment of existing Rupee loans.

In the context of MFIs, the NGOs engaged in micro finance activities can raise ECB up to USD 5 mn during a financial year with permission of RBI provided they have;

1. They have satisfactory borrowing relationship for at least three years with a scheduled commercial banks authorized to deal in foreign exchange and
2. Can produce a certificate of due diligence on 'fit and proper'' status of the board/ committee of management of the borrowing entity from the designated Authorized Dealer (AD)

Overseas organizations and individuals complying with following safeguards may provide ECB to Non-Government Organizations (NGOs) engaged in micro finance activities:

38 Please refer to RBI Master Circular on External Commercial Borrowings and Trade Credits, July 2010

39 There is an all-inclusive ceiling for ECBs under the approval route of 300 basis points above Libor for loans ranging from three to five years. The all-inclusive ceiling--the spread which companies can pay to raise funds--would be 500 basis points for loans with a maturity of more than five years

Overseas Organizations proposing to lend ECB would have to furnish to the AD bank of the borrower a certificate of due diligence from an overseas bank, which in turn is subject to regulation of host-country regulator and adheres to the Financial Action Task Force (FATF) guidelines. The certificate of due diligence should comprise the following (i) that the lender maintains an account with the bank for at least a period of two years, (ii) that the lending entity is organised as per the local laws and held in good esteem by the business/local community and (iii) that there is no criminal action pending against it.

Individual Lender has to obtain a certificate of due diligence from an overseas bank indicating that the lender maintains an account with the bank for at least a period of two years. Other evidence /documents such as audited statement of account and income tax return which the overseas lender may furnish need to be certified and forwarded by the overseas bank. Individual lenders from countries wherein banks are not required to adhere to Know Your Customer (KYC) guidelines are not eligible to extend ECB.

However, the designated Authorize Dealer bank has to ensure that at the time of drawdown the forex exposure of the borrower is fully hedged.

Only certain categories of NBFCs are allowed to take external commercial borrowing under certain condition and NBFC MFIs do not qualify for same.

As per RBI Master Circular on External Commercial Borrowings and Trade Credits, July 2010, issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, Financial Institutions and Non-Banking Financial Companies (NBFCs) from India relating to ECB is not permitted.

PRESENT SITUATION

Due to a number of factors, the foreign debt has not come to the MFIs. One, Investors are not comfortable investing in NGOs due to their non-regulated nature. Second, debt under ECB has to be hedged and present options of currency hedging are very expensive, making debt under ECB a bit prohibitive as an instrument. Third, with a lot of liquidity within domestic market, the NGO MFIs do not necessarily need to go through this option.

Recently Non-Convertible Debentures (NCDs) has emerged as an alternate mechanism to raise foreign debt. The RBI defines, Non-Convertible Debenture (NCD) as a debt instrument issued by a corporate (including NBFCs) with original or initial maturity up to one year and issued by way of private placement. NCDs are in the form of a loan to a company that cannot be converted into equity and have to be listed on Bombay Stock Exchange. Some of the large MFIs have raised funds through one year NCDs in the last year. However the costs are high given that they have to be listed and rated and therefore need a minimum ticket size to be a viable for the investors. NCDs are typically short term but as per central bank regulations in India they can not be less 90-day maturity.

NCDs may be issued to and held by individuals, banks, Primary Dealers (PDs), other corporate bodies including insurance companies and mutual funds registered or incorporated in India and nincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs).

FOREIGN EQUITY INVESTMENT

LEGAL FRAMEWORK

Foreign direct investment (FDI) regulation applies only to NBFC-MFIs. Though Section 25 Companies are legally permitted to receive foreign equity investment, their not-for-profit status prevents them from extracting profits and paying dividends. FDI in the NBFC sector is put on automatic route subject to compliance with guidelines of the Reserve Bank of India.

RBI's Foreign Investment Promotion Board (FIPB) has set up foreign direct investment (FDI) rules for start-up companies not traded publicly on a stock exchange, which includes NBFCs. Current guidelines used by FIPB require a minimum of USD 500,000 equity investment from a foreign entity.

NBFCs can receive foreign equity investment subject to certain minimum capital requirements which are linked to the level of foreign ownership in the company. For equity stakes between 0-51%, the minimum capital requirement for any FDI is USD 500,000. This amount can include any number of foreign shareholders as long as the total up front foreign investment exceeds USD 500,000. However, the capital requirements increase sharply as the foreign ownership stake increases beyond 51%.

Minimum Capitalisation Norms for fund based NBFCs are:

- FDI up to 51%: minimum capital requirement is USD 0.5 mn and entire amount must be contributed up front
- FDI between 51% and 75%: minimum capital requirement USD 5 mn and entire amount must be contributed up-fornt
- FDI between 75% and 100%: USD 50 mn out of which USD 7.5 mn to be brought up front and balance within 24 months.

100% NBFC with a minimum capital of USD 50 mn allowed to set up 100% downstream subsidiary to undertake specific NBFC activities. Such a subsidiary, however, would be required to dis-invest its equity to the minimum extent of 25%, through a public offering only, within a period of 3 years

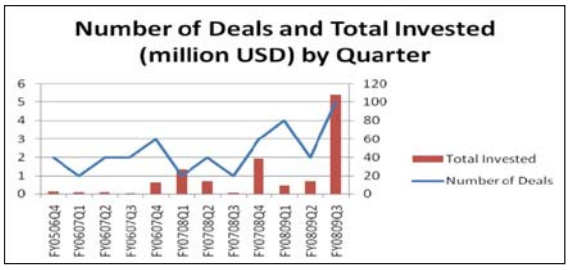
Please note that International investors that set up local semi-independent funds for investing in India (e.g., Blackstone, Sequoia Capital) possess foreign origins, and therefore fall under the restrictions for foreign capital.

PRESENT SITUATION

The equity financing flowing into the industry is growing at a very fast pace since last few year. From a slow start in 2006, equity investment in Indian microfinance has skyrocketed in the past three years. The total amount of funds invested in the sector grew by 390% from 2006 to 2007 and by 61% from 2008 to 2009[40]. Since 2006, more than 25 equity transactions totalling more than USD 295 mn in primary investments in the microfinance space have been completed.

Some of the key players in domestic equity market are Bellwether, Lok Capital, Aavishakar, Ananaya[41], Dia Vikas (of Opportunity International), DWM, IFC, Tridos, Incofin, Michael and Susal Dell Foundation among others.

It is important to note that Indian MFIs trade at significant premium to MFIs in other parts of the world. MFIs across the world face an equity valuation of 1.5x to 3.0x book value, whereas Indian MFIs face a valuation that is 3.0x to 4.0x book value. This premium is driven partly by strong performance of MFIs, large market and generous amounts of debt available to the industry to expand which in turn enables MFIs to achieve returns on equity of approximately 20% to 30%[42]. The interest of a dozen of larger private equity funds such as Seqouia and Legatum active in the Indian markets have also driven valuation up in this market.



Source: Microfinance State of Sector Report, 2009

30% of all microfinance equity transactions worldwide in 2009 took place in India.

40 Navigating the crisis, Intellecap-2009
41 Earlier knows as Friends of Women's World Banking (FWWB)
42 Microfinance India, State of the Sector Report 2009, N Srinivasan, Oct 2009

First Multi-Originator Securitization Deal in Microfinance

IFMR Capital has concluded a multi-originator securitisation of micro-loans originated by four indian microfinance institutions — Asirvad Microfinance Pvt Ltd, Sahayata Microfinance Pvt Ltd, Satin Creditcare Network Ltd, and Sonata Finance Pvt Ltd. The transaction worth Rs. 308 million (USD 6.5 mn) is backed by around 42,000 micro-loans originated by the four MFIs roped in for the purpose. IFMR Capital has arranged and invested in the subordinated strip of the transaction. A special purpose vehicle has been institutionalized for smooth transaction. IFMR Capital Mosec I, the multi-originator Special Purpose Vehicle, has issued two tranches of securities: a 77% senior-rated tranche with an expected maturity of 6 months, and a 23% subordinated strip with an expected maturity of 11 months. CRISIL has assigned the highest short term rating of P1+ (so) to the senior tranche, to which Dhanalakshmi Bank subscribed. The closing of this transaction has resulted in the emergence of a new pricing benchmark in the less-than-6-month-maturity asset class.

As per the waterfall mechanism in the structure, the senior tranche will be fully paid out before the subordinated strip begins to receive cash flows. The IFMR Capital Mosec I securitisation has an average credit enhancement of 13 per cent in the form of cash collateral provided by the four MFIs. The senior tranche has additional credit enhancement provided by the junior strip, to which IFMR Capital subscribed. The originators will continue to service the underlying loans. The structure has been designed to align the interests of the originator and structure with the interests of investors.

KEY CONTACTS

National Bank of Agriculture and Development (NABARD)

www.nabard.org

Reserve Bank of India (RBI)

www.rbi.org.in

Sa-dhan

www.sa-dhan.net

Small Industrial Development Bank of India (SIDBI)

www.sidbi.in

NEPAL

Population : 28.8 mn
Main towns : Kathmandu (0.67m), Biratnagar (0.17m), Birgunj (0.11)
Currency : Nepalese Rupee (Rs or NPR)[1]
Exchange rate : 1 USD = Rs. 74.25 (2009-10)
Fiscal Year : 16th July – 15th July

Development Indicators:

- Population below poverty line (National): 31% (2008)
- GNI per capital (Atlas method, USD): 400
- Literacy Rate (15-24 years) : 56.5% (2007)
- Mortality Rate (child<5 years): 51 per 1000 live births (2008)
- Life expectancy at birth: 67 years (2008)
- HDI: 0.553,144 among 182 countries (2009)

Indicator	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Nominal GDP (USD bn)	10.33	12.58	12.61	14.72	15.63
Real GDP Growth (%)	3.3	5.3	4.7	3.0	4.0
Consumer Price Inflation (avg,%)	6.4	7.7	13.2	11.8	8.0
Exchange rate (avg vs USD)	70.5	65.0	76.9	78.05	74.25
External Debt (as a % of GDP)	30.2	27.4	27.0	24.6	23.8
FDI (USD mn)	5.6	4.3	23.7	32.7	37.6

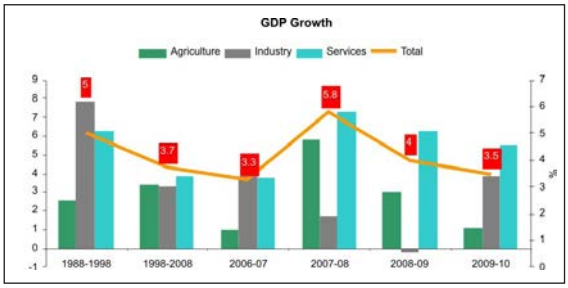
1 Average selling rate by Central Bank for 2009-2010

ECONOMY

Nepal continues to face significant socio-economic challenges. About 80% of Nepal's population still lives in rural areas, and the country is characterized by small landholdings, high population growth, and a fragile ecology, resulting in chronic poverty in many parts of the country. In recent years, the Nepalese economy is characterized by slow growth, weak output and exports and rising inflation. A decade long political conflict, prior to the peace agreement in 2006, had seriously affected Nepalese economic and social environment. It is estimated that Nepal lost an annual 2.1% of Gross Domestic Product (GDP) during the conflict[2]. The current political transition that Nepal is undergoing is proving to be arduous, weakening the country's focus on reform and the development agenda. Nepal's turbulent peace process continued to make frequent strikes and transport blockades a commonplace, undermining the much anticipated economic recovery in the post-conflict transitional period.

ECONOMIC GROWTH

The Nepalese economy grew on average at 5% per anum during 1988-1998, which declined in the following decade to an annual average of 3.7% in 1998-2008. As per to the early figures for 2009-10, GDP growth for is estimated to be 3.7%.

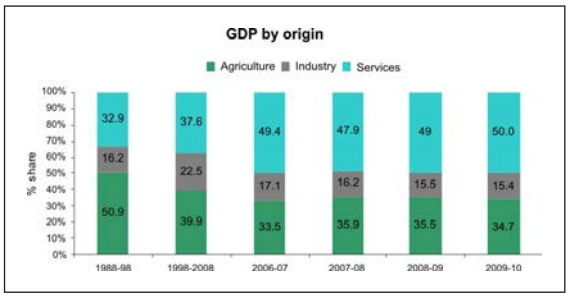


Source: World Bank and NRB

Much of the GDP growth has come from Services[3] and to a lesser extent from Agriculture. From the demand side, domestic consumption contributes to over 90% of GDP.

ECONOMIC STRUCTURE

The sector wise composition of the GDP has been gradually changing in the last few years. The Agriculture sector which was contributing over half of the GDP in the decade of 1988-98 now has a 34.7% share. Data shows that the share of Agriculture has been taken over by the Services sector which now accounts for half of the GDP. The Industry sector has remained stagnant over the years.



Source: World Bank and NRB

In Agriculture, paddy is an important crop that accounts for nearly 21% of agricultural production. The production of the Agriculture sector depends on the monsoon conditions to a large extent.

In 2009-10, Services were dominated by retail trade (25%), transport/communication (19%) and real estate renting services (16%). WIthin the Industry sector, manufacturing accounts for 43% and construction for 38%[4].

Industrial production continues to face challenges from poor labour relations, frequent strikes, load shedding, fragile industrial se-

2 Ra, S. and Singh, B. 2005. Measuring the Economic Costs of Conflict: the Effect of Declining Development Expenditures On Economic Growth, Asian Development Bank, NRM Working Paper Series, No. 2, June 2005

3 Ra, S. and Singh, B. 2005. Measuring the Economic Costs of Conflict: the Effect of Declining Development Expenditures On Economic Growth, Asian Development Bank, NRM Working Paper Series, No. 2, June 2005

4 Nepal Monitory Policy 2010-2011

curity and a lack of an investment friendly environment in the country.

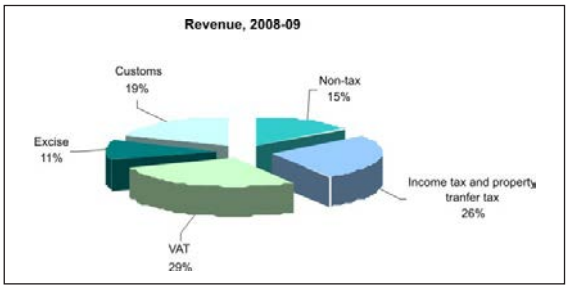
LABOUR

The economically active population between 15 and 59 years of age is 10.5 mn in 2001, up from 9.6 mn in 1991. According to the Nepal Labour Population Survey 2008, 73.9 % of the population is employed in agriculture and formal sector employment is only 16.9%.

The population aged between 15 and 29 years represent almost 25% of the total population and 13.6% of the total labor force. Only 13% from this group live in urban areas, thus indicating a high underemployment in rural areas. A White Paper on the Economy claimed that 1.5 mn Nepalese were unemployed in the country and at least 300,000 unemployed youth enter into the job market annually seeking jobs. It is difficult to describe the actual unemployment situation in Nepal in the absence of a reliable employment survey and projection of unemployment. Unemployment rates are reported to vary from 5.1% to 15% in different studies.

TAXES

Driven by improvements in tax administration, total revenue of the central government has increased from a low of 10.75% of GDP in 2005-06 to 14.5% of GDP in 2008-09, and is on course to rise by a further 1.5% of GDP in the current fiscal year.



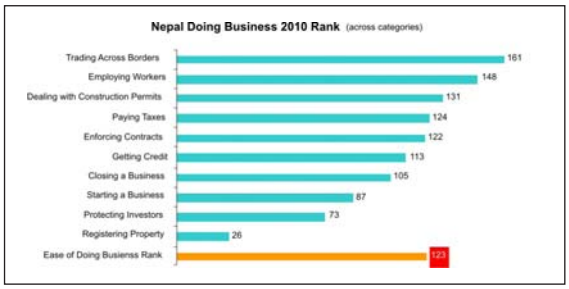
Source: NRB

Of the total revenue, the share of tax revenue and non-tax revenue stood at 84.6% and 15.4% respectively in 2008-09. Of the total tax revenue, value added tax (VAT) occupied the highest share followed by income tax.

The major components of direct tax are corporate income tax, house and land registration tax, investment and other tax and remuneration tax, whereas VAT, customs duties and excise duties are the major components of indirect tax revenue. The share of direct and indirect tax within total tax revenue stood at 30.6% and 69.4% respectively.

BUSINESS ENVIRONNENT

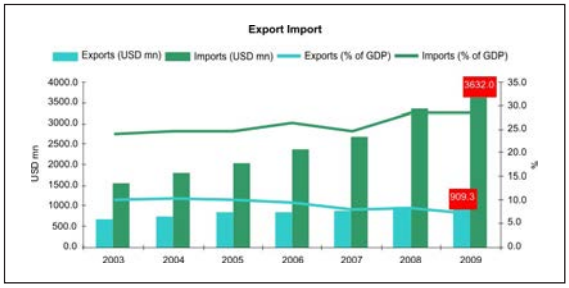
According to Doing Business 2010 that ranks 183 economies on various aspects of doing busines, Nepal ranks 123rd out of 181 countries. The worst ranking component comes in trading across borders (161), employing workers (148) and dealing with construction permits (131).



Source: IFC

EXPORT IMPORT

Exports of readymade garments, carpets and Pashmina – the main exports of Nepal – have all declined in the last years. Exports have remained under USD 1 bn, and as a share of GDP have continuously declined.



Source: NRB

Nepal exported about USD 200 mn worth of readymade garments in early 2000, but this has plummeted after the expiry of the Multi-Fiber Agreement (MFA), and now hovers under USD 80 mn. Pashmina exports declined from USD 90 mn in 2001-02 to USD 20 mn. Exports to India have declined every year since 2005-06, largely due to duties and taxes imposed by India's state governments. Improvements in this regard is expected, as the 2009 trade treaty with India (which took effect on March 31, 2010) abolished these taxes. Furthermore, high wages relative to labor productivity and appreciating real exchange rates also affected exports. India has over 60% share in exports.

Imports have risen fast from USD 1.6 bn (26% of GDP) in 2001-02 to USD 3.6 bn (30% of GDP) in 2009-10, largely due to thriving consumption made possible by remittances. Gold, petroleum products and vehicles were the main imports, with gold making up 18% of imports in the current financial year[5]. Petroleum products amounted to 11% of the import bill, and vehicles 8 % in the six months to January 2010. India accounts for 57.1% of imports.

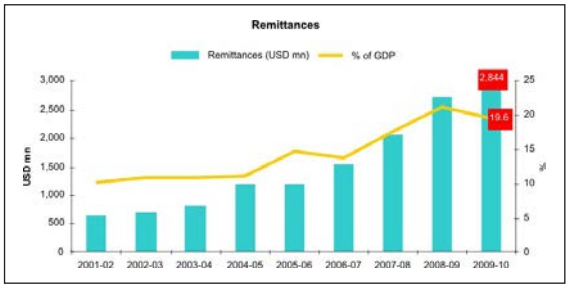
FOREIGN INVESTMENT

Nepal's foreign investment rules and regulations are based on the Foreign Investment and Technology Transfer Act 1992, which was amended in 1996 in line with open and liberal economic policies. Though many attempts were made in the past to boost Foreign Direct Investment (FDI) flows to the country, they did not have any noteworthy impact. One of the major policies of the Three-Year Interim Plan (2007-2010) is the promotion of domestic and foreign investment for the development of the economic sector of the country. Agriculture (mainly horticulture), tourism, hydropower and forestry are among the major areas of investments for broad-based development of the country.

According to the Department of Industry, the number of registrations of foreign investment projects (230) increased by 8.5% in 2008-09. Out of the total number of foreign investments, 78 were service related, 69 tourism related, 48 manufacturing related, 17 mining related, 9 power related, 8 agriculture related and 1 was construction related. Based on project cost, India secured the first position followed by United States of America, China, Norway, South Korea and United Kingdom[6].

REMITTANCES[7]

The total number of Nepali migrant workers leaving the country between 1993 and 2009 based on the official data on departures is nearly 1.5 mn. The number of Nepali migrant workers who are employed overseas without official permission is also believed to be 1.5 mn. Migrants are employed mainly as construction workers, security guards, drivers and cooks, etc.



Source: NRB

The proportion of households that receive remittances is 34% in Nepal, having grown from 23% in 1995-96. Rural areas have a higher proportion of recipients compared to their urban counterparts. The average income transfer in the form of remittance was

5 Gold imports began rising last year after India raised its import tariff, encouraging Nepalis to import gold from third countries and smuggle it to India.

6 Economic Survey Of Nepal 2009-10, Ministry of Finance, 2010

7 Data taken from Sharma and Gurung, Dec 2009, 'Impact of Global Economic Slowdown on Remittance Inflows and Poverty Reduction in Nepal'

Rs 34,698 per recipient per annum household in 2003-04[8].

In terms of region, the Gulf countries continue to be the top destination for Nepali migrant Workers followed by East Asia[9]. Over 80% of remittances come from the Gulf countries and Malaysia.As per data available for eleven months of 2009-10, Nepal received USD 2.83 bn in remittances which accounted for 19% of GDP. Remittances have sustained consumption and to a lesser extent investment.

COPING WITH THE GLOBAL FINANCIAL CRISIS

As a result of the global crisis, remittance inflows to Nepal slowed significantly and resulted in a liquidity crunch in the banking sector. The slowdown in remittance inflows from 31% in 2008-09 to about 17% in the first half 2009-10 shifted the current account balance into a deficit not seen since 1998-99 As remittances slowed, foreign reserves fell sharply and money growth slowed. Bank deposit growth also slowed to 22.6% in January 2010, compared to 27.0% in the previous year, and interbank rates spiked to 15% in January from 2% in September 2009. Liquidity injections by the NRB brought interbank rates down in recent months.

8 The International Monetary Fund (IMF) estimates that 80 % of foreign remittances are informal: 78 % through migrants, their families, and friends, and 2% through the informal system (hundi).10 Informal channels dominate largely because 90%of remittances come from India, whose proximity and porous border facilitate informal channels (Khatiwada 2005)

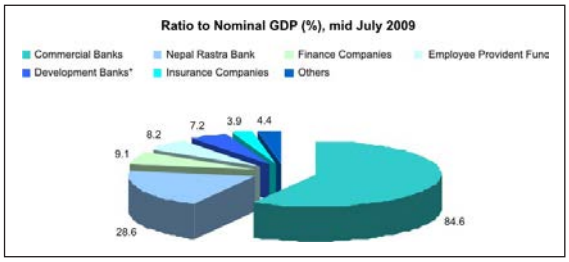
9 India is not included in the official figures as it is an open border that requires neither passport nor visa for the Nepali and Indian nationals. Since there is no system of registration, the flow of migrant workers in between Nepal and India is at best guess estimate

FINANCIAL SECTOR

REFORMS

Nepal's banking sector expanded significantly in the past several years amid loose monetary policy and weak supervision. In 2006, a new Banking and Financial Institutions Act (BFIA)[10] was passed to bring all banks and financial institutions under one law replacing various separate acts. As per this law, all commercial banks, development banks, finance companies and microfinance development banks are regulated as 'Class A', 'Class B', 'Class C' and 'Class D' institutions respectively. The apex microfinance organizations are also classified and regulated as 'Class D' financial institutions.

The National Rashtriya Bank (NRB) is the Central Bank with regulatory and supervisory capacity for the financial sector in Nepal. Each class of institution has different requirements for paid-up capital, CAR and other requirements such as Deprived Sector Lending (DSL).



Source: NRB

NRB also phased out the priority sector-lending program since 2007-08 to provide freedom to commercial banks in the selection of their loan portfolio. However, the DSL program is continued for credit access to the marginalized, backward, minorities, scheduled caste and deprived people and all banks and financial institutions are obliged to lend a certain percentage of their outstanding credit towards this.

10 Ordinance was later enacted in Bank and Financial Institutions Act (BFIA) in 2006

COMPOSITION

As of mid July, 2010, there are 270 financial institutions including 25 insurance companies, Employees Provident Funds, Citizen Investment Trusts and Postal Savings Banks. Among the 203 NRB licensed financial institutions:

- Commercial Banks ('A' class financial institutions): 26
- Development Bank ('B' class financial institutions): 79
- Finance Companies ('C' class financial institutions): 79
- Microfinance Institutions ('D' class financial institutions including Rural Development Banks): 18
- Cooperative (licensed by the NRB to undertake limited financial transactions): 16
- FINGOs (Financial Intermediary Non-Government Organizations (NGOs) licensed by the NRB to undertake micro-finance transactions): 46

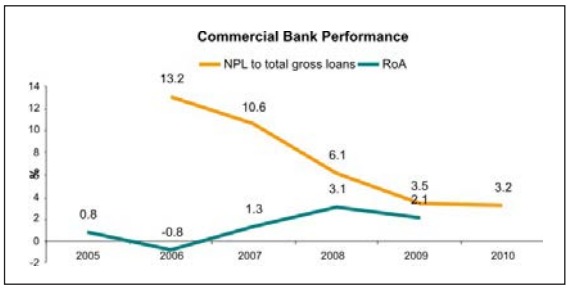
The ratio of total assets/liabilities of financial institutions including that of contractual saving institutions to GDP was 145.8 % in mid-July 2009. Including the market capitalization of the shares listed in the Nepal Stock Exchange, this ratio stood at 199.2 %. Commercial Banks dominate the sector with their share in the total assets/liabilities of the financial institutions at 58 %.

The number of commercial bank branches reached 966 as of mid-July 2010, of thses 334 are located in Kathmandu valley, 242 in the mountainous regions and 390 in the Terai[11].

Almost all commercial banks maintain capital in excess of the minimum statutory capital adequacy requirement (10%), although two small private banks and two large public banks did not fulfill the minimum Capital Adequacy Ratio (CAR) as of July 2009.

Though credit to the private sector has been in a trend of gradual growth for the past years, the share of credit of the Agriculture and Industry sector in total credit has been in a downward trend. The share of credit provided to the agriculture sector as a percentage of total credit was 6% in 2006/07, which came down to 4.5% in 2007/08 and to 3% as of mid-June 2010. The share of credit of the production sector came down to 20.7% as of mid-June 2010 from a share of 26.9% of total credit as of mid-July 2007. On the contrary, credit to real estate has been rising. The share of credit of this sector came up to 9% in mid-June 2010 from 1.1% in mid-July 2007.

After the execution of financial sector reform programs, the ratio of non-performing loans (NPL) is improving. The NPL ratio, which was 6.3% as of mid-July 2008, declined to 3.6% as of mid-July 2009 and further to 3.1% in mid April 2010. The ratio of non-performing loans (NPLs) to total loans declined since 2003-04 to 2.4% from 5.8% for private commercial banks, and 10.5% from 55.1% for the state banks[12]. Profits, given high net interest margins (about 3.5% in 2009), remain strong, with the average return on assets close to 2.1%.



Source: NRB

According to International Monetary Fund (IMF), Nepal's banking sector exhibits substantial vulnerabilities, under loose monetary conditions and lax supervision, rapid credit growth fueled asset prices and built up substantial credit and liquidity risks. A large portion of the banking sector is exposed to liquidity risk given slowed deposit growth

11 Banking and Financial Statistics, mid July 2009, NRB, July 2009

12 Though NPLs are decreasing, favorable NPL ratios may be masked by evergreening of loans and rapid growth of the loan portfolio

and high Credit to Deposit ratios of 90% on average. Although direct real estate exposure accounts for about 20% of the total loan portfolio, the actual exposure could be higher due to loan classification problems. In addition, total exposure, including loans collateralized with real estate properties, account for 70% of the total.

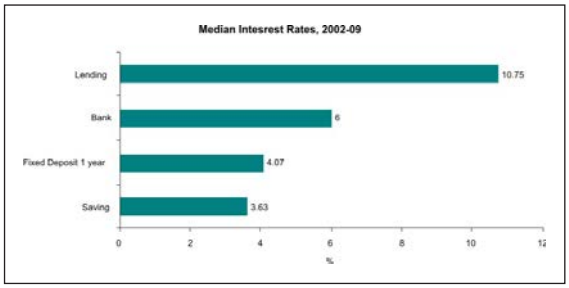
Until mid-July 2009, there were altogether 25 insurance companies operating in Nepal, which were established under Insurance Act 1992. The Insurance Board is the apex regulatory authority for insurance companies. Among the total insurance companies, the number of life, non-life and composite (both life and non-life) insurance companies were 8, 16 and 1 respectively. According to the ownership structure, 1 insurance company is government owned, 18 are owned by the private sector, 3 are foreign joint ventures, and 3 are foreign branches[13].

Nepal's bond market is at its infancy stage of development and remains dominated by government securities. The domestic bond market was around 14% of the GDP. The corporate bond market activity is negligible.

Equity market capitalization to GDP increased from 11.76% in 2001 to 34.5% in mid June 2010. However, the equity market is also not fully developed and a few main players dominate the stock market, as denoted by the high top 10 stocks turnover ratio. Of the total market capitalization of Rs 373.52 bn i(USD n mid-June 2010, bank and financial institutions accounted for 73.1%; manufacturing and processing sectors 2.0%; hotels 1.4%; business entities 0.4%; hydropower 4.3%; and other sectors 18.6%.

INTEREST RATE

For the period end of June 2010, bank rates are 6.5%, interbank rates 5.5%.



Source: NRB

FINANCIAL EXCLUSION

The Government has taken a number of steps, most notably deprived sector lending scheme and the establishment of regional development banks and apex financing institutions, to expand the outreach of financial services. However, financial exclusion is widespread. According to a World Bank Report 2006, Access to Finance in Nepal[14], about half of Nepal's households do not have access to formal financial services, which includes banks, financial-intermediary NGOs (FINGOs), cooperatives and finance companies. Access to accounts is concentrated in urban areas (where 74 % of households have one), in the Terai (52%), and among the wealthy (32% in the bottom quintile, compared with 79 % in the top).

Only 28% of Nepalese households have an account with a bank or have taken a loan from a bank. Some 28% rely solely on informal financial sources, while 19.6% are financially excluded and receive no service from the formal or informal financial sector. In comparison to urban people, rural people are deprived of bank services, as most of these formal financial institutions are located in the urban areas.

There is only one bank or financial institution in 16 backward districts while some districts even outside the Kathmandu valley have up to 103 financial institutions.

13 ADB Quarterly Economic Update Nepal, ADB, March 2010

14 Access to financial services in Nepal, Aurora Ferrari et al, World Bank, 2006

MICROFINANCE SECTOR

HISTORICAL EVOLUTION

Until the 1980s, the microfinance sector was served by cooperative (1950-60s) and nationalized banks (1970s-1980s) without much success. During the 1980s-90s, a number of pilot projects and initiatives were implemented such as the Small Farmers Development Project (SFDP) in the 1980s, the Microcredit Project for Women in 1994 with assistance from the Asian Development Bank (ADB), the Intensive Banking Program targeted at the poor and the Production Credit for Rural Women project that was launched through two national commercial banks and Agriculture Development Bank of Nepal (ADBN) exclusively to focus on women. These programs reached a certain level of outreach but could not provide a sustainable model to provide financial services for the poor.

Following this, some encouraging developments in the 1990s that matured in the 2000s, laid the foundation of the microfinance sector in Nepal, as we know it today. Among them was the formation of five Regional Development Banks (RDBs) by the government in five regions during 1992-96 based on the Grameen model with the objective of providing micro-credit services to the poor. While RRBs failed due to bad portfolio quality, high staff costs, lack of supervision and monitoring and professional management and eventually privatized[15], they later transformed to became Microfinance Development Banks (MFDBs) as class 'D' financial companies.

In the late 1990s, a number of NGOs and private microfinance banks also started microfinance programs in the country. Following the Grameen Bank model, in 1993-94, NGOs such as Nirdhan and Centre for Self-help Development (CDF) successfully implemented microfinance programs and later transformed into MFDBs. In the early 2000, three private microfinance development banks; Chhimek Bikas Bank Ltd. (CBB), Deprosc Bikas Bank (DBB) and Nerude Microfinance Developmet Bank Ltd. (NMDB), were also established.

During same period, in early 2000, NGOs involved in community based financial activities were given legal recognition and licensed by the Central Bank, NRB to provide a conducive policy environment to formalize micro financing services. As a result, there are 45 Financial Intermediary NGOs (FINGOs).

Development during this phase was greatly supported by the establishment of a number of wholesale funding institutions beginning with the Rural Self-Reliance Fund (RSRF) within NRB in 1991 to provide financial support to NGOs and cooperatives, the Rural Microfinance Development Centre (RMDC) in 1998 under public private partnership with NRB having a 26% stake with the remaining owned by 13 commercial banks[16], the Sana Kisan Bikas Bank Limited (SKBBL) in 2001 with a mandate to finance Small Farmer Cooperatives Ltd (SFCLs) and the National Cooperative Development Bank (NCDB) in 2003 to finance cooperatives in the country.

Presently, microfinance services are provided by Microfinance Institutions (MFIs) working as regulated MFDBs, FINGOs, Savings and Credit Cooperatives (SACCOs) and SFCLs. While the first two are regulated by NRB, SACCOs and SFCLs are governed by cooperative laws.

Based on the available data on borrowers served, the top 20 MFIs (among sixty major MFIs) cover 89.4% of borrowers, 96% of the total disbursement and 93% of the outstanding loans. Nirdhan Utthan Bank Ltd is

15 However, the NRB still holds 63.11% and 68.46% of shares in the Mid-Western RRDB and the Far-Western RRDB respectively, and the shareholding of the Government of Nepal in the Eastern RRDB (8.25%), the Western RRDB (16.5%), the Central RRDB (16.5%) and the Far-Western RRDB (8.46%) have remained unchanged since their inception

16 Presently, the commercial banks are the major owners of RMDC, holding 90.57% of its total paid-up capital.

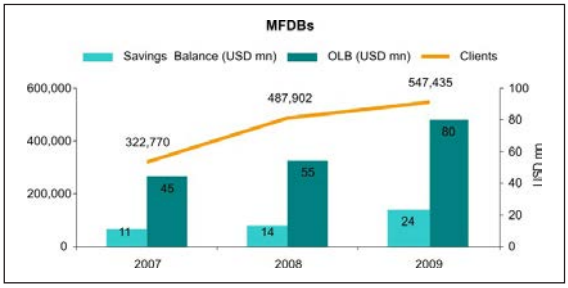
the largest MFI with maximum borrowers followed by the Chhimek Bikas Bank Ltd and Swabalamban Bikas Bank Ltd as second and third largest respectively. The Government RDBs has 25% of the total borrowers of the top twenty MFIs, while the share of the private MFDBs is 42%, of FINGOs 26% and of Cooperatives 7%.

TYPES OF MFIS

Three key microfinance providers can be classified as follows:

Microfinance Development Banks (MFDBs): Among these, there are five Grameen VIkas Banks and eight private sector Grameen Bank replicas.

- **Grameen Bikas Bank (GBB):** They provide micro-finance services to rural poor women under group guarantee without collateral. They are government owned bur recently four out of five GBBs are privatized.
- **Private Microfinance Development Bank (PMFDBs):** Eight of the Grameen Bank replicas established by the private sector include Nirdhan Utthan Bank Limited, Chhimek Bikas Bank Limited, Swabalamban Bikas Bank Ltd, Deprosc Bikas Bank Limited, Nerude Bittiya Sanstha Limited, Naya Nepal Laghu Bitta Bikas Bank Limited, Mithila Laghu Bitta Bikas Bank Limited and Summit Micro Finance Development Bank Limited.

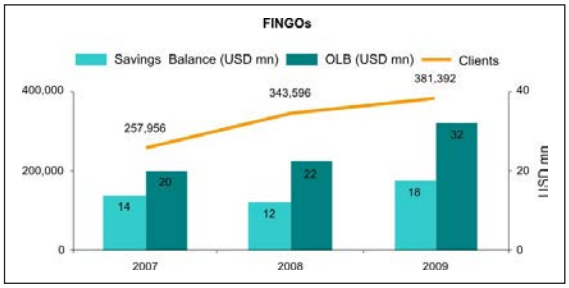


Source: Nepal Microfinance Summit 2010

Together MFDBs reach 547,435 clients with Rs 1,766 mn (USD 24 mn) in savings and Rs 5,992 mn (USD 81 mn) in OLB by July 2009.

MFDBs are financed by RMDC along with commercial banks and finance companies under the Deprived Sector Lending (DSL) scheme.

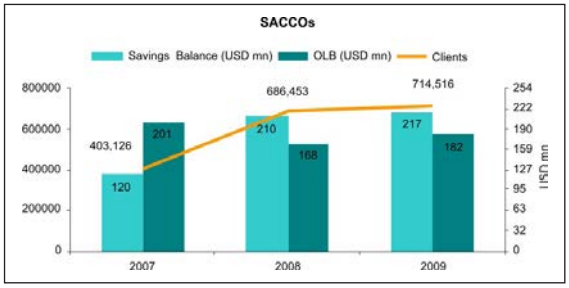
FINGOs: There are altogether 45 FINGOs licensed by NRB to undertake limited financial transactions. These are registered under Institutions Registration Act 1977 and undertake limited banking transactions in accordance with the provision of the Financial Intermediation Related Institutions Act 1999. As per the figures available for mid July 2009, they reach 381,392 clients in 38 districts with a coverage of 64% hill districts and 36% Terai districts. Most FINGOs normally serve between 2,000 – 30,000 clients.



Source: Nepal Microfinance Summit 2010

Cooperative: They can be classified into two subgroups:

Savings and Credit Co-operative (SACCOs): There are 5,161 SACCOs reaching 714,516 individuals in 72 districts as of mid-July 2009. They normally serve 50-200 members and are governed by cooperative laws.

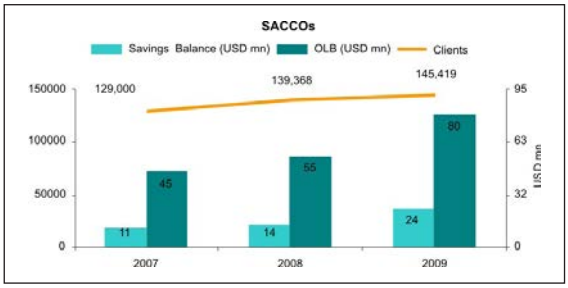


Source: Nepal Microfinance Summit 2010

SACCOs are not well regulated and supervised; as a result, many of them do not have standard accounting and sound management practices and lack good governance. In spite of all this, SACCOs are considered more suitable models for the hills and mountains

as they provide both savings and financial services to the members who are local people without much bureaucratic process. In addition to member's savings, SKBBL is main source of financing to SACCO at 9.5%.

Small Farmers Cooperative Limited (SFCL): SFCL is a member-managed multi-service cooperative designed to deliver primarily financial as well as non-financial services to its members in rural areas. By mid July 2009, 225 SFCLs reached 145,419 individuals in 40 districts of the country. The SFCL is generally confined to one Village Development Council (VDC) area and targets only small farmers. Each SFCL on average serves around 500 households catering to 200-700 clients in a community.



Source: Nepal Microfinance Summit 2010

SKBBL provides them with wholesale loans while the federation of SFCLs regularizes and supervises their financial activities. Federations of SFCLs also provide non-financial i.e. social mobilization, trainings and technical support services.

MAJOR HIGHLIGHTS OF THE SECTOR

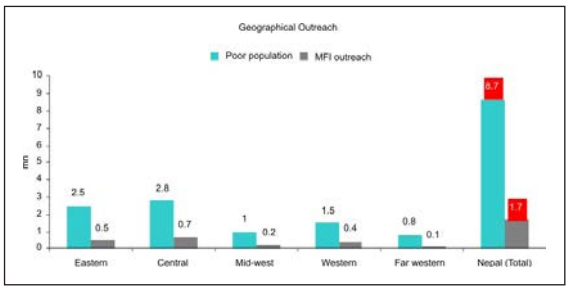
OUTREACH

The microfinance sector as of mid July 2009 reached over 1.7 mn people.

While the Terai region is largely well served by MFIs, the remote and mountainous regions continue to lack microfinance services. MFDBs largely operate in the Tarai, whereas FINGOs and cooperatives are the largest service providers in the hills and mountains.

Microfinance Outreach as of July 2009				
MFI Type	Number	Members	Savings	OLB USDmn
Microfinance Development Banks (MFDBs)	13	547,435	24	80
Financial Intermediary Non Government Orgnization (FINGOs)	45	381,392	18	32
Small Farmer Cooperative Ltd (SFCL)	25	145,419	17	31
Savings and Credit Cooperatives (SCC)	5,161	714,516	217	182
Total	5,244	1,788,762	275	324
USD = 75 Rs				

Source: Nepal Microfinance Summit 2010



Source: Nepal Microfinance Summit 2010

GROWTH

The microfinance sector in Nepal has grown at a fast pace in recent years though growth rates vary among different types of MFIs. In the last three years, MFDBs have grown at a much faster pace. However, last year's growth slowed down both in number of borrowers, savings and OLB on account of various factors including high inflation, contraction in savings and negative perception among others.

Microfinance Growth (%')			
	Clients	Savings	OLB
MFBs			
2008	51	24	21
2009	12	69	46
FINGOs			
2008	33	-11	12
2009	11	44	44
SACCOs			
2008	70	76	0
2009	4	3	0
SFCLs			
2008	8	24	21
2009	4	69	46

Source: Nepal Microfinance Summit 2010

PRODUCTS

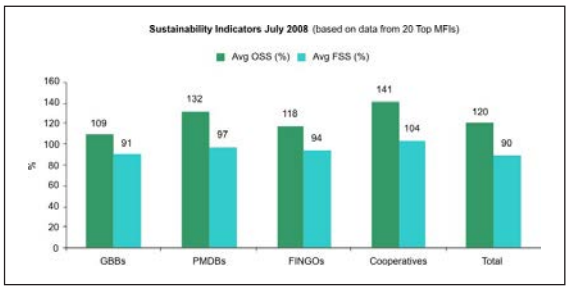
In Nepal, MFIs are allowed to mobilize savings only from their members/clients. They cannot accept deposits from the general public. Most MFIs offer mandatory and voluntary saving schemes. Under mandatory savings the clients need to deposit a certain amount in their regular meetings and a certain percentage of loan amounts (ranging from 3 to 5%) is also deducted and deposited in the same account. The MFIs in Nepal have been providing interest rates on saving deposits of their members ranging from 5% to 8% per annum. Interest is capitalized in every 6 months (January and July) during bi-annual closing of their transactions. Some MFIs have introduced other savings schemes like pension funds, child education funds, etc. and have given interest of up to 10% per annum. It is important to note that the saving balances finance about one third of the loan portfolio of MFIs.

MFIs serve clients for small loans generally below Rs 50,000 (USD 673) though NRB defines microfiance loans as below Rs 150,000 (USD 2020) for MFDBS. Most provide short-term loans of less than 18 months for productive uses such as agriculture, livestock, poultry, petty trading and grocery stores. MFIs have complete freedom to fix interest rates. However, the NRB Act 2002, in case of the Rural Self- Reliance Fund (RSRF) has specified the interest rates for its borrower cooperatives and NGOs, which are far below the market rates. This has to some extent distorted the market interest rates. The PMFDBs charge between 20% - 25%; the government owned GBBs charge a 20% interest rate per annum on the loans to their clients; SFCLs charge an interest rate of 13% per annum; some FI-NGOs are charging as low as 18% per annum (Deprosc), while others are charging interest between 20 to 25% per annum. Initially most of the MFIs charged interest on a flat basis but now more and more MFI are charging on a declining balance basis.

A few microfinance banks and cooperatives now offer remittance transfer service products. Due to the lack of insurance services available in rural areas, most MFIs have offered some institution-based protection schemes related to livestock death and life insurance.

SUSTAINABILITY

Following the failure of many subsidy-oriented government microfinance programs and projects, the present set of MFIs in the country including those which are state owned, have a key objective to provide microfinance services to the poor in a sustainable manner without subsidy or grant supports.



Source: InM Report, 2009

The sector wide data for key sustainability indicator is not available. However, the Institute of Microfinance (InM) Study of the Nepal microfinance sector in 2009[17] provides infor-

17 State of Microfinance in Nepal, InM and RMDC, 2009

mation through data collected from the top twenty MFIs on Operational Self-Sufficiency (OSS) and Financial Self-Sufficiency (FSS).

MESO LEVEL INFRASTRUCTURE

Each four categories of MFIs have their separate associations as networks.

MFDBs have a network association called Nepal Microfinance Bank Alliance (NMBA), FINGOs have Microfinance Association of Nepal (MIFA) and SACCOs have Nepal Federation of Savings and Credit Cooperatives Union Ltd (NEFSCUN). SFCLs has recently formed an association under the name of Agriculture Cooperative Bank to function as network of SFCLs.

Centre for Microfinance (CMF) is providing valuable technical assistance (TA) services to the sector as a whole. CMF is expanding its role from TA provider to become the National Network for all the microfinance providers in the country in coming years and take policy advocacy roles.

There are no domastic Rating Agencies and Credit Information Bureau catering to microfinance sector in Nepal.

COMPETITION

According to InM Study on Microfinance Sector in Nepal[18], the top 20 MFIs are facing problems of overlapping clients as they all are more concentrated in densely populated areas. According to this study, enrollment of clients in more than one MFI is a common practice in many areas. This factor has now started affecting outreach, disbursement and repayment of all concerned MFIs. There is no specific study on multiple borrowings; however, the MFIs reported that multiple borrowing is about 20-40%.

RISKS

Externally, the high inflation has an impact on microfinance sector as inflation affects the saving capacity of the clients and thus financing structure of MFIs. During last years, many MFIs have seen drop in savings due to high inflation.

Another key risk to the sector is regulation and governance issues for much of the sector. A large number of cooperatives remained outside of effective regulations and supervision and have serious problems with governance and management.

REGULATIONS

Presently the central bank, the NRB is supervising MFDBs and FINGOs. Cooperatives do not fall in the regulatory and supervisory responsibility of NRB. The Department of Cooperatives under the Ministry of Agriculture and Cooperatives is the regulatory body for the Cooperative Societies including Savings and Credit Cooperatives registered under the Cooperative Act 1992. Laws and Regulations that govern MFIs are as following:

- Nepal Rastra Bank Act, 2002
- Bank and Financial Institutions Act, 2006
- Cooperative Societies Act, 1992
- Financial Intermediary Act, 1998
- NRB Directives for Banks and Financial Institutions, 2010

MFDBs are categorized as 'D' type financial institutions under BAFIA and the prudential norms are designed in line with normal financial institutions except that paid-up capital requirements are lower[19]. Out of their paid up capital at least 30% should be sold to the general public.

The Financial Intermediary Act is designed to accommodate non-government organizations under regulation and 45 financial NGOs are licensed under the Act[20]. The supervision of FINGOs, by NRB is quite week

18 State of Microfinance in Nepal, InM and RMDC, 2009

19 Rs 10 mn to operate in 3 districts and an additional Rs 2.5 mn per extra district; Rs 20 mn to operate in 10 districts; Rs 60 mn to operate in a region, and Rs. 100 mn to operate at the national level. With a view to expand microfinance programs in the hills and mountains, NRB also allows MFDBs to expand their programs to an additional five hill districts without injecting additional paid up capital

20 Dhakal, 2007, Role of State for the development of Microfinance sector

and the NRB has not taken any action for non-submission of reports or non-compliance of regulations. Any NGO willing to operate a microfinance program has to get a license for financial intermediation from the central bank. However, before getting a license of microfinance operation from NRB, an NGO has to be registered with the respective District Administration Office.

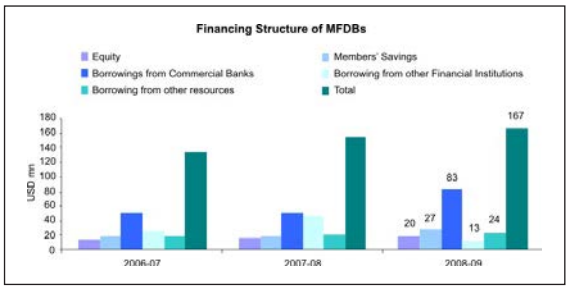
Cooperative do not come under the regulatory framework of the NRB. Department of Cooperative regulates SFCLs and SACCOs under Cooperative Act 1992. However, some cooperatives that have been licensed from NRB for limited banking services and these come under its regulation and supervision.

In view of increasing demand for microcredit and its critical role in poverty reduction in the country, the Government of Nepal issued a 'National Microcredit Policy, 2007' with an aim to create a conducive financial infrastructure and legal environment for the promotion and development of the microfinance industry and to use microfinance as a tool for poverty reduction in the country. The specific objectives of the policy are: (i) increasing the outreach of microfinance services to women and families from low income groups, (ii) simplifying and increasing access to quality microfinance services for the target group, (iii) strengthening institutional capacities of microfinance service providers, (iv) formulation of necessary microfinance laws, and (v) development of appropriate institutional infrastructures for maintaining financial discipline and accountability in the whole industry.

The NRB has recently drafted an act to establish a Nepal Microfinance Authority for this purpose, but it has not been forwarded to the parliament for the approval. As per this new act, the MFDBs, FINGOs and Cooperatives would come under the supervision of the new Regulatory Authority created for this purpose.

FINANCING

From the financing mix of these MFIs, borrowing is the most critical component of financing. It covers about 76% of total resource mobilization. The members' savings comes next followed by equity.



Source: NRB

As per latest data[21], the financing structure of MFDBs and FINGO has, borrowings : 74.5% ; saving : 17.4% ; institutional capital : 8.1%. For SACCOs and SFCLs, borrowings : 20%, Saving : 77%, and institutional capital : 3%

The study of partner MFIs of RMDC revealed MFIs were able to raise 38% of the fund from members Savings, about 30% RMDC and rest from the commercial banks and their equity[22].

Savings: According to data from the main MFIs, the saving to loan ratio in these institutions varies from 27.18% to 71.05% and approximately one third of lending requirement is met through savings.

Loans by Apex Funding Institutions				
	Partner MFIs	Disbursed (USD mn)	OLD (USD mn)	As on
RMDC	80	51.11	21.63	March 2010
SKBBL	232	75.43	14.88	April 2010
RSRF	305	2.60	1.20	July 2008
Source: RMDC, SKBBL and NRB website				

Borrowing: Rural Microfinance Development Centre Ltd. (RMDC), Sana Kisan Bikas Bank Ltd. (SKBBL) and Nepal Rastra Bank- Rural Self Reliance Fund (RSRF) are the major sources

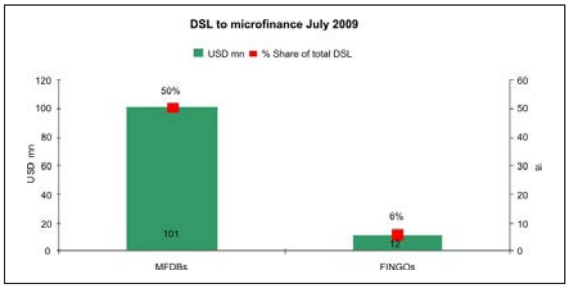
21 Based on presentation by K K Pradan of NMBA at a AGM organized in the second week of Sep 2010
22 Based on the feedback recived from RMDC over mail

of wholesale funding to MFIs in Nepal. In addition commercial bank and financial institutions lend to microfinance providers under DSL scheme.

RMDC: Since the establishment of the Rural Microfinance Development Center Ltd. (RMDC) in 1998 (which started its operations in January 2000), the number of partner MFIs increased steadily from eight in July 1999 to 60 in July 2008 and to 86 by June 2010 (7 MFDBs, 9 Development Bank, 46 SCCS, 24 FINGOs). RMDC provides wholesale loans at 6% interest per annum for general loans and at 5% per annum for livestock loans under the Community Livestock Development Project. Over 75% of loans are disbursed to MFDBs and FINGOs.

SKBBL: This is a specialized wholesale microfinance development bank established with the aim of promoting and strengthening grassroots level Small Farmer Cooperatives Ltd. (SFCLs) in particular and similar other microfinance intermediaries in general. It charges an interest rate of 9.5% per annum.

RSRF: The government of Nepal established RSRF in 1991. RSRF lends to SFCLs, Cooperatives and FINGOs at the interest rate of 8.0%. However, 7% of the interest rate charged by the RSRF is paid back to the respective institution for its development if the borrowing institutions repay the principal and interest in a timely manner. Thus, the net interest rate stands at only 2%. This has distorted the market rate to some extent. The ceiling of credit to the SACCOs and NGOs is 10 times or their total savings/ or share capital or a maximum of Rs 1 mn whichever is lower. Only four FINGOs have received credit funds from RSRF out of total 334 recipient institutions by mid-July 2008[23].



Source: NRB

Another important source of financing for MFIs is Commercial Banks. They provide wholesale funding to MFIs under the DSL Scheme. As per NRB directives, DSL mandatory lending obliges commercial banks (class "A" financial institutions) to lend at least 3% of their portfolio to the deprived sector, while class "B" development banks and class "C" finance companies are obliged to lend 1.5% to the deprived sector. They can either lend directly small loans to clients, lend to MFIs or invest in the equity of such MFIs. A penalty equal to the highest interest rate charged on loans is to be imposed on any of the banks that do not meet the prescribed requirements. The commercial banks charge 3-6% interest per annum on wholesale loans to MFIs depending on the urgency of their disbursement to meet the deprived sector lending requirement. They extend loans to MFIs generally for one year and further extension or renewal is made for another one year after the expiry of each loan. However, currently banks have revised their deprive sector lending rate to 6-9%) which is the very higher rate for the MFIs.As of July 2009, total funding available under DSL is USD 199 mn of which 50% is channeled to class "D" microfinance development banks.

MARKET GAPS AND CHALLENGES

Despite the vibrant microfinance sector in Nepal, there is still a scarcity of MFIs. Total rural credit requirement in the country is estimated at Rs 23.3 bn (USD 313 mn), while the total supply from the formal and semi-formal sectors is only Rs 9.6 bn (USD 129 mn). Of the approximate 2.1 mn households

23 Challenges and Issues Currently Experienced by Micro Finance Institutions (FINGOs) in Nepal, Sudhir P. Lohani, MIFAN, Feb 2010

living below the national poverty line, nearly half are deprived of services from the formal microfinance sector.

Further, there are financing gaps as well. According to estimates, during 2009-10, there were significant funding gaps to meet the funding needs of MFIs.

Financing Gaps (2009-10, USD mn)	
Total Funding Needs for MFIs	122.0
Availabilty from DLS for MFIs	77.0
Funding Gaps	45.0

Source: Nirdhan Bank

In terms of institutional capacity, Cooperatives, often lack focus and institutional capacity. Most FINGOs are also at a nascent stage of development, with weak systems, leadership, staff capacity and organizational culture and structure. Most of the FINGOs and cooperatives do not have adequate capacity and sufficient equity capital to borrow funds from commercial sources. The growth of microfinance in Nepal is therefore constrained by the limited number of capable microfinance providers and limited capability of the public-owned MFDBs.

MICROFINANCE INVESTMENT

GENERAL INFORMATION

The NRB has taken a number of steps to encourage investment into microfinance sector, including DSL scheme, obligation of MFDBs to raise a minimum 30% of the paid-up capital from public among others

As per WTO regulation, the Nepalese financial sector would be completely open to the foreign ownership and this implies that MFDBs can also have 100% foreign equity. However, details of this move are not presently available.

DOMESTIC DEBT INVESTMENT

LEGAL FRAMEWORK

As mentioned in the section above, there is no regulatory hurdle for domestic debt investment into MFIs in the country. Both NRB regulated MFIs and non regulated cooperatives have freedom to secure debt from domestic financial institutions including banks, finance companies and development banks.

PRESENT SITUATION

Presently the debt market is influenced by the DSL directive of the government which makes it mandatory for class A, B and C institutions who have been charging rates of between 3-6% per annum. Apex funding institutions are another major source of debt financing.

DSL and Apex financing is not enough in medium term and long term to meet the financing need of MFIs. Further most of the lending is very short term in nature.

DOMESTIC EQUITY INVESTMENT

LEGAL FRAMEWORK

For MFDBs, the NRB stipulates 30% paid-up capital to come from the pubic funds. Further class A, B and C institution can take equity stakes in MFIs.

PRESENT SITUATION

So far, promoter (Banks, NGOs and Individuals) are injecting money as equity from theri own sources i.e. institutional capital or savings.Since FINGOs cannot pay dividends, they are unable to raise equity. MFDBs also raise equity from capital markets.

FOREIGN DEBT INVESTMENT

LEGAL FRAMEWORK

As per current regulations, MFDBs, FINGO and other microfinance providers can take foreign debt. There are no specific guidelines or structure on conditions of foreign debt like amount, term, interest rate, repatriation of interest and principle amount etc. It is based on the bilateral agreement but the agreement should get approval from NRB.

PRESENT SITUATION

So far there are only a few examples of foreign investment in Nepal. Patan Business and Professional Women (BPW Patan) is a FINGO that recived loan from KIVA. Grameen Trust has also made a few debt investment in the past.

FOREIGN EQUITY INVESTMENT

LEGAL FRAMEWORK

The MFDBs can take foreign equity after taking approval from central bank but the foreign investor must be a bank or finance company. This means Microfinance Investment Vehicles can not take euity in the MFDBs. Foreign equity is not allowed in FINGOs and Cooperatives.

PRESENT SITUATION

In June 2010, Nirdhan has entered into agreement with International Finance Corporation (IFC) where IFC has taken 10% equity in Nirdhan Bank. There are no other example of foreign equity.

KEY CONTACTS

Centre for Microfinance (CMF)
www.cmfnepal.org/

Nepal Rashtirya Bank (NRB)
www.nrb.org.np

Rural Microfinance Development Center (RMDC)
www.rmdcnepal.com/front/index.php

Sana Kisan Bikas Bank Limited (SKBBL)
www.skbbl.com.np/

PAKISTAN

Population : 173.51 mn[1]
Main towns : Karachi (13.4 mn), Lahore (7.2 mn), Faisalabad (2.9 mn), Rawalpindi (2mn)
Currency : Pakistani Rupee (PKR or Rs)
Financial year : 1st July – 30th June
Exchange rate : 1 USD = Rs 83.80 (period Average for 2009-10)[2]

Development Indicators[3] :

- Population below poverty line (National): 22.3% (2006)
- GNI per capita (Atlas method, USD): 950 (2008)
- Literacy rate (10 years and above)[4] : 57% (2009)[5]
- Mortality rate (child<5 years) : 95.2 per 1000 live births (2009)
- Life Expectancy at birth: 66.5 years (2008)
- Human Development Index (HDI): 0.572, 141 among in 182 countries[6] (2009)

Indicator	2005-06	2006-07	2007-08	2008-09	2009-10p
Nominal GDP (USD bn)	127.3	145.7	171.2	166.5	177.9
Real GDP Growth (%)	5.8	6.8	4.1	1.2	4.1
Consumer Price Inflation (avg,%)	7.9	7.8	12.0	20.8	12.7
Exchange rate (avg, vs USD)	60.2	60.4	68.2	81.3	85.3
External Debt (year-end, USD bn)	35.9	39.0	44.5	50.8	43.5
External Debt (as a % of GDP)	28.2	27.3	7	30.4	33.5
FDI (USD bn)	3.5	5.1	5.3	3.7	2.2
FDI (as a % of GDP)	3.4	3.7	3.8	2.4	1.3

p: provisional

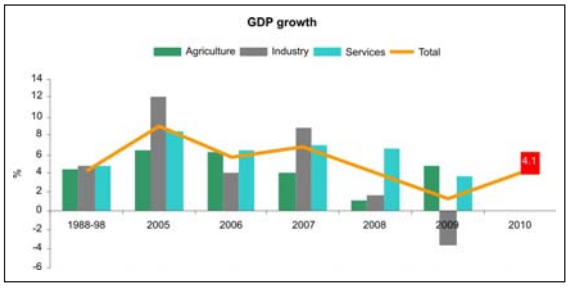
1 Pakistan Economic Survey 2010
2 The period average has been calculated by taking the average of the monthly average of interbank floating exchange rate published by the Central Bank
3 Figures taken from Pakistan Economic Survey 2010
4 Public Expenditure on Education as % of GDP is lowest in Pakistan at 2.1% in 2009-10 as compared to other countries of the South Asian region. According to UNESCO's Education for All Global Monitoring Report 2009, the Public expenditure on Education as % of GDP was 2.6% in in Bangladesh, 3.2% in Nepal, 3.3% in India
5 According to the latest Pakistan Social and Living Standards Measurement (PSLM) Survey 2008-09, the overall literacy rate (age 10 years and above) is 57% (69% for male and 45% for female) compared to 56% (69% for male and 44% for female) for 2007-08
6 Index is based on 2007 figures in Human Development Report (HDR) 2009

ECONOMY

The high poverty levels and low social development factors continue to impact economic growth of Pakistan. Currently, 22.3% of the country's total population lives below the poverty and another 20.5% living in vulnerable conditions. A large proportion – approximately 79% these poor reside in rural areas. International Monetary Fund (IMF) stresses the fact that the rising inflation, low social spending, high fiscal deficit and lower economic growth could offset the already achieved gains in poverty reduction. IMF, under its fourth review of Pakistan's economy under Stand-By Arrangements (SBA) during June 2010, has underscored the on-going economic recovery and implementation of some structural reforms such as implementation of Value Added Tax (VAT) as positive economic measures in the backdrop of the tough and uncertain political and security situation within country.

ECONOMIC GROWTH

In the last couple of decades, Pakistan has progressively introduced several policy reforms in the areas of privatization, financial sector, institutional restructuring, exchange rate alignment, formalization of foreign remittances and foreign investment among others for high economic growth. The economy grew at an average of over 6% during 2003-08. The Agriculture, Industry, and Services sectors grew by 4.1% 10.1% and 6.9% respectively during this period. However, this momentum in economic growth was not sustained in the last couple of years, due to the presence of structural imbalances, fiscal slippages, sustained high inflation, energy shortages, vulnerable external accounts and uncertain political and security situation within the country. The Gross Domestic Product (GDP) growth declined to 1.4% in 2008-09 though it recovered in 2009-10 to 4.1%. The rebound in growth took place mainly due to high aggregate demand that was made possible by government crop support and higher than expected remittances.

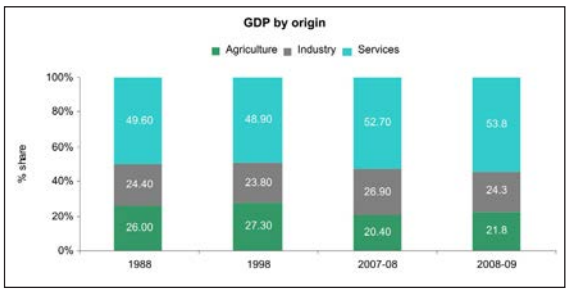


Source: World Bank and SBP

The Asian Development Bank (ADB) projects the GDP growth rate to be 4% for 2010-11. However, achieving such a growth rate will be a huge task in the face of existing setbacks in the form of crowding out of the private sector by the high government borrowing from the banking sector, increase in public debt, rebounding inflation, uncertain security situation, weak political atmosphere and energy failures. The situation has been aggravated further by the recent devastating flooding in the country, affecting the country's target for exports, inflation, and fiscal balance and therefore, according to some estimates, would push down the overall GDP growth by 1-1.5% during 2010-11.

ECONOMIC STRUCTURE

Pakistan has a low production base with the service sector accounting for over half of the GDP. A further break-up of the Service sector for a five-year average share show dominance of retail trade with a 33.6% share and transport/communication with a 19.5% share in the sector.



Source: World Bank and SBP

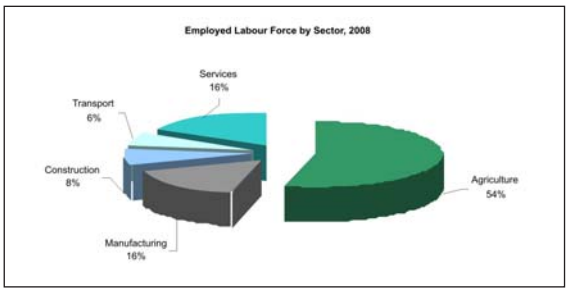
In the past six years, Agriculture has grown at an average rate of 3.7% per annum. However, volatility in the sector is high,

with the range of growth varying between 6.5% and 1.0%. Agriculture remains by far the largest employer, absorbing 45% of the country's total labor force. The four major crops (wheat, rice, cotton, and sugarcane), on average, contribute 33.1% to the value added in overall agriculture and 7.1% to GDP. Livestock contributes 53.2% to agricultural value added. The Agriculture sector is affected by problems of small landholding, low productivity, unsustainable cropping, inadequate irrigation and government administered prices among others.

In Manufacturing, the sector is mainly concentrated in cotton based manufacturing aimed at export markets. Factors such as lack of a skilled work force, poor physical infrastructure - notably the energy crisis - and political instability continue to pose big hurdles in the form of high costs of manufacturing. According to the Pakistan Economic Survey 2010, terrorism and the energy crisis cost approximately 6% and 2.0%-2.5% respectively of GDP in 2009-10. The absorption of employment in Manufacturing has remained stagnant at around 13% in the last 10 years.

LABOUR

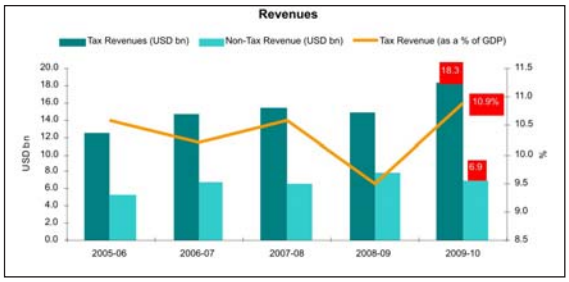
Pakistan has the 10th largest labour force in the world. Approximately 29% of the 161 mn population of Pakistan is in the age group of 15 to 24. The size of the labour force is estimated at 53 mn as of 2008-09. Of the total labour force, 50 mn are employed while 3 mn persons are unemployed, resulting in an unemployment rate of 5.5%. The share of the informal labour in the economy remains high at 73.3% in 2008-09.



Source: Ministry of Finance

TAXES

The country has a low tax-to-GDP ratio (9-10%) for reasons of a narrow tax base, low tax on agriculture, widespread tax exemptions, low tax compliance, corruption, undocumented informal economy and weak audit and enforcement.



Source: Ministry of Finance

According to the Pakistan Economic Survey 2010, Agriculture which contributed around 22% to GDP has a contribution of just 1% to total taxes while the industrial sector contribution to GDP stood at 25% with a contribution to taxes of 63%. On the other hand the services sector contribution to GDP was around 53% while it contribution to taxes was 26%.

Income tax contributed to over 95% of total direct taxes. Broadening and strengthening the tax regime remains one of the biggest need and challenge for the country.

BUSINESS ENVIRONMENT

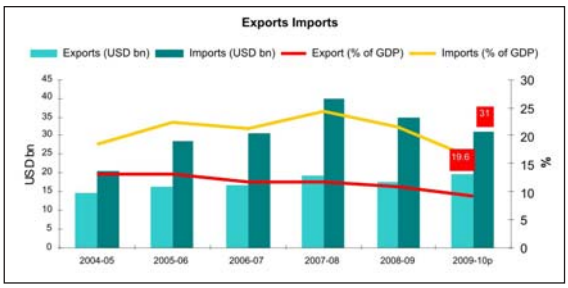
According to the recent World Bank's Doing Business Report 2010, Pakistan is ranked 85th out of 183 countries. Across categories, the country has best ranking with respect to protecting investors (27th). Pakistan has best ranking among eight countries of south Asia.

Source: IFC

The government has been implementing various incentive measures not only to protect the investors' interest in the country but also to improve the business environment. These include solving the problem of energy availability by encouraging private sector investment in the energy sector, easing and controlling law and order and increasing security, reforming the existing tax system and increasing financial protection of investors in the form of a stable exchange rate, lower inflation and improving the legal framework for safeguarding the investors' funds.

EXPORT IMPORT

The country's exports are dominated by the textile sector, though the share of textiles in exports has decreased from a high of 63.3% in 2001-02 to 51% in 2009-10. Textiles are followed by manufacturing with a 24% share and food with a 15% share[7]. Other main export products include leather, rice, synthetic textiles and sports goods. In terms of exports destinations, Pakistan has been successful in diversifying its exports markets. During the start of the decade, around 55% of total exports were to a small number of countries including US, UK, Germany, Japan, Hong Kong, Dubai and Saudi Arabia. Currently their share declined to 31.6% with remaining countries making up around 68.4% of exports[8]. The USA remains the biggest export market for Pakistan at 17.3%.



Source: IFC and SBP

During 2008-09, commodities worth USD 17.7 bn were exported, declining by 7.2% from the previous year mainly due to lower global output and aggregate demand in the aftermath of the global recession along with the domestic economic slowdown, currency depreciation and tighter demand management policies, energy failures and uncertain security situation in the country. However, the provisional figures for 2009-10 show marginal improvement in export performance by 2.1% to USD 19.6 bn[9].

On the imports side, the major import categories are petroleum products followed by industrial raw materials, machinery and food groups. Most of Pakistan's imports are concentrated with over a 36% share from seven countries i.e. Saudi Arabia, Kuwait, Malaysia, U.S.A, Japan, Germany, and U.K. with Saudi Arabia having the lion's share of an average of 11.7% since 2003-04.

Exports, Import and Trade balance are 10.9%, 21.5% and 10.6% of GDP respectively for 2008-09.

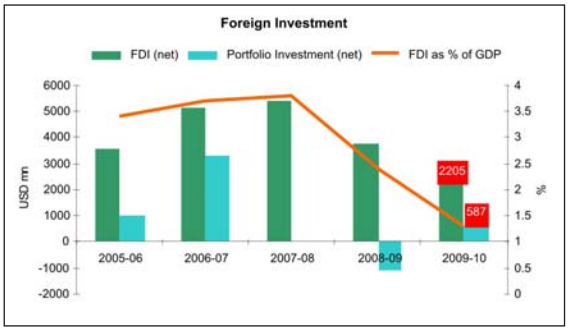
FOREIGN INVESTMENT

Foreign investment grew at an average rate of 61% per annum for four years with an average investment of USD 3.3 bn between 2003-08. However, it declined significantly by 31.2% in 2008-09 compared to the previous year. A combination of external and internal factors like the global financial crisis and economic slow down, energy crises, political climate and security situation contributed to this.

The major sources of FDI into Pakistan are USA, UAE and UK with respective average share in total for the last five years as 20.4%, 16% and 10.5% respectively.

7 Ibid
8 Ibid

9 Monetary Policy Statement, SBP, July 2010

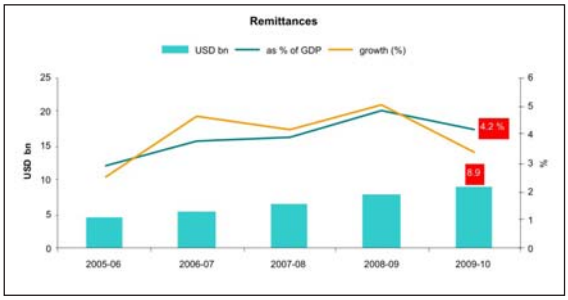


Source: Wourld Bank and SBP

The sector wise FDI data reveals that IT & Telecom, Financial Business and Oil and Gas sectors have been the major beneficiaries of FDI related inflows for the last five years. On average, the IT & Telecom has been getting 31.8% share in total inflows during the last five years, followed by financial business and Oil and gas with average share of 17.7% and 17.2% respectively.

REMITTANCES

For the last few years, remittances have been showing impressive growth, increasing on average by 14% during 2004-08 and as a percentage of GDP stood at an average of 3.6%. During 2009-10, remittances reached USD 8.9 bn. Such an increase in remittances, in spite of previously held worries about possible decline in remittances in the aftermath of the global slowdown, may be due to positive results generated by the Pakistan Remittance Initiative – a package initiated by the Government with the Central Bank, under which different incentives have been offered to channel remittances flow through the formal financial sector.



Source: Wourld Bank and SBP

The recent country-wise remittances data shows that UAE is leading the race by having a share of 22.8% in total remittances, followed by Saudi Arabia with a share of 20.9%, USA with a 20% share, other Gulf countries with a share of 14.1% and UK with a share of 10% during July-April 2009-10[10].

COPING WITH THE GLOBAL FINANCIAL CRISIS

During the period of Global Financial Crisis, Pakistan's economy witnessed a period of significant instability with weak economic fundamentals. Fortunately enough, with relatively limited linkages with the global market, the country's financial sector remained directly unaffected by the contagions produced in the international financial market. However, effects of the crisis have been felt, though on a limited scale, by the real sector of the economy and transmitted through the trade balance with the decline in global aggregate demand substantiated by the fall in commodity prices and almost 50% reduction in capital inflows into the country.

10 Pakistan Economic Survey 2010, Ministry of Finance

FINANCIAL SECTOR

REFORMS

Financial sector reforms were initiated during 1989 and strengthened during the latter 1990s, such as strengthening the role of the Central Bank, State Bank of Pakistan (SBP) as autonomous regulator and supervisor, introduction of market based monetary and exchange rate policies, privatization of state-owned banks, strengthening the loan recovery process, encouraging secondary market, establishment of Securities and Exchange Commission of Pakistan (SECP) for the regulations and supervision of the non-banking sector including capital market, facilitating foreign investment in financial sector, automation of three stock exchanges and facilitating the establishment of Islamic and Microfinance banks among others.

Due to massive privatization, the government ownership in the financial sector has drastically declined from 80% to 20%. Total financial sector asset stood at USD 215 bn in 2008. The liberalization and reform process such as permission to foreign investors to repatriate their capital freely out of country also initiated a large mobilization of funds into the equity market thus contributing to the growth of the stock exchanges in the country.

The financial sector is largely regulated by the SBP and SECP. Although all banks are required to register with the SECP, the sector is regulated and supervised by SBP. Non Banking Finance Companies (NBFIs) including Development Finance (DFIs), leasing companies and housing finance companies and capital markets fall under the SECP regulation.

COMPOSITION

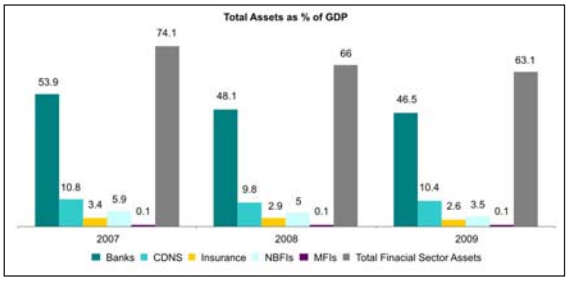
Broadly speaking, the formal financial sector in Pakistan is composed of the Banking Sector, Non-Banking sector and microfinance services providers.

Composition of Financial System in Pakistan 2009	
Commercial Banks	**48**
Public Sector Commercial Banks	4
Local Private Banks	25
Foreign Banks	7
Specialised Banks	4
Microfinance Banks	8
NBFIs	**161**
Development Finance Institutions	7
Investment Banks	9
Leasing Companies	11
Modaraba Companies	27
Housing Finance Companies	2
Mutual Funds	102
Venture Capital Companies	3
Insurance Companies	**45**
Non-Life Insurance Companies	***32***
Domestic Private	29
Foreign	2
State-owned	1
Takaful	***5***
General Takaful	3
Family Takaful	2
Life Insurance Companies	***7***
Domestic Private	4
Foreign	2
State-owned	1
Reinsurance Company	***1***
State-owned	1

Source: SBP-FSR 2008-09

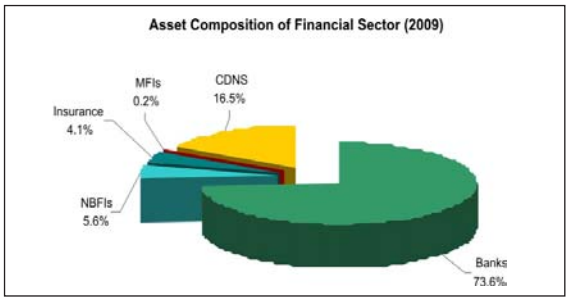
Banks dominate with an asset share of over 73% of the total industry's assets while as a percentage of GDP, banks' stood at over 46%. Among 48 banking institutions supervised and regulated by the central bank include 4 nationalized commercial banks, 25 domestic private commercial banks, 7 foreign banks, 4 specialized banks and 8 microfinance banks.

This also includes Islamic commercial banks[11]. Top five banks account for 50% share of the market[12]. Domestic private banks account for 76.1% of deposits and 74.6% of assets as on 2009[13]. As per World Bank Access to Finance data for 2009, the total number of banks' branches in the country are 9,050 out of which 6,349 (70%)are located in urban centres. The value of commercial banks deposits and loan as a % of GDP stood at 37.6% and 26.9 % respectively[14].



Source: IMF and SBP

All banks except state banks maintain Capital Adequacy Ratio (CAR) well above the international benchmark of 8%. Low interest rates prevailing until a couple of years together with aggressive action towards consumer finance[15] have increased credit portfolios and hence the profitability of the banks. Intermediation costs have stayed stable, while interest rate spreads have been on the increase. However, the increase in profitability has not given financial institutions much incentive to move from urban market to rural areas. By the end of July-2010, the credit to private sector business stood around 37% of GDP. Out of total private sector credit, 55.6% were allocated to manufacturing sector (Textiles has a share of 37.2% in total manufacturing sector credit and 20.7% of total private sector credit), followed by commerce and trade (10.2%), electricity, gas and water supply (9.8%) and agriculture, hunting and forestry (7.6%)[16].



Source: IMF and SBP

The Central Directorate of National Savings (CDNS) currently known as National Saving Organization (NSO) is as an apex government body that mobilizes domestic savings on behalf of the government through national saving schemes through its 368 nationwide branches. Pakistan Post also provides different deposit and money transfer services to the public through its 13,000 branches all over the country.

The Non-Banking sector is composed of Non-Bank Financial Institutions (NBFIs) such as development finance companies, investment banks, leasing, mutual funds and insurance companies. These institutions are regulated and supervised by the SECP. In 2009, there are 233 NBFIs in operations including development finance institutions, life and non-life insurance companies, Modaraba companies, investment banks, leasing companies, mutual funds, housing finance companies and discount house[17].

The insurance sector is also regulated by SECP. At present of the total 45 insurance companies, 32 in non-life insurance, 5 in Tafakul, 7 in life insurance and 1 state owned company in re-insurance . The insurance sector is highly concentrated; three companies command 80% of the general insurance market. Eastern Federal Union (EFU) General Insurance claims the largest market

11 As of Dec 2007, there are 18 banks involved with Islamic banking with 6 of them being full-fledged Islamic Banks
12 March 2010, 5 top banks account of 49.9%, 6-10 for 22.7%
13 SBP Financial Stability Review 2008-09
14 CGAP Financial Access 2009
15 Consumer lending increased by 320% in terms of borrowers and 500 % in terms of loan amount between 2003-07

16 SBP data on credit/loans classified by borrowers available at www.sbp.org.pk
17 Financial Stability Review 2008-09

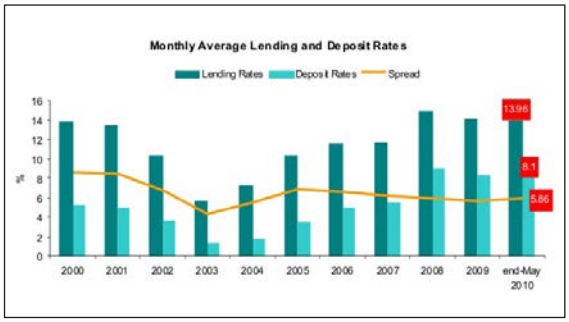
share (33%), followed by Adamjee Insurance Company (30%) and New Jubilee Insurance (10%).

The microfinance sector comprises Microfinance Banks (MFBs), specialized microfinance institutions (MFIs), NGOs and the Rural Support Programmes (RSPs). The Microfinance Banks are licensed, regulated and supervised by SBP under specially laid down prudential rules and regulations. MFIs are those NGOs which provide only microfinance services to their clients. They are not allowed to mobilize deposits from the general public but they can mobilize savings from their clients and they also often provide insurance services bundled with credit. NGOs and RSPs are providing microfinance services as part of their multidimensional activities.

Market capitalization to GDP is currently just under 48%[18]. For the 2009-10, the Karachi Stock Exchange (KSE) has a market capitalizaiton of USD 34.6 bn with an average daily turnover of USD 58 mn. The leading sectors of the market includes chemicals, travel and leisure, financial services, banks, construction and materials, Oil and gas and telecommunications.

INTEREST RATES

In Pakistan, the leading policy rate is called the SBP Reverse Repo Rate and movements in this rate transmit to the interbank market and the KIBOR (Karachi Inter-Bank Offered Rate of Different Tenures). The SBP policy rate is also the maximum ceiling for the interest rates for the inter-bank overnight transactions.



Source: SBP

KIBOR based rates are the leading interest rate indicators for short to medium tenure lending and borrowing in the banking sector.

The SBP policy rate reached its peak of 15% during November 2008 due to rising inflation, but subsequently reduced gradually and currently stands at 12.5%[19]. The lending rates have declined during the last year due to the continuation of the easy monetary policy stance. Banks have also cut the deposit rates from its peak level of 6.7% in March 2009 to 6.1% in March 2010, in order to avoid a fall in their profits. The interest rate spread remains above 7%. A higher interest rate offered by government on its national saving schemes have been a factor of distortion in interest rate structure and recently different steps have been taken to rationalize the return on these assets.

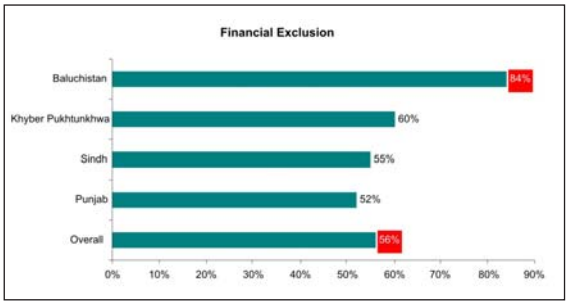
FINANCIAL EXCLUSION

Even though the financial sector has grown impressively in the last decade, a large proportion of the poor population does not use formal financial services. According to various estimates made in the recent past by ADB, World Bank, Pakistan Microfiannce Network (PMN) and SBP, only 11% of the adult population use formal financial services[20].

18 Market capitalization data for 2nd September 2010 from KSE (website accessed on 6-9-2010).

19 The last time it was changed to 12.5% was during November 2009

20 As per PMN Access to Finance (A2F) survey, around 56% of population in Pakistan is excluded from the mainstream financial services. Only 11% people have access to formal financial services and 32% have access to informal financial services



Source: PMN

According to SBP, the banking sector is serving only around 6 mn borrowers (3.6% of the population) compared to 25 mn (15% of the population) depositors. Only 25% of total bank depositors and 17% of total bank borrowers are from rural areas. On average there is only one bank branch to serve 20,000 peoples. There are in total 7.5 commercial banks branches per 100,000 adults in the country which are mostly based in urban areas.

In order to promote financial inclusion, the government and SBP have launched various initiatives. A key initiative is the Financial Inclusion Programme launched with the support of Department for International Development (DFID) in 2008. Other initiatives undertaken towards financial inclusion are the national level Microfinance Strategy to reach 3 mn microfinance clients by 2010 and 10 mn by 2015 with focus on commercialization, the Annual Branch Licensing Policy (obliging all commercial banks with 10 branches or more to open at least 20% of their branches outside big cities), the Basic Accounts Policy (requiring all commercial banks to offer a Basic Banking Account targeted at low income groups), promotion of branchless banking and the promotion of the Post Office Network for providing financial services.

MICROFINANCE SECTOR

HISTORICAL EVOLUTION

During 1980s, the success of the Agha Khan Rural Support Programme (AKRSP) through Community Based Organizations (CBOs) and the Orangi Pilot Project led to the paradigm shift in thinking about addressing the issue of poverty in the country through financial services. In the 1990s, a number NGO-MFIs joined the already existing institutions and therefore contributed in paving the way for the development of policy infrastructure for the microfinance industry in the country.

However, a turning point in Pakistan's microfinance sector came in 1996 when microfinance was recognised as a specialised activity and not just a part of multidimensional poverty alleviation programmes. Besides the formation of many specialised microfinance institutions during the same period, another important step was the establishment of the Microfinance Group-Pakistan in 1998, which later on evolved into a full-fledged meso-level institution, known as Pakistan Microfinance Network (PMN). During 2000, with the help of international agencies, the Pakistan Poverty Alleviation Fund (PPAF) was created as an apex body for wholesale lending to the MFIs.

These developments influenced the government in acknowledging the value of the microfinance sector as an effective poverty alleviation tool in the key government strategy document, 'Poverty Reduction Strategy Paper'. Following this, an important policy step was taken by introducing the Microfinance Ordinance in 2001 that established a separate legal and regulatory framework to promote formal microfinance institutions in the country known as Microfinance Banks (MFBs).

This is widely recognized in literature as the beginning of the commercial era of the microfinance sector in Pakistan. Though the Khushali Bank (KB) was already established under a separate ordinance in 2000, the first

private sector MFB came into being during 2002 by transforming the AKRSP microfinance operations into the First Microfinance Bank Limited (FMFBL). This also heralded the beginning of the NGO-MFIs transformation into MFBs in Pakistan.

TYPES OF MFIS

Presently the microfinance sector has microfinance providers (MFPs) categorized into five peer groups by the industry network PMN as MFBs, RSP, specialised MFIs, multi-dimensional NGOs providing microfinance services, and others.

Existing Legal Framework in Microfinance Sector in Pakistan	
Form of Registration	**Regulatory Authority**
The Voluntary Social Welfare Agencies Ordinance 1961 (the " Social Welfare Ordinance")	Provincial Registration Authorities
Societies Registration Act 1860 ("the Societies Act")	Provincial Registration Authorities
Trust Act 1882	Provincial Registration Authorities
Section 42 of The Companies Ordinance 1984 (the "Ordinance")	Security and Exchange Commission of Pakistan (SECP)
Microfinance Institution Ordinance 2001	State Bank of Pakistan (SBP)

The MFBs are licensed, supervised and regulated by SBP and are part of the formal banking industry and therefore are licensed, regulated and supervised by the central bank. The central bank has issued separate prudential guidelines for the MFBs. The prudential regulations are issued under the guidance of the Pakistan Microfinance Ordinance 2001 and have set different criterion for microfinance banking operations with respect to paid-up capital, CAR and maximum exposure to single borrower, group etc.[21] The SBP has allowed a separate set of parameters to establish microfinance banks such as :

- Nation-wide MFBs with minimum paid up capital of Rs 500 mn (USD 5.88[22] mn)
- Province-wide MFBs with minimum paid up capital of Rs 250 mn (USD 2.94 mn)
- District-wide MFBs with minimum paid up capital of Rs 100 mn (USD 1.18 mn)

Out of total 8 MFBs, Rozgar Microfinance Bank and Network Microfinance banks are district wide institutions while the rest are in country wide operations.

The non-bank MFPs (Specialized MFIs, NGO-MFIs and RSPs), are registered with SECP under the Companies Ordinance 1984 or Societies Registration Act 1860 or Trust Act 1882. The non-bank MFPs largely remain unregulated and for this reason are prohibited from providing a full range of financial services.They cannot mobilize deposits from the general public. There is no specific notification by SECP or SBP forbidding non-bank MFPs to mobilize savings from member, and non-bank MFPs are indeed offering saving services to their members, however, the SBP have in recent past have take a negative view of this practise. Non-banks MFIs are negotiating with the SBP to allow them to take deposits, but so far SBP is reluctant to give such permission to non-bank MFIs[23]. The SBP has encouraged these institutions to transform into MFBs and recently two of the largest MFPs have transformed as MFBs, Kashf has already completed the process while NRSP in underway.

The SBP has also issued guidelines pertaining to NGO-MFIs transformation to full-fledged MFBs and guidelines for commercial banks to start microfinance business along with credit guarantee facilities for commercial banks for onward lending to MFIs in the industry. However very few commercial banks provide microfinance services, with First Women Banks and the SME bank among exceptions. The SBP has issued regulations allowing

21 Microfinance banks are required to have CAR of 15% of risk-weighted assets while the commercial banks are required to have CAR of 8% of risk-weighted assets with paid up capital of USD 82.1 mn (Rs 7 bn). MFBs are allowed to have maximum exposure USD 1,758.8 (Rs 150,000) to single borrower under General Loans while under Housing loans, MFBs can lend up to USD 5,863 (Ra 500,000)

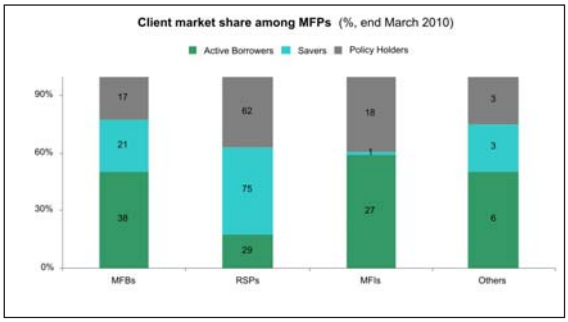
22 USD = Rs 85

23 Please note that savings mobilized by non-bank MFPs do not reflect in the balance sheet of MFPs. Non-bank MFPs deposit, such receipts in the commercial banks

banks to open microfinance windows, but no banks have yet demonstrated an interest in extending their services down-market.

Among PMN members, 8 are MFBs, 5 RSPs, 8 are specialized MFIs and rest 12 are in other categories.

As per their legal status, all MFBs, 4 RSPs[24], three specialized MFIs[25] are registered as Section 42 companies. The rest are registered under Societies or Trust acts under various provincial registration authorities.



Source: PMN

Under section 42, the institutions are allowed to register as NGO or NBFIs. The later called for specialized operations such as insurance, leasing or investment companies while registration under NGO section allow to carry on multidisciplinary operations along with microfinance. Also NBFIs by regulation are not allowed deposit mobilization and non-specialized activities other than those for which they are registered for.

As per latest data available for March end 2010, RSPs lead in number of savers and insurance policy holder while MFBs have largest share in active borrowers. However, there would be significant shift in the market share of MFBs from 45% to 55% when NRSP's transformation to MFB is complete. The shift in favor of the MFB peer group would continue in the following years culminating in a final 60-40 split in market share by 2015 between MFBs and non-MFBs[26].

MAJOR HIGHLIGHTS OF THE SECTOR

OUTREACH

The microfinance industry has remarkably reached to 1.9 mn active borrowers from an almost negligible base in 2003, out of which nearly half are female clients. The present set of microfinance providers who are members of PMN[27], reach over 1.9 mn clients as borrowers with GLP of Rs 23,354 mn (~ USD 276.9 mn), 2.7 mn as savers with net savings of Rs 8,354 mn(~ USD 99 mn) and 3.9 mn as insurance clients with sum insured of Rs 54,823 mn (~ USD 649.9 mn).

However, despite this high growth rate, the penetration rate is very low at around 7% where potential microfinance clients are over 27 mn. Penetration rates are high in populated states of Punjab (69.7% of active borrowers) and Sindh (22.3% of active borrowers).

24 NRSP, PRSP, SRSP, TRDP
25 Asasah, Kashf Foundation and ASA are registered under section 42 while SAFWCO is under transformation process

26 PMN MicroWatch 15, Jan – March 2010
27 PMN has 26 Microfinance Providers (MFP) as members representing over 90 % of clients and GLP. While there are numerous small NGOs spread across country, providing microfinance program in the country, their outreach is very small. This publication only provides data from MFPs who are members of PMN

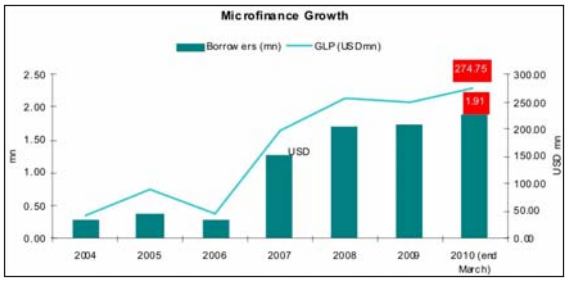
Microfinance Outreach, March 2010								
Province	**Active Borrowers**	**Gross Loan Portfolio (USD mn)**	**Active Savers**	**Value of Savings (USD mn)**	**Policy Holders**	**Sum Insured (USS mn)**	**Potential Microfinance**	**Penetration Rate**
Baluchistan	16,041	1.5	44,570	0.3	10,360	1.2	1,656,762	0.97
Khyber Pakhtunkhwa	90,134	9.5	199,157	5.3	60,732	7.6	4,083,817	2.21
Punjab	1,331,507	195.0	1,613,237	25.0	3,160,779	533.0	15,233,924	8.74
Sindh	426,430	63.7	646,921	52.4	600,134	91.1	6,357,795	6.71
AJK	23,595	2.2	154,871	0.7	62,022	11.9	-	-
FANA	17,386	4.3	47,503	10.5	17,386	4.3	-	-
FATA	2,005	0.1	-	-	50	0.0	-	-
ICT	2,002	0.5	14,708	4.8	2,053	0.7	74,750	2.68
Total	**1,909,100**	**276.9**	**2,720,967**	**99.0**	**3,913,516**	**649.9**	**27,407,048**	**6.97**
Source: PMN MicroWatch Issue 15 Jan-March 2010; for end-March 2010: 1 USD = Rs 84.35								

NRSP, Khushali Bank (KB) and Kashf remained the market leaders in terms of both active borrowers and GLP, holding together about 60% of the market. NRSP has the largest market share (22.8%) in terms of active borrowers, followed by KB (20.1%), Kashf (16.2%), FMFBL (11.9%) and TMFB (4.2%). Similarly, in terms of geographic spread, KB covers 80 districts, NRSP 51, FMFBL 46, TMFB 29 and Kashf 25 districts[28].

As per latest estimates for March 2010, 55% borrowers are rural and female clients.

GROWTH

In the five years between 2004-2008, the microfinance sector grew at a Compounded Annual Growth Rate (CAGR) of 67%. Since then growth in the sector has slowed a bit and in 2009, the active borrowers in the microfinance industry increased only by 5% with a 16% increase in Gross Loan Portfolio (GLP), however, active savers and insurance policy holders in the industry continued to show remarkable growth. In 2008-09, savers and saving grew by 35% and 59% respectively, while insurance policy holders and sum-insured increased 48% and 27% respectively. The first quarterly data for 2010 also shows substantial growth in the number of active savers and insurance policy holders.



Source: PMN

28 MicroWatch 15, Jan – March 2010

	2004	2005	2006	2007	2008	2009	March -2010
Active Borrowers	278,939	373,617	282,009	1,267,209	1,695,421	1,729,734	1,909,100
GLP (US$'000')	43,296	91,036	44,917	196,154	256,426	249,889	274,753
Total Staff	1,695	2,335	2,506	9,529	11,039	13,474	13,474
OSS (%)	48.45	59.39	24.49	76.72	82.28	94.1	-
PAR>30 daya (%)	10.9	5.1	2.5	3.1	2.1	1.9	-

Source: PMN

Microfinance Growth						
	2008	2009	Change	Q4: 2009	Q1: 2010	Change
Micro Credit Active Borrowers (mn)	1.73	1.83	5%	1.83	1.91	5%
Value (USD mn)	223	258	16%	258	277	7%
Micro Savings Active Savers (mn)	1.74	2.35	35%	2.15	2.72	26%
Value (USD mn)	64	102	59%	102	99	-3%
Micro Insurance Policy Holders (mn)	2.24	3.31	48%	2.09	3.91	88%
Sum Insured (USD mn)	408	517	27%	517	650	26%
Source: PMN MicroWatch Issue 14 Annual (Jan-Dec) & Issue 15 (Jan-Mar 2010)						

PRODUCTS

Savings: As MFBs are authorized to mobilize savings other than credit, their product profile also includes full fledged financial products including different saving products catering to the needs of people with differing income levels. Non-bank, MFPs mostly mobilize voluntary or compulsory savings from their clients and as per law, they are not allowed to hold or intermediate deposit from the public.

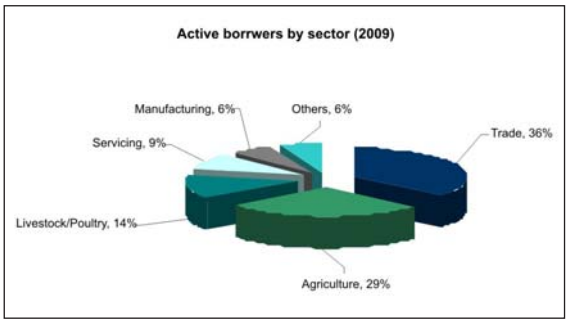
According to the latest SBP Development Finance Review for June 2010, MFBs deposits increased by 46% (year-on-year) basis and underscore the importance of self funding among the MFBs. The composition of deposits further reveals the dominance of fixed deposits with a share of 55% in overall deposits, followed by Profit and Loss Sharing (PLS) [29] and current accounts with a share of 22% and 24% respectively. According to latest issue of MicroWatch, average saving amount is Rs 3, 607 per saver, with high of Rs 13,987 for saving under intermediation and Rs 626 under mobilization.

Credit: The majority of lending is either individual or group lending based on conventional and Islamic microfinance models. The repayments begin more or less immediately and repayments are made generally on a weekly or bi-monthly basis. According to the latest estimates for January to March 2010, group methodology accounted for 89% of borrowers and 85% of GLP. The average loan size for group lending is Rs 15,812 (USD 186) while for individual loans it is Rs 24,308 (USD 286). The individual based lending is generally availed by productive small-scale business people for working capital. Mostly the sector offers a general loan or an agricultural loan of just under USD 200 for a year. The most common use of loans is for trade (36%), agriculture (26%), livestock (15%) and manufacturing (7%).

29 Profit and Loan Sharing deposit are based on Islamic principles and many commercial banks also offer this product

The most recent quarterly data for 2010 shows a decline of 3% in the agriculture sector share in active borrowers while the share of livestock/poultry sector active borrowers has increased by almost 1% basis points reaching to 15% share.

Recently, the sector is seeing product diversification. For example, Akhuwat offers microfinance loans based on Islamic principles to its clients along with business development, insurance and health related services while a few MFIs such as CWCD, Asasah and SAFWCO are offering asset based lending through Islamic financial instruments such as Modaraba, Murabaha etc. Recently the FMFBL signed an MoU with Agha Khan Planning and Building Services to launch microfinance housing loans for poor people. FMFBL also in partnership with Pakistan Post Office is offering its microfinance products though Post Office network of branches to poor clients.



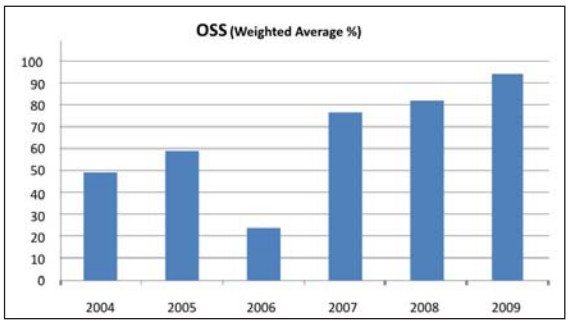
Source: PMN

Insurance: Many MFIs have clubbed micro insurance products with their credit products. Among insurance policies, 57% are health policies while rest are life insurance policies.

Leasing: Some MFIs also offer micro leasing products for the purchase of equipment or vehicles and loans for education purposes or for school building.

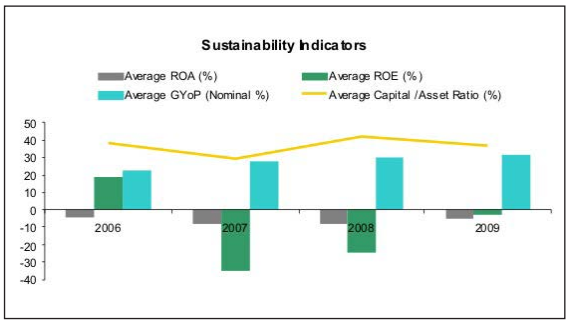
SUSTAINABILITY

On the sustainability front, the microfinance industry in Pakistan is still striving hard. The industry average for financial revenue/asset ratio stood just above 80% with an increasing trend during 2009. The average operating expense/asset ratio was stable around 20% for the whole industry but its average operating expense/loan portfolio did increase from 33% to 44% during 2009. Based on the MFI reporting to the MIX Market for 2009, the success of the sustainability strive has been constrained by rising delinquency profile of the industry during 2009 with a record write-off ratio of about 15% (showing over 100% increase from the previous year's level of 7%)[30].



Source: PMN

The ratio of gross loan portfolio to total assets in USD terms stood at 49%.



Source: Mix Market

MESO LEVEL INFRASTRUCTURE

The Pakistan Microfinance Network (PMN) is a registered network of MFPs in Pakistan representing over 95% of the sector outreach through its members. The network is significantly contributing to the sector through in-

30 The average has been calculated by taking year's wise average for each indicator, reported by Mix Market data

dustry benchmarks for transparency, performance indicators, capacity building support, research and advocacy for policy support and networking with national and international stakeholders. Its efforts as a network have been widely recognized domestically as well as globally[31]. A few provincial level networks are also operating in the country but except for Sindh Microfinance Network that was established through the efforts of the local NGOs, others have failed to move forward.

PMN in collaboration with SBP and other industry stakeholders recently established the Credit Information Bureau (CIB) for the microfinance industry in the country. The CIB is in its nascent stages and its operations have been taking place on a pilot project basis only in Lahore , however, it is expected to include all PMN members in future.

The only microcredit rating company in the country is the JCR-VIS which is a joint venture between Japan Credit Rating Agency Limited (JCR) and Vital Information Services (Pvt.) Limited (VIS) and which provides ratings for the MFBs and MFIs. MFBs under the regulation of the SBP have to rate themselves in order to ascertain their standing relative to standard benchmarks. Some MFIs also rate themselves to improve their transparency and to have access to commercial funding.

The Pakistan Poverty Alleviation Fund (PPAF) is the only apex wholesale funding body in the country established by the government. Currently there are six multilateral, bilateral and international institutions, which are funding PPAF activities in the country. The PPAF has been making disbursement through its different windows of operations such as lending for micro credit and enterprise development, community physical infrastructure, health and education, human and institutional development, social mobilization and rehabilitation and reconstruction[32]. The funding under micro credit and enterprise development comprised about 74% of its total funding. By June 2009, the PPAF has disbursed around USD 996 mn to different MFIs. The main beneficiaries of PPAF funding are RSPs, MFIs and NGOs, though the share of RSPs in terms of access to PPAF funding has been declining gradually to around 32% in 2009 as compared with its share of around 92% and 74% in total funding provided by PPAF during 2001 and 2002 respectively[33].

There are different technical assistance (TA) providers in the form of individual consultants, small consultancy firms and a few renowned institutions who are involved in providing consultancy and capacity building services. Among these institutions are Lahore University of Management Sciences, Social Enterprise Development Centre (LUMS-SEDC), ShoreBank Internaitonal and National Institute of Banking and Finance (NIBAF), a subsidiary of SBP.

COMPETITION

Before 2000, the microfinance sector was viewed as commercially un-viable and therefore there was no competition in a grant driven atmosphere. The promulgation of the Microfinance Ordinance in 2001, the establishment of new MFBs, and the setting up of the regulatory framework gave a new direction to the microfinance sector and underscored the commercial viability of the sector in the country. This in turn led to competition among the MFPs to achieve scale and gain access to commercial and socially-driven funds and revise their business strategies in order to reach more potential microfinance clients.

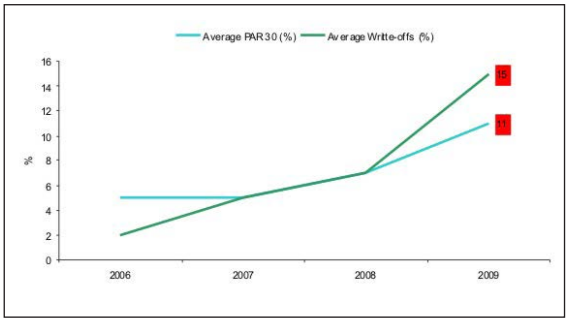
The competition can be observed in highly penetrated areas in Punjab and Sindh. In order to have expanded client outreach, the institutions compete with new and innovative products and services and different client

31 PMN was awarded best network of the year award by SEEP in 2009
32 PPAF Annual Report 2009
33 PPAF Annual Report 2009

mobilization strategies. Due to the absence of a regulatory set up for MFIs and weak credit information sharing systems in the industry, the competition is aggravating the already high risk profile of the microfinance industry by increasing the multiple borrowing and average loan sizes.

RISKS

The industry specific risks include macroeconomic shocks in the form of weak economic fundamentals, high inflation, energy failures and economic shocks created by natural calamities such as earthquakes and floods. These in turn affect the livelihood and income level of the rural and urban poor differently, therefore affecting the portfolio quality of the MFIs.



Source: Mix Market

The concentration of microfinance market is another risk as much microfinance activities are taking place in Punjab and Sindh with a lower penetration in Khyber Pakhtunkhwa [34] and Baluchistan. This high concentration encourages multiple borrowing in the market.

Since unregulated MFIs are not entitled to mobilise deposits, they have to seek funding through donors or commercial channels. Given that most of the institutions still haven't reached performance standards to attract the commercial capital and find it extremely difficult in having access to funding other than PPAF. This lack of funding poses a potential threat to microfinance industry performance in terms of achieving social and commercial viability.

In late 2008, a few MFIs in central part of Punjab province in semi-urban areas adjacent to the provincial capital of Lahore were hit by a wave of borrower groups refusing to repay their loans in late The impact was initially concentrated in one MFI, but later spread to couple of other MFIs working in same areas resulting in a sharp rise in PAR in 2009, and it is likely that at least three MFIs lending in this same region now face significant repayment difficulties. A number of internal and external factors such as week internal controls, loan waiver proclamation by a local politician, and the spread of false loan waiver news gave momentum to the mass default. This clearly illustrate how concentrated lending and competition, particularly when introduced rapidly, can diminish incentives to repay and can weaken the risk-mitigating effects of MFI. Subtle changes in repayment incentives and amounts of borrowing can change market dynamics and potentially lead to repayment crises[35].

The recent devastating flooding in the country not only led to human casualties but also resulted in wide scale human displacements and damaged crops, livestock, rural infrastructure and affecting over 17 mn people and 1.38 mn acres of agricultural land (30% of agricultural land). Of the total 124 districts, 79 districts are severely affected by the floods. This has direct impact on rural clients as most of the MFIs have been lending to the people attached to the farm sector in one way or other. There could be a possible impact on urban clients as wel if food shortages arise and kick up inflation. Though the farm experts are of the opinion that the fertile layer will result in good yields in the coming year but for the time being the microfinance sector would see a rise in delinquency ratio in months to come[36].

34 Earlier known as North West Frontier Province

35 CGAP Growth and Vulnerabilities in Microfinance, June 2009

36 ADB & World Bank would lead the assessment of the floods impact. IMF has approved USD 450 mn emergency assistance while the World Bank has approved USD 1 bn assistance. ADB also pledges over USD 2 bn for flood relief

According to the PMN, the recent floods have adversely affected four out of ten borrowers of a small loan which will lead to the writing off of almost 11% of the microfinance institutions' balance sheets. The preliminary estimates show that recent floods have affected 733,000 clients and will result in a write-off of Rs 2.7 bn (USD 32 mn) worth of loans and would require Rs 5.1 bn to offset the impact of the written-off loans and to give new loans to affected individuals. It is estimated that out of Rs 25 bn, Rs 8 bn of microfinance loans were disbursed in those areas which have been adversely affected by the floods.

REGULATIONS

Regulation in Pakistan is relatively a nascent phenomenon and applies only to MFBs which are licensed by the Central Bank and can provide full-fledged financial services to their clients. Other than MFBs the microfinance sector in the country is unregulated and for this very reason they are not allowed to provide a full range of financial services.

The Central Bank has been encouraging these MFIs to transform themselves into MFBs and has issued regulatory guidelines and assists them through funding for institutional restructuring and achieving sustainability. The regulations allow the MFBs to provide full fledge financial services to their customers including having access to cheap funding in the form of deposit mobilization form the general public. From the financial stability point of view, the MFBs in Pakistan are required to keep 15% of CAR for which they are also allowed to raise subordinated debt in the local currency. The equity requirements vary with respect to extent of geographical spread such as operations at district level, province level and country level. Moreover, the MFBs are required to keep general provisioning at 1.5% net of outstanding advances along with specific provisioning with a write-off of loans after one month of it being categorized as loss (the loss category requires 100% specific provisioning).

A number of regulations and guidelines, pertinent to microfinance sector, issued by the Central Bank are[37], Microfinance Ordinance 2001, Microfinance Prudential Regulations for MFBs, Branchless Banking Regulations, Guidelines for commercial banks to undertake microfinance business, Prudential regulations for commercial banks to undertake microfinance business, Fit and proper criteria for CEOs/member of boards of MFBs and MFIs/NGOs transformation guidelines among others. The SBP regularly updates and revises these regulations from time to time through various circular letters.

FINANCING

The primary funding sources for MFPs in Pakistan are grants or concessional loans, commercial loans and client deposit with significant dependence on donor funding mostly from PPAF, ADB and DFID.

In 2008, savings, equity and borrowing account for 15%, 23% and 62% of total assets respectively[38]. PPAF roughly owns 50% of all micro-credit given out in Pakistan. Most donor funds in Pakistan are channeled through the PPAF with the exception of a small percentage of donors who loan out directly to various MFP. The commercial borrowing in low at 15% of gross loan portfolio.

Savings: In the context of funding requirements of MFPs, savings and consequently deposit mobilization will need to grow at a substantial rate in order to meet the growing funding needs of MFPs. This is an arduous task given currency high inflation in the country that have negative impact on the available pool of deposits that could be mobilized from the market as a greater percentage of income is devoted to expenditures rather than savings.

37 Source: SBP, PMN & CGAP/IFC State of microfinance in Pakistan 2009
38 Estimated funding shortfall in Paksitan Microfinnace Indisutry 2010-215, PMN, July 2010

Industry Finance Structure				
	2005	2006	2007	2008
Total Assets (USD mn)	160	209	273	396
Gross Loan Portfolio (USD mn)	68	100	153	239
Deposit and Voluntary Savings (USD mn)	8	17	35	49
Deposits to total assets (%)	5.2	8.6	12.7	12.3
Deposit to Gross Loan Portfolio (%)	12.3	17.9	22.7	20.5
Source: PMN				

PPAF: PPAF was established in late 1990s by the World Bank. The Bank's previous engagement under PPAF-I (USD 90 mn) and PPAF-II (USD 238 mn) were more focused on microfinance, technical assistance and infrastructure development. The financing under the on-lending facility has been provided by the World Bank under PPAF-III (USD 33 mn) for the period 2009-2013. PPAF currently has a differentiated interest rate policy with regard to its partner organizations. Funding to NGOs took place at a fixed rate of 8% while funding to private sector leasing companies were provided at a flat rate of 10%[39]. To move towards a market rate based lending mechanism, PPAF has recently linked its interest rates to the interbank rates and for the MFIs having a particular exposure limit (Rs 500 mn), the rate charged by PPAF would be linked with KIBOR[40]. With these loans now being pegged with the KIBOR (around 13% in August) this will greatly impact the cost of PPAF borrowing in Pakistan. It is also expected that such a move by PPAF towards market interest rates will push the MFIs to pass on the cost to the clients and therefore their sustainability would improve as well.

PPAF can not provide loans to MFBs since PPAF requires MFI/MFBs to give a charge on their loan book, and as per the prudential regulations for MFBs, they cannot give such a charge unless approved by the central bank. The PPAF offers a one year line of credit for microfinance providers. This credit line requires the pledge of loan portfolios, which leaves only NGOs and RSPs eligible for this financing as MFBs can not pledge their loan portfolio as per Prudential Regulations for MFBs.

PPAF is also implementing a number of other programs such as:

Program for Increasing Sustainable Microfinance (PRISM): This is the IFAD-funded program designed to provide leveraging capacity to sustainable PPAF partner organizations through cash collaterals, letter of credit and direct guarantees to commercial banks. But this project has not yet taken off due to liquidity constraints in the market.[41] Under the guarantees, IFAD has provided a guarantee worth USD 31.1 mn to PPAF for the period 2007-2011. Under equity financing, IFAD established the Equity Fund worth USD 7.4 mn for the period 2007-11 for the PPAF under the programme for Increasing Sustainable Microfinance (PRISM) to facilitate sustainable growth in the microfinance sector. PRISM was launched in July 2008 was centered on accessing significant amounts commercial funds, with commercial debt replacing subsidized debt in large measure.

Microfinance Innovation and Outreach Program (MIOP): PPAF in collaboration with IFAD has also designed and implemented the USD 30 mn MIOP to enhance the outreach of partner organizations to the poor. MIOP has a particular emphasis on new microfinance product schemes and market access initiatives. According to PPAF, so far about USD 1.2 mn has been disbursed under MIOP's Innovation and Outreach component. Another component of MIOP is the Young Partner Program (YPP) under which new microfinance institutions in the rural areas are financed to support their growth.

39 State of Microfinance in Pakistan 2009, InM
40 PPAF Annual Report 2009
41 Ibid

The SBP is also implementing a couple of program to increase the outreach of microfinance sector in the country.

Improving Access to Financial Services (IAFS): ADB has set up an endowment fund worth USD 20 mn with SBP for 20 years to be utilised for training and capacity building under the project.

Institutional strengthening Fund (ISF): DFID has provided grants worth £10 mn (approx USD 15.4 mn) to SBP.

Microfinance Credit Guarantee Facility (MCGF): DFID has also provided guarantees worth £10 mn (approx USD 15.4 mn)[42] to SBP. MFBs and those MFIs who are in their transformation phase are eligible for financing under MCGF[43].

Commercial Funds: in Pakistan, the commercial funding is scarce and MFPs are unable to tap funds from the formal banking sector due to several institutional, and market related reasons. Though some of the Tier-I MFPs have access to commercial banks' funds; this is available only for working capital needs with a very low maturity period. According to the MIX Market, all financing in the microfinance sector in the last few years were from development programs and took place in the local currency with a fixed interest rate in the range of 6-9% per annum. Medium-to-long-term debt funding is available on a limited basis and banks are hesitant to lend to microfinance providers because of their lack of knowledge about the sector but also because MFPs are not profitable and lack lengthy track records. For MFBs, they cannot access commercial debt by pledging their assets or loan book without prior permission of the SBP.

A typical MFP borrows at a rate of 13-15% per annum from commercial loans, making it a very expensive form of financing for MFIs and underscoring the needs to tap into the deposit market.

In the funding structure of MFPs[44], the commercial liabilities are limited to very few MFIs. For example in the case of MFBs, only Khushhali Bank and Tameer Microfinance Bank have commercial liabilities and the average 'commercial liability to GLP' ratio for all MFBs taken together is 13%. For RSPs, only National Rural Support Program (NRSP) and Punjab Rural Support Program (PRSP) have commercial liabilities and the average 'commercial liability to GLP ratio' for all RSPs is 21.4%. For NGO MFIs, only Orangi Pilot Project and ASASAH have commercial liabilities and for this group of MFIs 'commercial liabilities to GLP' the average is 28.2%. This clearly shows that not much commercial debt has come to MFPs.

MARKET GAPS AND CHALLENGES

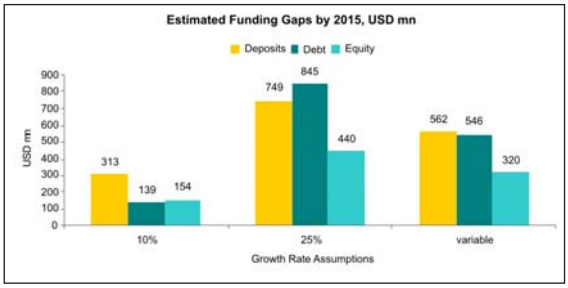
The current outreach of the microfinance industry stood at 1.9 mn active clients with overall penetration rate of 6.7%. On the contrary, there are 27 mn potential microfinance clients in the country. Punjab has the highest potential clients (15 mn), followed by Sindh (6.4 mn), Khyber Pakhtunkhwa (4.1 mn) and Baluchistan (1.7 mn)[45]. Other estimates highlight that there are approximately 9.7 mn poor households and 66.3 mn poor people in Pakistan, out of which 29.5 mn people are potential clients of credit[46]. Based on these estimates, the presence of unmet demand is apparent. To reach 3 mn people by 2010 and 10 mn by 2015 as planned by the government would therefore require not only significant up-scaling of the current level of services but also need an increase in the volume of funds.

Thus, if the microfinance industry grows at 10% annually, the total funding gap for 2010–2015 is estimated at Rs 50.77 bn (USD

42 1£ = USD 1.54
43 Funds for microfinance in Pakistan: an overview by PMN

44 PMN, Achieving Efficiency, Pakistan Microfinance Review, 2007
45 MicroWatch Issue 14, Annual (Jan-Dec 2009), PMN
46 State of Microfinance in Pakistan 2009 by Institute of Microfinance

0.6 bn). The gap increases to Rs 172.29 bn (USD 2.03 bn) at 25%. At a variable growth rate the funding gap is estimated at Rs 121.38 bn (USD 1.43 bn)3 . The incremental amount required through debt, deposit mobilization, and equity investments is shown in the figure.



Source: PMN

MICROFINANCE INVESTMENT

GENERAL INFORMATION

Pakistan has a liberal investment policy and the foreign investment is open in many sectors of economy including the financial sector. The foreign investment is protected by Foreign Private Investment (Promotion and Protection) Act, 1976 and Protection of Economic Reform Act, 1992. The GoP offers attractive investment packages and foreign equity's participation can be upto 100% in many sectors. The transfer of capital and profits are allowed.

The foreign investor has to consider Foreign Exchange Regulation Act, 1947. Under the Act, the regulations are issued by the government and the SBP in the form of notifications which are published in official gazette.

The corporate Income tax is 35%. Dividends are taxed at 10%. If a foreign or domestic debt investment is made in Pakistan, the interest payments will be subject to withholding tax of 10%. For a foreign entity the tax rate would depend on the terms of double taxation treaty between Pakistan and donor country of the foreign investment.

DOMESTIC DEBT INVESTMENT

LEGAL FRAMEWORK

As per the legal framework all legal forms of MFIs (Section 42 companies, Societies, Trusts and MFBs) can take debt from the domestic market. However, there are certain restrictions as well as regulations on lender, both on commercial banks and PPAF that makes lending to MFIs and MFBs rather limited.

For example, MFBs face restriction in accessing standard bank debt[47] since the commercial banks offering standard bank debt are not permitted to lend unsecured.

47 A type of debt offering syndication, credit lines and term loans

PRESENT SITUATION

While debt financing is considered critical for the future growth of the sector, MFPs find it difficult to raise because they can not pledge their loan portfolios or assets and therefore are left with unsecured and costly financing options. Further prohibition on unsecured bank lending in Pakistan and the requirement that banks have low spreads in deals with MFPs, this means there are few financing options available to MFBs. NGO MFIs, non-shareholding companies and MFIs formed under the company ordinance can have more debt financing since they may pledge their loan portfolio or other assets to add leverage to their capital structure.

Also it is important to note that Commercial Banks also face many constrains in lending to MFIs as they can not lend significant funds without security. Bank debt financing is priced at KIBOR plus 1 to 4%, with short maturity periods of 1-3 yearrs, with most coming for very short tenor. Indeed the commercial lending interest rates have been very high and are currently close to 15%.

Pakistan has witnessed high inflationary pressure in the recent past and this has been a prominent concern for MFIs operating in the country. Since the domestic economy is consumption-driven, any surge in prices driven mainly by the food prices has a substantial effect on the income and expenditure level of the MFIs clients. According to some estimates, around 45% of expenditure basket of MFIs clients are food related, followed by expenses related to utilities with a share of 27%. Additionally, the rising price level has resulted in stringent monetary policy and high policy rates, which in turn translates into higher cost of commercial loans for MFIs. This not only affects the cost of debt but also influence the availability of funds. Though, inflation on its own has limited impact on the equity investment, it carries indirect repercussions as it shakes investors confidence and therefore adversely affect the overall investment environment[48].

Term Finance Certificates (TFCs) are issued at either a fixed or variable interest rate. TCFs are regulated by the SECP and must follow certain procedures with an Information Memorandum. While the TFCs are the most flexible form of debt financing, available to all microfinance players, there are not many examples of MFIs taking this option to raise debt.

> Kashf Foundation signed a USD 8 mn Commercial Loan Facility, with a consortium of local Pakistani commercial banks in 2007. In this 3-year Commercial Loan Facility which Grameen Foundation provided partial risk coverage by way of a USD 2 mn Citibank Standby Letter of Credit in favour of the participating banks. Beside the USD 8 million Commercial Loan Facility arranged by Habib Bank Ltd (HBL), MCB Bank Ltd (MCB) and Citibank N.A. (Citi), Citibank has also been mandated by Kashf to arrange additional USD 14 mn of long term financing for Kashf whereas HBL and MCB are jointly executing another USD 8 mn term financing facility for Kashf through a Privately Placed TFC issue - the first private placement for a micro finance institution in Pakistan.

More recently SBP has been encouraging the commercial banks to provide funding to MFBs/MFIs to enable them to achieve outreach targets as the commercial banks have so far been reluctant to invest in the microfinance sector. As an incentive SBP issued MCGF for the commercial banks. In collaboration with a DFID grant of £10 mn (Approx USD 15.4 mn[49]) provided as a reserve, the SBP under this facility will provide Partial Guarantee or First Loss Default Guarantee up to a certain limit prescribed by the SBP to reduce the credit risk to banks/DFIs entering into lending arrangements with financially and socially sustainable MFBs/MFIs. The structure of the guarantee will enable MFBs/MFIs to borrow in the local currency.

48 PMN study on impact of food inflation and monetary policy on MFIs in Pakistan.
49 at 1£=USD 1.54

The leverage and risk-sharing provided to the banks under this facility is in the form of either a Partial Guarantee of 40% of the loss incurred on account of the principal outstanding or up to 25% First Loss Default Guarantee on account of disbursed principal only. Furthermore, SBP also provide an incentive in the form of Statutory Liquidity Requirement (SLR) exemption to funds under this facility. SBP has stipulated that the interest rate charged from the borrowing institutions under this facility should not exceed 2% over and above the prevailing 6-months KIBOR.

Tier-II Capital Allowance for MFBs by SBP:

SBP has allowed MFBs to raise Tier-II Capital including subordinated debt in order to help MFBs to leverage Tier-I capital and maintain a minimum Capital Adequacy Ratio (CAR) at 15%. The other conditions related to raising subordinated debt are;

- Subordinated debt can be raised from any person or entity preferably from sponsors in local currency only
- The principal and profit payments of the debt remain subordinate to all other indebtness of the MFB including deposits
- Rate of profit would be decided by MFB with clearance from SBP
- The loan should be unsecured, plain vanilla (The most basic and standard form of financial instrument, with a simple expiration date and strike price and no additional features), and subordinated as to payment of principal and profit to all other indebtedness of the MFB including deposits. I don't understand
- The loan should have an original fixed term to maturity of 5 years minimum
- The loan should not be repayable before the agreed date without approval of SBP. The MFBs are bound neither to pay principal nor interest even at maturity if such payments negativly affect MFB's CAR.

DOMESTIC EQUITY

LEGAL FRAMEWORK

The equity investments are governed by Microfinance Institutions Ordinance 2001, The Companies Ordinance 1984 and the rules and regulations as imposed by SECP. Given the non-profit nature of RSPs and NGO MFIs, the only legal form that is attractive for commercial equity investor is MFBs.

As per the Prudential Regulations for MFBs', "no less than 51% of the paid up capital shall be subscribed by the promoters or sponsor members and the shares subscribed to by the promoters or sponsor members shall remain in the custody of the State Bank and shall neither be transferable nor encumbrance of any kind shall be created thereon without prior permission, in writing, of the State Bank'. Hence only 49% private equity investment could come to MFBs. Further, the maximum equity which a commercial bank can acquire in listed shares of a company or a MFB can not exceed 5% of its paid up capital.

PRESENT SITUATION

The formation of MFBs have given major push to equity market into microfinance sector in Pakistan. The MFBs have got the attention of many equity investor and MFBs such as Khushhali Bank, First Microfinance Bank, Pak-Oman microfinance banks, Rozgar Bank and Tameer Bank have received equity investment. However, so far commercial banks have been major players in the domestic equity market for the MFBs

The capital adequacy requirement for MFBs is 15%, and projections show that this will be a constraint very soon. Similarly, for NGO MFIs, the capital constraint is much higher since they are considered as manufacturing concerns by the banks and not as financial institutions, and hence cannot leverage their balance sheet more than four times (Financial Institutions can leverage upto 6 times). There will be the need for more equity capital which could partly be met by retained earn-

ings (if MFIs/MFBs sustantially improve their financial performance over this time period), and would be further enhanced through share capital or possibly mezzanine financing (such as subordinated debt), and may be through unrestricted funds from donors or social investors/foundations. Some examples of equity in MFBs are:

Khushhali Bank

Over 15 commerical banks including domestic, public and multinational banks, such as Habib Bank Ltd, Mybank Ltd, National Bank of Pakistan, RBS ltd, Citibank and Standard Chartered invested in Khushhali bank.

First Microfinance Bank

The main shareholders include the Aga Khan Rural Support Program (46%), the Aga Khan Fund for economic development (24%) and International Finance Corporation (30%).

Pak-Oman Microfinance Bank

Pak Oman investment company (a joint venture between Govt. Of Pakistan and Sultanate of Oman) has 33% shareholding.

According to PMN, with the growth rates of 10%, 25% and with a variable rate, the industry's equity gap by 2015 amounted to USD 0.15 bn, USD 0.44 bn and USD 0.96 bn respectively. Since MFBs share in the market portfolio is expected to increase and its existing market share of 45% has to increase to 55% therefore one can expect the major chunk of equity demand in the future may come from the MFBs.

FOREIGN DEBT INVESTMENT

LEGAL FRAMEWORK

In order to facilitate MFBs/MFIs, SBP decided to allow them to raise foreign currency (FCY) loans from international financial institutions/donor agencies or specialised banks/ institutions. The underlying terms and conditions of FCY borrowing are;

- The loan must only be used for financing MFBs/MFIs loan portfolio.
- Borrowing can only be made in four major currencies, namely USD, EUR, GBP and JPY.
- The loan tenure must not be less than two years.
- The interest rate must be competitive relative to other options locally available and should also be based on a reference rate such as LIBOR.
- The disbursed FCY funds will immediately be converted into PKR and credited to borrowing MFB/MFIs PKR account maintained with the concerned Authorized Dealer (bank). Under no circumstances MFB/MFIs will be allowed to retain such funds in foreign currency.
- The borrowing MFB/MFIs will be allowed to make payment of the principal amount at maturity or may start repayment of principal in instalments after six months through the Authorized Dealer receiving disbursement of loan. However, frequency of the interest payment may be made in accordance with the related repayment schedule.
- Authorized Dealers may provide forward cover/hedging facility on the foreign currency loans to the MFB/MFIs from the interbank market in accordance with the prevailing foreign exchange regulations.
- The MFB/MFIs will provide an undertaking that the loan deal is compliant with the provision of legal and regulatory framework applicable to the lender and the borrower.
- Draft Term Sheet agreed between the lender and borrowing MFB/MFIs should be submitted to SBP while approaching for in-principle approval. However, for formal approval, MFB/MFIs will approach SBP through Authorized Dealer (bank).
- MFB/MFIs will ensure that internationally acceptable 'Know Your Customer' (KYC) standards for the Lending institutions/lenders are complied. Funding should only be obtained from quality lenders which comply with KYC standards.
- Any change/deviation in the terms and conditions after obtaining formal approval from SBP will require prior clearance from SBP.

According to SECP, not-for-profit associations guidelines, Section 4.2 'The Company shall not appeal, solicit, receive or accept funds, grants, contributions, donations or gifts, in cash or in kind, from foreign sources except with the prior permission, clearance or approval from the relevant public authorities as may be required under any relevant statutory regulations and laws'.

PRESENT SITUATION

Only a few MFIs such as Asasah and Kashf Foundation have borrowed in foreign currencies. The Kashf Foundation had access to long term foreign debt of USD 0.15 mn from Accumen Fund International and USD0.36 mn from Grameen Foundation. Similarly Asasah had access to foreign currency denominated debt from KIVA (running finance).

FOREIGN EQUITY INVESTMENT

LEGAL FRAMEWORK

The equity investments are governed by the Microfinance Institutions Ordinance 2001, The Companies Ordinance 1984 and the rules and regulations as imposed by SECP. Additionally, Foreign Exchange Regulation Act 1948 and Foreign Exchange Manual issued by SBP are also taken into consideration.

Given the non-profit nature of RSP and NGO MFIs, the only legal form that is attractive for equity investor is MFBs.

PRESENT SITUATION

In 2008 Telenor Pakistan acquired a 51% share in Tameer Microfinance Bank for a foreign direct investment of USD 12.5 mn through a direct rights issue. There are no other examples of foreign equity.

KEY CONTACTS

Ministry of Finance Pakistan
www.finance.gov.pk/

Pakistan Microfinance Network (PMN)
www.microfinanceconnect.info/

Pakistan Poverty Alleviation Fund
www.ppaf.org.pk/

Security and Exchange Commission of Pakistan (SECP)
www.secp.gov.pk/

State Bank of Pakistan (SBP)
www.sbp.org.pk/

SRI LANKA

Population : 20.45 mn (2009)
Main Towns : Colombo (2.4 mn), Gampaha (2.1mn), Kurunegala (1.5mn), Kandy (1.4mn)
Currency : Sri Lankan Ruppee (SLR or Rs)
Exchange Rate : 1 USD = Rs 114.94 (annual average 2009)
Fiscal Year : 1st January-31st December

Development Indicators[1] :

- Population below poverty line (National): 15.2% (2007)
- GNI per capita (Atlas method, USD): 1,780 (2008)
- Literacy Rate (15-24 years) : 97.5% (2006)
- Mortality Rate (child<5 year): 15 per 1,000 live births (2008)
- Life Expectancy at birth: 74 years (2008)
- HDI: 0.759, 102 rank among 182 countries(2009)

Indicator	2005	2006	2007	2008	2009	2010*
Nominal GDP (USD bn)	24.4	28.3	32.6	40.7	42	na
Real GDP Growth (%)[2]	6.2	7.7	6.8	6.0	3.5	6.5
Consumer Price Inflation (avg, %)	11.25	10.0	15.8	22.6	3.4	4.3[3]
Exchange rate (avg, vs USD)	100.5	103.9	110.6	108.3	114.9	na
External Debt (year-end, USD bn)	11.3	12.21	14.25	14.08	13.5	na
External Debt (as a % of GDP)	46.5	42.2	43.2	37.1	44.5	na
FDI (USD mn)	272	451	548	691	384	450
FDI (as a % of GDP)	1.2	0.8	0.9	0.9		na

1 Figures taken from Annual Bank Report Sri Lanka 2009, Asian Development Bank Database and Development Indicators, Basic 2010 Indicators
2 Asian Development Bank Outlook 2010
3 2010 July YoY inflation

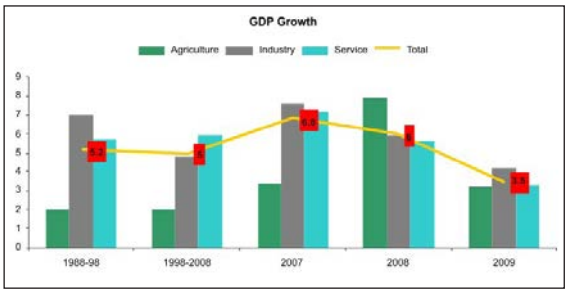
ECONOMY

Compared to other south Asian countries, Sri Lanka displays relatively favourable socio-economic indicators. However, these figures mask wide regional disparities. Economic activity is concentrated in the relatively prosperous Western Province which accounted for over 50% of GDP in 2006, while all other provinces in the country each contributed less than 10% of GDP. However, more than 70% of the country's population is concentrated outside the Western Province. A substantial infrastructure gap exists between the Northern and Eastern Provinces and the rest of the country due to 30 years of destruction and virtually no investment. The investment that two provinces need to bridge this gap is enormous.

On a positive side, the economy of Sri Lanka is expected to recover steadily and the projected growth rate is around 6-7% in the medium term. The integration of the Northern and the Eastern provinces[4] will contribute to the growth of the agricultural and fisheries sector, and in turn will benefit the whole country.

ECONOMIC GROWTH

On the back of economic reforms initiated in the early 1980s towards economic liberalization, including the strengthening of the export sector among others, the Sri Lankan economy has been growing at an annual average of 5% and above since 1988[5], with the Services and Industry sectors being the major contributors to the GDP growth. The growth has been resilient amidst crises resulting from conflict, the Tsunami and the more recent global recession.



Source: World Bank and CBSL

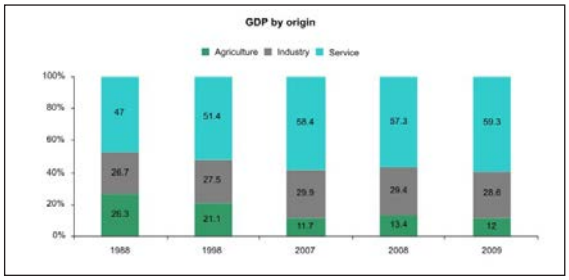
During the past few years, prior to the economic recession, GDP growth was around 6% to 7% resulting from the gradual recovery from the Tsunami, substantial inflow of foreign remittances and increased affordability of services such as telecommunications. In 2009, the global food, energy and financial crises slowed down economic growth to the rate of 3.5%. However, GDP now shows a steady growth trend, as indicated by data from the latter part of 2009 and early 2010. This is mainly due to the gradual recovery of the global recession and the expansion of the domestic economy resulting from the end of the three decades long conflict and the subsequent re-integration of the Northern and Eastern Provinces with the rest of the country. The World Bank forecast GDP growth to be between 5% - 6% for 2010.

ECONOMIC STRUCTURE

In the last couple of decades, the share of Agriculture in national output has declined from a high of 26.3% in 1988 to 13.4% in 2008, with Services increasing its share by over 10% in the same period. The Industry sector has only marginally deviated from 15% to 18% in the period. As per the latest data available for financial year 2009, Services further increased its share of the overall GDP accounting for 59.3%, while the Industry and Agricultural sectors contributed 28.6% and 12.0% respectively.

4 These two provinces account for over two thirds of the country's coastal and maritime resources and about one third of the country's fertile land area which shows tremendous potential for the development of the agricultural and fisheries activities and related industries in these areas

5 According to ADB, it grew at an average annual rate of 5.2% in 1988-1998 and 5.0% in 1998-2008



Source: World Bank and CBSL

As on 2009, the key sub-sectors contributing to the Services sector are Wholesale and Retail Trade (23.3%), Transport and Communications (13.5%), Banking, Insurance and Real Estate (8.9%) and Government services (7.8%). The service sector also has the highest share of the employed labour force[6].

Manufacturing sub-sector within the Industrial sector contributes to 17.4% of the total GDP, of which the largest share is held by the factory industries (15.8%). The other significant sub-sectors in the Industry sector are Construction (6.6%), Electricity (2.1%) and Mining and Quarrying (2.1%). However, the number of employed people in the Industry sector has declined from 26.3% in 2008 to 25.1% in 2009 owing to the contraction of the global and local economy. Textiles and garments have 62% share in Industrial sector (for 2009).

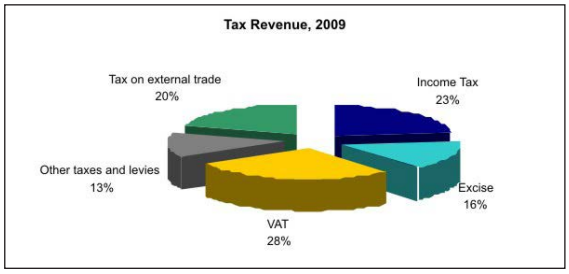
In the Agriculture sector, Paddy (1.7% of the GDP and about 17% of the total Agriculture production) is the main single crop. For Paddy, the fertilizer support scheme and the harvest purchasing scheme are practiced by the government as this is the country's staple food.

LABOUR

According to the Sri Lanka Labour force survey, the labour force[7] stands at 8.07 mn in 2009 implying a labour force participation rate (LEPR)[8] of 48.7%. The total labour force comprised 7.6 mn employed and 0.47 mn unemployed persons. Around 42.3%, 32.6% and 25.1% out of the estimated of the total employed persons are engaged in the Services, Agriculture and Industry sectors respectively. The unemployment rate is higher among the age group of 15 – 24 years at 21.3% in 2009[9] as observed during the last few years. The gender analysis of the LFPR over the years had shown that the participation rate of males has been almost twice that of females throughout the recent past.

TAXES

The total tax revenue for the year 2009 was Rs 619 bn (USD 5.38 bn), with the highest contribution from the Value Added Tax (VAT) category. Several steps were taken in2009, to broaden the tax base, change the tax rates and improve tax administration. A Presidential Tax Commission was also set up in 2009 which is expected to recommend measures to broaden the tax base.



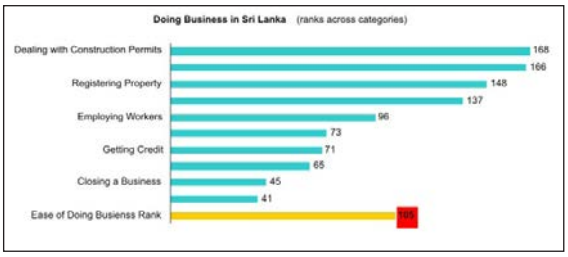
Source: CBSL

While tax revenues increased by 6% compared to that of 2008, tax revenues as a percent of GDP decreased to 12.8% in 2009 from 13.3% in 2008. The share of non-tax revenues as a percentage of GDP is only 1.7% though it increased by 20% since 2008.

6 Annual Report 2009, Ministry of Finance and Planning, 2009
7 Labour force is defined as the economically active population aged 10 years and above
8 LFPR is the ratio of the labour force to the total population aged 10 years and above
9 The unemployment rate of young females was 27.9% as compared to that of 17.1% among young males

BUSINESS ENVIRONMENT

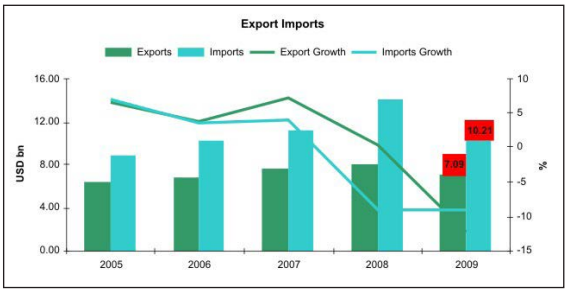
According to the Doing Business Sri Lanka - 2010, Sri Lanka stand at the 105th position compared with 183 other economies in the world. As indicated in the chart here, the rank is relatively low in indicators dealing with construction permits, registering property, paying taxes and enforcing contracts. It is relatively easy to start a business in the country according to the procedures, time, cost and paid-in minimum capital to open a new business.



Source: World Bank

EXPORT IMPORT

Sri Lanka has come a long way in diversifying its export base. According to the Central Bank, agriculture accounted for 74% of exports in 1977 which has come down to 24% in 2009. Textile and Garments hold the major proportion (46.2%) among industrial exports, followed by Food, Beverages and Tobacco (5.7%), other industrial exports (5.6%) and rubber products (5.4%). Agriculture exports are led by the Tea sector (16.7%).



Source: CBSL

The import expenditure is dominated by Intermediate goods (55.5%) which include products such as petroleum, textiles and fertiliser, consumer goods. With the changes in global economic conditions, prices of most commodities, including petroleum, exhibited a series of historical highs during the past two years. This rise in international commodity prices led the terms of trade to deteriorate significantly. In 2009, imports declined by 19.6% compared to the previous year, largely explained by lower imports of machinery and equipment as well as building materials.

Sri Lanka historically runs a negative trade balance and the trade balance has been increasing over the years. However, the trade balance was at USD 3,122m in year 2009 indicating a 47% contraction from year 2008. This was due to lower expenditure on imports in 2009 leading to a trade deficit dropping to 7.4% of GDP in 2009.

Western countries continued to be the main export market while the Asian countries dominate Sri Lanka's imports. The Unites States of America (USA) continued to be the largest single market for Sri Lanka's exports, accounting for nearly 22% of exports. Amongst the members of the European Union (EU), the United Kingdom is the largest market for Sri Lanka, followed by Italy, Belgium-Luxumburg, and Germany[10]. Textile and apparel were the main export commodities to USA, United Kingdom (UK), Italy and Germany, while Belgium is the main destination of processed diamonds. The main destination for tea continued to be the United Arab Emirates (UAE) and the other Middle Eastern countries.

In terms of imports, India accounts for nearly 17.8% of Sri Lanka's imports in 2009. The main imports from India included refined petroleum products, sugar, motorcycles and auto-trishaws, copper wires, etc. Singapore and China followed as the second and third

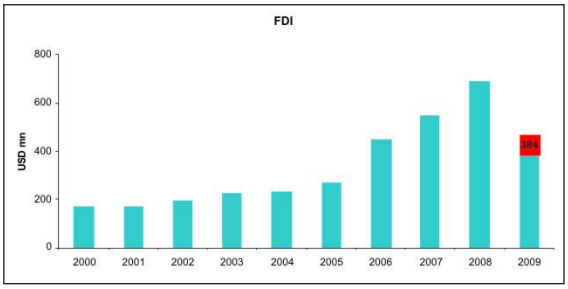
10 Sri Lanka's share of apparel imports will face significant challenges due to the European Commission withdrawing the preferential tariffs under the Generalized System of Preferences Plus (GSP Plus) to Sri Lanka's exports. External trade is expected to continue gathering momentum as the global economy recovers, however, exports will be below potential in 2010 owing to the impending withdrawal of GSP Plus concessions (as well as only a modest improvement in demand for garments)

largest import source with 10% share of total imports. Main imports from Singapore comprised fertilizer, petroleum products and unwrought gold, and cotton from China.

FOREIGN INVESTMENT

Since the Foreign Investment Act in 1978, investment policies in Sri Lanka have been engineered to attract foreign investment and reached up to 691 mn in 2008. The Board of Investments in Sri Lanka plays a significant role in attracting Foreign Direct Investment (FDI), and offers an attractive package of fiscal incentives to foreign and local investment; such as establishment of free trade zones, investor protection agreements, etc. Foreign investment is encouraged in enterprises, which involve extensive use of foreign capital or sophisticated technology, in export-oriented manufacturing, and in large-scale infrastructure projects.

The impact of the global financial crisis had a significant impact on FDI and in 2009 the figure decreased to USD 384 mn[11]. The main areas of foreign investment were concentrated in telecommunication and power generation in the recent past while FDI in textiles and apparel have reduced within the recent year.



Source: CBSL

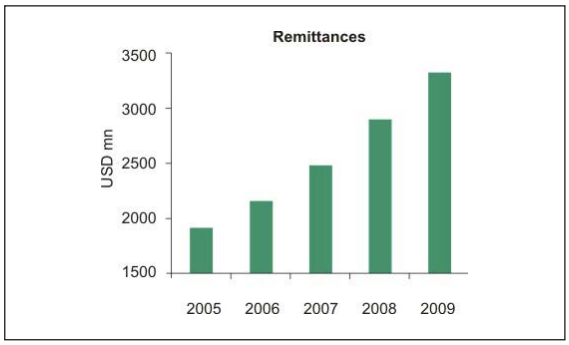
When 2009 is considered, the highest FDI inflow was recorded from China amounting to USD 145 mn. The second and third highest inflow was from UK and India amounting to USD 80 mn and USD 78 mn, respectively.

With the ease of the global financial crisis and the initiation of the development in the North and East, especially in the tourism, agricultural and manufacturing sectors, the FDI flows are expected to improve more favorably in the medium-term.

REMITTANCES

According to the Sri Lanka Bureau of Foreign Employment, the Sri Lankan migrant population is around 1.8 mn and foreign employment continued to be second largest source of foreign currency inflows to the country accounting for 35.87% of foreign exchange earning in the country in 2008.

Inward workers' remittances increased to USD 3.3 bn becoming the foremost foreign exchange earner in 2009, and were in excess of the trade deficit. The initiatives taken by the Central Bank and commercial banks to promote the inflow of workers' remittances through formal channels have also helped in recording a higher level of remittances in 2009.



Source: CBSL

The Middle Eastern region dominates the foreign employment market, accounting for more than 90% of the total migrant workforce, with the majority consisting of housemaids. Over a period of 1990-2008, remittances from the Middle-East accounted for approximately 60% of the total share. Within the Middle East region, Saudi Arabia, Doha Qatar, Kuwait and UAE accounted of 82.4% of the total departures for foreign employment in 2009.

11 Central Bank of Sri Lanka, Annual Report 2009

COPING WITH THE GLOBAL FINANCIAL CRISIS

The global financial crisis had multi-faced effects on the financial system, mainly the exchange rates came under pressure and reserves were drawn down with the withdrawal of foreign currency. In addition, exports and financial intermediaries with large exposure to foreign currency denominated loans came under strain. The provision of foreign currency to the foreign exchange markets led to a commensurate decline in domestic currency liquidity as well. The Central Bank of Sri Lanka took certain measures to cope with the crisis and ease the effects on the economy. The notable policy action was the decision to provide emergency liquidity assistance to banks and other financial institutions which were systemically important to the stability of the financial system.

Economic growth has regained its momentum after the second quarter of 2009. This has mainly resulted from the combined effects of the fiscal and monitory polices, which have also had spin-off effect in the economy. The main factor contributing to the economic growth is the end of three decades of war, which opened avenues and new market potentials. With the gradual recovery in the major export destination economies such as USA, EU, etc, exports have shown an increasing trend. With the progress made on the resettlement process and the ongoing large-scale infrastructure development projects, the quarterly analysis the GDP growth rate shows a V shaped recovery.

FINANCIAL SECTOR

REFORMS

In the South Asian region, Sri Lanka was the first country to commence financial sector reforms. In 1977, the government began to dismantle the regulatory structure and a number of policy changes were introduced. Interest rate deregulation, introduction of market based credit policies, relaxation of market entry for foreign and local banking firms and improved supervisory measures including appropriate legislative measures to safeguard the financial system are some of the significant measures introduced.

The financial market reforms brought substantial changes in money market, capital market and electronic market activities throughout the country. Modern facilities such as telephone banking with mobile phones, widespread automatic teller machines, and internet banking are now common. Major utility users such as electricity or telephone facilities now have the capability to pay their bills using mobile phones showing society- wide benefits to the country. As a result of relaxed market entry conditions a number of new domestic and foreign banks have been operating in Sri Lanka, competing against the dominant state owned banks.

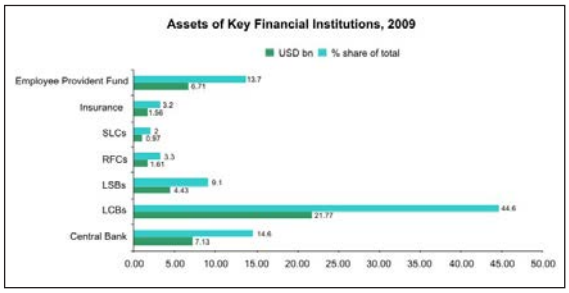
The Central Bank of Sri Lanka (CBSL) through its conduct of monetary policy influences the different segments of the financial market, credit and capital in varying degrees. The Central Bank's policy interest rates have the greatest impact on a segment of the Money Market called the inter-bank call money market and a segment of the Fixed Income Securities Market, i.e. the Government Securities Market. The Central Bank also intervene in the inter-bank Foreign Exchange Market, which is closely connected to the Money Market.

The importance of corporate governance in the banking industry was given a significant importance during the year 2009, with the CBSL issuing a several prudential regulations

on corporate governance and on risk management. This was a very crucial step taken to maintain the stability of the financial system.

COMPOSITION

The financial sector in Sri Lanka consists banking institutions, registered finance companies, and contractual savings schemes including insurance and provident funds. Among these, the banking sector dominates the financial sector with over 68% of assets as per 2009 data.



Source: CBSL

The CBSL supervises systemically important institutions that own own about 75% of the assets of all financial institutions and include all large and important institutions in the financial system in the country. The institutions regulated by the Central Bank of Sri Lanka include;

Licensed Commercial Banks (LCBs): There are 22 LCBs operating through a network of 2,214 branches and 2,788 other banking outlets. Among LCBs, the 2 largest banks are state owned, 9 privately owned and 11 are foreign banks. LCBs account for 44.6% of the total financial sector assets. According to the sector-wise distribution of credit, consumption activities, including pawning advances and credit cards (28%), manufacturing including apparel products (16%), trading (15%) and construction including housing and property development (15 %) accounted for the largest proportion of total credit. The Banks maintain Capital Adequacy Rate (CAR) of 14.2% in 2009, and profitability in terms of Return on Assets (ROA) and Return on Equity (ROE) stand at 2.0% and 14.4% respectively[12]. The gross Non Performing Loan (NPL) ratio, stood at 7.6% as at end 2009.

Licensed Specialised Banks (LSBs): At end of 2009, there are 14 LSBs operating through a network of 465 branches. They comprise of 6 Regional Development Banks, which were amalgamated into one in the first half of 2010. The balance comprised National Savings Banks, Long term lending institutions, Housing finance institutions and Private savings and lending banks (2 from each category). They are mostly state owned with a market share of about one fifth of LCBs. The single largest LSB is the state-owned National Savings Bank. The CAR level of LSBs stood at 19.2% by end 2009 and NPLs stand at 10.9% in 2009 against 8.9% in the previous year.

Registered Finance Companies (RFCs): The total number of RFCs in operation are 35 operating through 289 branches at the end of December 2009 accounting for 3.3% of financial sector assets. The largest nine RFCs accounted for approximately 73% of the total assets of RFCs, whereas eighteen medium size RFCs accounted for only 24% of total assets. Hire purchase and lease facilities for vehicle financing accounted for about 63% of the RFC industry's assets as of the end of 2009

Registered Finance Leasing Establishments: There are 74 finance leasing establishments as of the end of 2009, consisting of 19 licensed banks, 34 RFCs and 21 Specialized Leasing Companies (SLCs). SLCs account for 2% of financial sector assets. However, 89% of total assets of SLCs were reported from 8 companies. This could be observed both in the leasing portfolio, as well as borrowings. The SLCs cater primarily to lower income groups and less creditworthy customers who do not have easy access to credit facilities from banks. Finance leasing and hire purchase are the major businesses of SLCs

12 Before tax

which accounted for more than 71% of total accommodations.

Authorised Primary Dealers (PDs): The total capital of the industry was recorded at Rs 11 bn, or 1.7% of financial sector assets, which is an increase of 82 % over the previous year. Owing to high market risk associated with PDs with their single product market, a policy decision was taken to allow the PDs to diversify their activities including fee- based activities and invest in shares and debentures of its own group companies.

Besides CBSL, The Securities and Exchange Commission (SEC) is responsible for licensing and regulating stock exchanges, stock-brokers, stock dealers and unit trust companies. The SEC also registers underwriters, margin providers, credit rating agencies, investment managers and securities clearing houses.

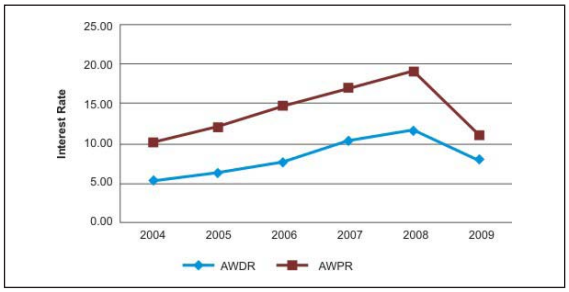
The Insurance Board of Sri Lanka (IBSL) regulates and supervises the insurance industry, insurance companies and their agents and insurance brokers. The insurance sector consists of 18 companies, of which 11 are composite insurers (engaging in both long-term and general insurance business), while 5 offer only general insurance and 2 firms engage solely in long-term insurance business. The insurance industry is highly concentrated, with the two largest companies accounting for about 65% of the total assets of the industry, while the largest five companies account for 93% of total insurance assets.

The superannuation funds sector accounted for about 18% of total financial sector assets. The sector is dominated by the Employee Provident Fund (EPF) which accounted for 76% of the assets of the superannuation funds sector. The EPF funds are managed by the Monetary Board of the CBSL. Privately managed provident and pension funds, which are monitored by the Department of Labour, numbered 171 with a total membership of 157,453 persons.

There were five unit trust management companies managing 18 funds of which 13 were open-ended funds, while 5 are closed-ended funds. While the net asset value (NAV) of the unit trust industry increased by 47% to Rs 9.9 bn (USD 86 mn) at end December 2009 due to an appreciation in the value of investments, they still remain a meager 0.2% share of the financial sector. Market capitalization of stock exchange is USD 9.5 bn in 2009, up by 136% from 2008 level which is 22.9% of GDP.

INTEREST RATES

Due to the reduction in the policy rates by the Central Bank, the entire market interest rates had gradually shifted downwards. This is visible in the average weighted deposit rate (AWDR) and averagely weighted prime lending rate (AWPR).



Source: CBSL

At commercial banks, as of the end 2009, the one year fixed deposit interest rate is between 7.25% to 19% while the savings deposit interest rate is 1.50% to 10.50%. The Average Weighted Deposit Rate is 11.12%, while Average Weighted Primary Lending Rate is 17.41%.

FINANCIAL EXCLUSION

A number of reports that capture the financial access in the country, points to a well served market. According to the World Bank report 'Getting Finance in South Asia 2009', Sri Lanka is leading the south Asian region with access to finance. Sri Lanka has the widest network of branches and ATMs. The ATM penetration rate expanded over the years and the district wise distribution of branches and outlets has improved. According to a

household survey on financial services, conducted by the Institute of Policy Studies in Sri Lanka (covering 2,945 households in 22 districts in 2007), it was found that 82.5% of households have obtained savings, credit or both services from financial institutions. This report mentioned that nearly 75% of households have saved with a financial institution, compared with 47% of the households who have obtained loans.

However, this report shows that the access to financial services has variations across determinants such as gender, sector and geographical dispersion and poverty level and there are market gaps. For example, the highest number of commercial banks and bank branches are concentrated in the Western Province while the number of banks are very limited in the North and East. At the end of 2007, there were 678 banking outlets of LCBs in the Western Province out of a total branch network of 1,697 in the whole country. A 25% of the estate sector, 17.5% of rural and 15% of urban households have not utilised the services of a financial institution.

MICROFINANCE SECTOR

HISTORICAL EVOLUTION

The microfinance movement in Sri Lanka started under the British Colonial administration in 1906, with the establishment of Thrift and Credit Co-operative Societies (TCCS) under the Co-operative Societies Ordinance. These were the first credit co-operatives established in Sri Lanka that undertook the tasks of procurement of inputs and distribution of products, etc during the early decades of the 20th century. This role was eventually taken over by the Multi-Purpose Co-operative Societies (MPCSs) which were originally established during the 1940s as Consumer Co-operative Societies and renamed Multi Purpose Co-operatives in the 1950s.

However, by the late 1970s, there were very limited numbers of TCCSs, and those in existence were not performing well. During that time, the TCCS movement was revived by the charismatic Dr. P. A.Kiriwandeniya, under a new name: SANASA.

In 1985 the Government established 17 Regional Rural Development Banks (RRDBs) covering all districts of Sri Lanka with the exception of the North and East, to reach small and medium entrepreneurs in remote rural areas. A significant restructuring and recapitalization took place in 1998-1999 and the RRDBs were consolidated into the six Regional Development Banks (RDBs) which were again merged into one entity in 2010 as Regional Development Bank.

The late 1980s and 1990s saw the entry of several local and international NGOs into the microfinance business. During this period the Janasaviya subsidiary program was introduced by the government as one of the main poverty alleviation mechanisms later replaced by tthe Samurdhi Development programme in 1995 consisting of . the network of 1,038 member-owned Samurdhi Bank Societies (SBSs). During the late 80s commercial banks and financial institutions entered the microfinance market, where Hatton

National Bank's (HNB) "Gami Pubuduwa" ("Village Awakening") microfinance programme is probably the oldest microfinance programme.

The Tsunami, which struck Sri Lanka in 2004, saw the influx of foreign aid to the microfinance sector, which many were either grants or subsidized loans. Many microfinance program combines with multi-sectoral livelihood programmes during this phase, prove unsustainable in the long-term and had some detrimental effects on the sector in the short term through their mix of grants and subsidized loans and had negative impact on credit culture in the country.

A recently emerging trend is the entry of commercial banks and registered finance companies and other large corporate entities into the microfinance business, notable among them is Lanka Orix Microcredit Limited (LOMC).

TYPES OF MFIS

The Sri Lankan microfinance sector comprises a range of institutions which are monitored and supervised by several different legislations. The main types of the microfinance institutions include:

Regional Development Banks (RDBs) and other Licensed Specialized Banks (LSBs): There is one Regional Development Bank (established in 2010), which was formed with the merger of 6 RDBs targeting the small and medium enterprises. Apart from that, Sanasa Development Bank is the only other licensed specialized bank with a focus on microfinance. They come under the supervisions of the Central Bank.

Samurdhi Bank Societies (SBSs): Samursdhi bank societies (SBSs) were established in 1996 as part of the governmental poverty alleviation program. The Samurdhi Authority of Sri Lanka regulates SBSs. In July 2007, there were 1038 SBS.

Co-operative Rural Banks (CRBs) and other co-operatives: There are 1,608 CRBs, of them 8 CRBs were independent CRB societies and the rest 1,600 have been managed under 302 multipurpose cooperative societies (MPCS). They are regulated by the Department of Co-operative Development.

Thrift and Credit Co-operative Societies (TCCSs/ SANASA Societies): The TCCSs are the oldest mediums of providing microfinance, and many were re-organized into a federation under the Sanasa during the late 1970s. However, most TCCSs in the North remain independent of the Sanasa movement and have their own federation. Sanasa TCCS have access to Sanasa Development Bank.

NGO-MFIs: A large number of local and international NGOs are engaged in microfinance activities and some have now spun off their microfinance operations into separate entities. They are registered as NGOs, guarantee or private companies. They are unsupervised and their microfinance activities are not governed by any specific regulations.

Other Financial Institutions: Commercial banks, Finance and Leasing companies who have entered the microfinance business are main type institutions in this category. Among them, the more significant players are the government owned People's Bank and the privately owned Hatton National Bank, Commercial bank, and Finance companies as LOMC. They come under the supervisions of the Central Bank.

MAJOR HIGHLIGHTS OF THE SECTOR

OUTREACH

When it comes to spread of outreach, there is an only estimate available for total number of clients and outstanding loan balance (OLB) as information is not available for the entire sector. Only 20 MFIs report to the MIX market and until recently, even the large MFIs operated on a manual basis.

Of the 4.2 mn total families in Sri Lanka, less than 50% could be considered to be the micro credit market. According to GTZ ProMiS

2009 Industry Report[13], there are over 10,400 microcredit service points in the country suggesting that there is one service point for every 200 families. The distribution of the service points are although not even, there is a reasonable spread of the microfinance branches throughout the country with the exception of the very remote areas of all districts, plantation areas and conflict affected North districts except Jaffna,

RDB and Licensed Specialized Banks: The RDB[14] estimate, on average, 86% of their business is microfinance. The microfinance client base is estimated around 1.85 mn. The RDB was formed by merging regional evelopment banks of the island's regions of Rajarata, Ruhuna, Wayamba, Uva, Kadurata and Sabaragamuwa in July 2010. For 2009, the total credit distribution of the 6 regional banks (before amalgamation) is around Rs 29,090 mn (USD 253 mn)[15].

SANASA development bank which is registered as a public company in companies act and in banking act as a licensed specialized bank, has operations in all most all the district in Sri Lanka. Currently, SANASA lends through Primary Thrift and Credit Societies (PTCCS) and to individuals and has an outreach of 516,373 active member, 190,427 borrowers with Rs 10,660 mn (USD 93 mn) as outstanding loan balance (OLB) in 2009.

SBSs : They serve a total of 2.3 mn members and another 227,000 non-member clients. The industry report of Sri Lanka mentions that there are 1,038 Samurdhi Bank societies and reported 5.8 mn deposit and savings accounts and 0.6 mn active borrowers. [16]They had Rs 7.8 mn as OLB and Rs 20.8 mn in savings in 2006.

CRBs and other Cooperatives: Data on the number of clients reached is not available but Central Bank data indicates 1.5 mn loan accounts and 6.5 mn savings accounts across 1,608 CRBs in 2007. Even allowing for multiple accounts, it is likely that CRB's has over 3 mn members . They had Rs 14.6 mn as OLB and Rs 25.3 mn in savings in 2006.

Sanasa/TCCSs: The outreach of the Sanasa TCCSs in 2007 is Members: 464,632, Borrowers: 55,898, OLB: Rs 523 mn (USD 4.5 mn) and Savings: Rs 522 mn (USD 4.5 mn)

Other MFIs (NGOs/Limited liability companies/ companies limited by guarantee): The Lanka microfinance Practitioners' Association (LMFPA) Profile of members data for 2010 (unpublished) indicate that there are 961,850 members of 51 NGO-MFIs[17] (including SANASA Bank). The largest NGO MFI is Sarvodaya Economic Enterprise Development Services (Gte) Ltd (SEEDS) have a member base of 544,915 members and active borrowers of 161,280 as of March 31st, 2010.

Largest MFIs (among LMFPA members)	Number of members
Sarvodaya Economic Enterprise Development Services Ltd (SEEDS)	544,915
SANASA Development Bank Ltd	516,373
Sabaragamuwa Development Bank	265,501
BRAC Lanka Ltd	100,985
Lak Jaya Micro Finance Ltd	34,033

Source: LMFPA

The total loan portfolio of all the 51 Institutions comes to Rs 25,432 mn (USD 221), with three institutions SANASA, Sabaragamuwa and SEEDS accounting for 80% of outstanding 80%. The average loan balance per borrower is Rs. 28,130.

When it comes to depth of outreach it appears that the SBSs and the NGO-MFIs have the greatest depth of outreach, with 85% and 50.4% of clients respectively having a monthly household income of less than Rs

13 Microfinance Industry Report, GTZ and BWTP, 2009
14 The bank is jointly owned by the Sri Lankan treasury, and state-owned Bank of Ceylon, People's Bank and National Savings Bank
15 Annual Report 2009, Ministry of Finance and Planning, Sri Lanka
16 End June 2007

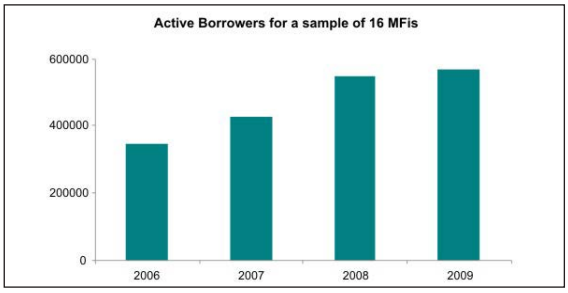
17 Out of LMFPA membership only

3,000 (USD 26). For the NGO-MFIs, nearly 82% of their clients have a monthly household income of less than Rs 5,000 (USD 43.5). The RDBs clearly serve a different market segment, with over 50% of their clients falling into the Rs 5,000-20,000 range of monthly household income.

GROWTH

The historical growth tends for the sector as whole or for a large number of MFIs is not available.

The State of Microfinance in Sri Lanka report prepared by Institute of Microfinance (InM) reveals that there are about 1,061,457 active borrowers in 2008, in 20 key MFIs comared to 981,724 in 2006. In terms of portfolio growth, the total outstanding loan balance (OLB) was around Rs 18 bn (USD 157 mn) in 2008 that is around a Rs 6 bn (USD 52 mn) increase from 2006.



Source: InM, 2009

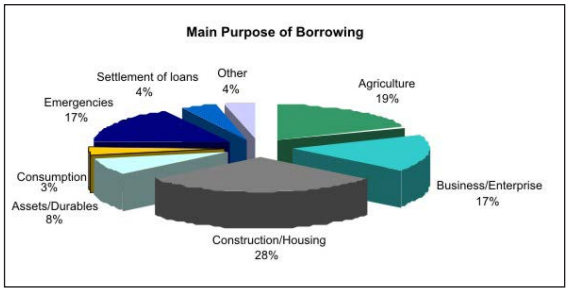
Growth indicators for a sample of institutions[18] (not including Samurdhi, CRBs and SBS), mainly comprising of key NGO-MFI players, show that the number of active clients are growing. The growth trend in members and clients will continue with the expansion of microfinance activities in the North and East.

PRODUCTS

Savings and loans are two main of products that most MFIs are providing. Some institutions provide insurance products attached with the loans and regulated institutions such as RDBs offer pawning services to clients. The main outreach methodology is community based groups or societies.

Individual lending either directly or via Community Based Organisations (CDOs) or groups is the main lending mechanism, where bulk lending to CBOs, which was popular in late 80s and 90s, seems less prominent. It is noted that though institutions rely on "groups or CBOs" as means to mobilize clients, the predominant mode of lending is individual lending. The average loan balance per borrower is Rs 28,130 (USD 245) for 51 MFIs reporting to Lanka Microfinance Practitioner's Association (LMFPA) Member Profile 2010 (unpublished).

The RDBs and Sanasa Development Bank are permitted to mobilize deposits. Cooperative societies can also accept member deposit. In practice, many NGO MFIs also accept deposits on a limited scale.



Source: LMFPA

The most common lending rate is in between 15% to 25%, where flat or reducing balance methods are used for the calculations. The deposit interest rate is usually around the commercial bank interest rates and ranges from 5% to 10%.

Pawning is offered by the RDBs, Sanasa, CRBs and other MFIs such as SEEDS as well as licensed commercial banks. The People's Bank has a particularly large pawning portfolio and the RDBs as a group have a larger number of pawning accounts than loan accounts.

18 The sample comprises of 16 MFIs and SANASA development bank. The data sources are State of Microfinance in Sri Lanka-InM, the MiX market and LMFPA members Profiles-2010

Micro-insurance reaches 1.46% of the population. The primary players in the market are HNB, Ceylinco Insurance and Sanasa Bank providing life, property, mortgage, loss of income and disability insurance. Currently, MFIs can only provide insurance as an agency of a licensed insurance provider. The high capital requirements which are a pre-condition for engaging in insurance business exclude MFIs from obtaining licenses for these activities.

The primary market for micro-leasing is purchase of trishaws, motorcycles and hand tractors. This is reasonably well provided for by both commercially minded microfinance providers and finance companies in the urban areas. Registration with CBSL under the Finance Leasing Act of 2000 is mandatory to carry out leasing activities. The leasing companies cannot mobilize savings or deposits. It can provide micro leasing, hire purchase and micro loans under a leasing license.

SUSTAINABILITY

There is limited focus on sustainability as the sector has been protected by a large amount of subsidized funding from government and foreign donors alike, although the latter source is now much reduced. Most government-led microfinance programmes have subsidized interest rates, weak repayment rate and high recurrent costs, and are far from sustainability. While Government supported or subsidized loans offer rates ranging from 8 to 18% sustainable rates are considered to start as high as 33%.

An important hindrance to the sector's sustainability is the low concern to the portfolio quality. Many microfinance providers are not familiar with Portfolio at Risk (PAR) and are unable to calculate it with their manual system. As a result, the average PAR>30 reported by RDBs ranges between 6% and 9% while MFIs report a PAR>30 between 5% and 25%, being closer to 25%[19]. According to LMFPA, based on data from 51 member MFIs, PAR 30 figures vary 43% to 0% for these institutions and there are only 18 institutions that have PAR less than 5%. Approximate average of PAR 30 days for the sector would be around 16%.

There is no sector wide data available to track and analyze the sustainability figures for the various types of MFIs. According to InM Report 2009[20], which looked at various indicators of top 20 MFIs in Sri Lanka, only 10 MFIs reported Operational Self Sufficiency (OSS) and only 6 MFIs has OSS over 100%. According to the MIX data, and LMFPA member profile data many institutions (such as SEEDS, Arthacharya, Berendina, WDF-Hambanthota, etc) are operationally sustainable. However, there are a large number of regional small players still thriving to achieve the operational viability.

MESO LEVEL INFRASTRUCTURE

The meso level infrastructure for the microfinance sector is week though GTZ ProMiS has taken a number of initiatives to improve the meso level infrastructure in last few years.

The Centre for Banking Studies of the Central Bank of Sri Lanka, the Bankers Training Institute and the Distance Learning Center, The University of Colombo offer various short training programmes and diploma courses in microfinance. The leading MFIs, such as SEEDS, SANASA, Cooperatives and Samurdhi have their own staff training centers. The private agencies for Technical Assistance (TA) are still rare, however, now there is an independent trainers' pool for CGAP training module developed by GTZ-ProMiS. An important feature of technical assistance in the country is that it is grant driven. During the last 5 years, Rural Finance Sector Development project funded by ADB worth USD 27.29 mn and a

19 Policy Analysis paper on Draft Proposals for Regulating MFI in Sri Lanka, S.P. Permaratne, May 2007
20 State of Microfinance In Sri Lanka, Anura Attapattu, InM, 2009

GTZ program the Promotion of Microfinance Sector (ProMiS) equivalent to USD 5.6 mn value have provided Technical Assistance to MFIs for computerization, staff training, and developing TA providers for the sector.

The Lanka Microfinance Practitioners' Association (LMFPA) a network of MFIs represents the sector. The association has a membership of around 80-microfinance stakeholder, consisting primarily of NGO-MFIs and also some meso level service providers. The network has objective to create a conducive environment for microfinance in Sri Lanka but as an institution, it is still at formative stages.

The Credit Information Bureau (CRIB) of Sri Lanka includes Commercial banks, Specialized banks, Leasing companies and Finance companies. Other than these four types, borrowers of the National Development Trust Fund (NDTF), Merchant bank and Export Credit board is using the CRIB. However, the CRIB for microfinance borrowers is not yet incorporated unless they are covered by existing institutions.

There are 3 wholesale funding agencies operating in the Sri Lankan microfinance sector. These are the government owned National Development Trust Fund (NDTF), Stromme Microfinance backed by the Stromme Foundation of Norway, and Consorzio Etimos, a funding agency based in Italy.

COMPETITION

According to InM Study[21], there is an increasing trend of commercial banks and finance companies going towards the lower end of the scale and moving to the more remote areas. This has created a certain degree of competition in deposit mobilization affecting the the availability of deposit resources for micro credit providers to provide credit services to much needed microfinance clients.

Further while exact number are not available, many of the sample surveys on access to credit found that large percentage of families have multiple memberships and access to credit and savings institutions.

RISKS

The main risk MFIs are facing now is the lack of funds to finance their portfolio. With only three apex funding institutions, and the state owned institution having a interest rate ceiling, MFIs - which are not regulated - do not have access to commercial investments and are unable to mobilise deposits, which aggravates the problem. It is important to note that none of the major players in micro credit market consider that competition is one of the major challenges for their growth and sustainability and more importantly many of them consider limited funding sources is the number one challenge for their growth.

In addition, many MFIs are spin-offs of NGO and the focus on sustainability is limited with many. As shown in the MIX market study on performance and transparency (2005) even basic data on outreach and profitability data are not available in certain MFIs, making it difficult to assess performance levels and sustainability of operations in the sector. Most institutions lack adequate management information systems (MIS) and are unable to track their loan portfolios and other performance measures. What little data are available rarely adhere to international standards and instead track cumulative indicators which do not accurately capture institutional performance. The LMFPA does not collect performance data in regular intervals on member performance although initial survey and data base is established. Only very few institutions are familiar with international best practice reporting standards for micro finance. Another related issue is that the measures of portfolio quality often varies across organizations, some measuring PAR at one day and others tracking this indicator after 90 days which make comparisons

21 State of Microfinance In Sri Lanka, Anura Attapattu, InM, 2009

of performance difficult. Lack of information, combined with the large number of competing microfinance providers risks creating situations of over indebtedness among poor clients, who may take out multiple loans.

REGULATIONS

The different categories of micro-finance institutions are registered under various laws but are not regulated or monitored through a specific regulatory and supervisory authority or arrangement. Some of the key laws applicable to microfinance institutions are as follows:

- Banking Act No.30 of 1988 (amended by Act No. 33 of 1995, Act No. 2 of 2005, Act No. 15 of 2006 and Act No. 46 of 2006). This law applies to licensed commercial banks and licensed specialized banks. Banking licenses are issued by the Monetary Board of CBSL with the approval of the Minister of Finance.
- Finance Companies Act No.78 of 1988 (amended by Act. No.23 of 1991). This law applies to all registered finance companies. License to carry on business is issued by the Monetary Board of CBSL.
- The Samurdhi Authority of Sri Lanka Act No.30 of 1995 (as amended by Act No. 02 of 1997) ("Samurdhi Authority Act"). This was a governmental initiative for the provision of welfare services through the state and the Samurdhi Authority Act provides the ability to mobilize savings and extend credit facilities.
- The Co-operative Societies Law No. 5 of 1972 (as amended by Act Nos. 5 of 1972, 37 of 1974, 11 of 1980, 32 of 1983 and 11 of 1992) ("Co-operative Societies Law") was enacted to provide for the development of co-operative societies. They are entitled to make loans to members (or another registered co-operative society with the approval of the Registrar of Co-operative Societies) and accept deposits.

In addition, many institutions who conduct microfinance business are registered under The Companies Act No.7 of 2007 ("Companies Act") and the Voluntary Social Service Organizations (Registration and Supervision) Act No. 31 of 1980 (as amended by Act No. 8 of 1988) ("the VSSO Act").

In August 2010 a proposed microfinance act was released to the public, which included setting up a Microfinance Regulatory and Supervisory Authority to license, register, regulate, supervise and strengthen companies, non-governmental organizations, societies and co-operative societies carrying on microfinance business. A board shall govern the Authority, consisting of officers from the Ministry of Finance, Central Bank and three members nominated by the Finance Minister.

FINANCING

There is not sector wide detail data available for financing structure of MFIs in the country.

The main financing sources are donor grants, savings, soft loans and commercial loans, however, donor grants are declining now and they are mostly now available for Northern and Eastern parts of Sri Lanka.

Savings are mobilized from the members of MFIs. The regulated banks mobilize savings from non-members too. However, savings mobilization by non regulated MFIs even from their members are restricted now to a lager extent. Therefore, certain such MFIs collect funds from their clients under different labels such as loan contribution, security deposits etc which are how ever a part of the capital for those MFIs.

The State-owned apex lending institution NDTF provides bulk loans to finance loan portfolios. The NDTF[22] lends to microfinance institutions for 7% (per annum on reducing basis) reducing balance, and has a interest rate ceiling of 15% reducing balance per

22 There is Government approval for merging the Sri Lanka Savings Bank and NDTF, but the NDTF will remain as a separate entity under Sri Lanka Savings Bank

annum. The institutions who apply for the credit services from NDTF needs to registered entities, with one year experience of microfinance, and should have a recovery rate above 90% with less than 10% non performing loans. As per the Central Bank Annual report 2008 NDTF has lend Rs 1,402 mn (USD 12 mn) to 189 partner MFIs. The 2006 CLEAR Review[23] cites underutilized apex funds as a challenge facing the sector, stating that disbursement of the main apex funds is low, indicating limited interest or absorption capacity of MFIs.

The debt financing from commercial banks or financial institutions is very rare in the country. There are MFIs such as SEEDS who have obtained bulk loans from state banks to finance their loan portfolio, but the involvement of the commercial banks in lending to MFIs is limited to implementation of government programs such as Povery Alleviation Microfinance Project (PAMP) under the central bank supervision. The commercial banks get financing from the central bank under PAMP at 4.5% interest rate which goes to end clients at 16%. The PAMP disbursed Rs 514 mn (USD 4.5 mn) in 2008.

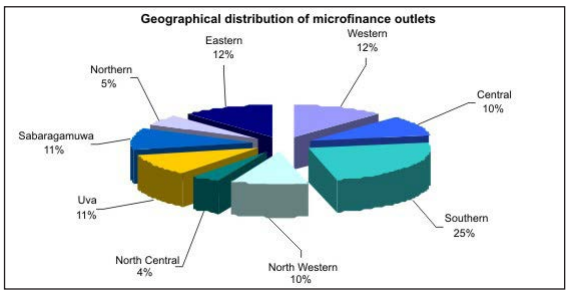
Stromme Microfinance is another wholesaling lending institute similar to NDTF which also provides technical assistance. The interest rate charge by Stromme Foundation are between 9-9.5% per anum (on reducing balance). It has 40 NGO partners. Stromme has disbursed Rs 1,193 mn (USD 10 mn) for the microfinance sector. Ecumenical Loan Fund (ECLOF) is another international source of funding for this sector. ECLOF has disbursed Rs 131 mn (USD 1.5 mn) during the year 2007 (ECLOF annual report 2007).

ETIMOS, the Italian agency having an office in Sri Lanka also provides whole sale loans to MFI.

There is a positive trend of commercial borrowing from local and international sources in the last couple of years As an example SEEDS has borrowed from NOVIB in the Netherlands and as well as from Peoples Bank, Hatton National Bank and Lankaputhra bank in Sri Lanka. However, local commercial funding institutions, which could play a role as wholesale lending agencies, are reluctant to get involved in the microfinance sector due to high risk perception association with the sector. While a large number of off-shore microfinance funding agencies are available, the restrictive legal environment and the long and cumbersome process of obtaining approval from the Controller of Exchange serve as deterrent factors for many potential off-shore funders. Against this background, funding becomes the key issue especially for MFIs (NGO/Companies) which are restricted by law from accepting public deposits and further restricted from obtaining off-shore debt and equity funding due to prevailing exchange control restriction.

MARKET GAPS AND CHALLENGES

GTZ demand side survey (2008) found that 80% of Sri Lankan households which has borrowed from institutional sources have borrowings below Rs100,000. In the urban areas 67.9% households which took loans were borrowing below Rs100,000 whilst in rural areas it was 100% for borrowing households. This shows that Sri Lanka is primarily a micro finance market and MFI's can attract more and more customers in the rural areas.



Source: ProMiS

23 Country-Level Effectiveness and Accountability Review, Sri Lanka, CGAP, February, 2006

The above-mentioned study by GTZ also found that despite the presence of so many MFI's informal credit still remained an important source of credit and savings. A 32% of the households who were members of MFI's have borrowed from informal sources. The study also showed that informal credit as a % of credit received from MFI's was 15%. The average credit obtained from informal sources were smaller at Rs10,862. In fact over 60% of house holds borrowed less than Rs 5,000 and 20% even less than Rs 1,000. The percentage of people using informal credit was highest in plantation sector. This shows that microfinance has not been able to offer products in the lower band. The Microfinance outlets are more widespread in Southern province (24% of total) while north and eastern area (3.9% of total) are very much underserved. Also 90% of microfinance outlets are concentrated in rural areas; approximately 10% in urban areas and 1% in the estate sector. This also points to the fact that there is unmet demand and market potential in those areas is still to be tapped. In light of the rebuilding of North and East, there is huge scope for expanding microfinance services.

Approximately 50% of Sri Lankan households do not have access to credit and this unmet demand for microfinance in Sri Lanka is estimated at Rs 125 bn (USD 1.1 bn)[24]. A major gap from a demand side is the abundance of income generating loans and paucity of lending for other credit needs.

On challenges, certainly there is an inappropriate donor intervention and pervasive government presence. Following the fact that the microfinance sector is highly fragmented and diversified, sector data is largely unavailable. Indeed, the available performance data is often inconsistent across institutions and often does not comply with standards. Thus while a number of MFIs are reported to be doing well, a large number of them have low recovery rates and several hundred of CRBs and TCCs are poor performing. The continuation of this over an extended period of time could result in collapse of institutions and loss of public confidence in these community-based institutions[25].

MICROFINANCE INVESTMENT

GENERAL INFORMATION

The Board of Investment (BOI) is an autonomous statutory agency and the primary government authority responsible for investment, with focus on foreign investment. The BOI acts as a facilitator for investment. It is intended to provide "one-stop" service for foreign investors, with duties including approving projects, granting incentives, and arranging services such as water, power, waste treatment and telecommunications. However, microfinance falls outside of the businesses targeted by the Board of Investment (BOI). The CBSL is the Government's focal point and highest administrative authority on policy and implementation related to private investment in financial sector.

Credit Guarantee through LFSUS

UN–HABITAT has set up a credit guarantee mechanism, with government support, to allow banks to lend housing upgrading loans to Sri Lanka's slum communities, through micro finance institutions. The credit guarantees are offered through the Lanka Financial Services for Underserved Settlements (LFSUS), a non profit company. Already three commercial banks, HSBC, HNB and People's Bank, are on board for the credit guarantee scheme.

For foreign investment the following acts also come under consideration:

24 GTZ Promis, Outreach of Financial Services in Sri Lanka – a look at the demand-side from a microfinance perspective, April 2008

25 WB, Microfinance in South Asia, December 2006

- Exchange Control Act, Foreign Exchange Manual, Central Bank of Sri Lanka, December 2001
- Finance Act No 11, of 2006, Certified as on March 2006

The corporate income tax is 35%. The foreign investors are allowed to transfer their profit and capital outside the country after getting an approval from Foreign Exchange Department of CBSL. In addition to these is 10% withholding tax on interest earned. Sri Lanka has double taxation treaty with most countries and any request for paying of taxes has to be put to Department of Inland Revenue.

DOMESTIC DEBT INVESTMENT

LEGAL FRAMEWORK

The legal framework for domestic investment remains the Finance Act. All legal forms of MF Providers including MFIs (companies, NGOsand cooperatives) can have take debt investment from domestic Financial Institutions.

PRESENT SITUATION

Domestic debt is the most common form of financing to many of the Sri Lankan MFIs. The government, through its funds such as National Development Fund, Sahana, Isuru and PAMP is one of the biggest players in the domestic debt. In addition, wholesale lending institutions, such as ETIMOS and Stromme Foundation, play a major role. There are one to one arrangements for loans (This is usually concessional rates or for rotating loan funds) between MFIs and different development partners.

The private commercial market for domestic debt is not very active in the microfinance sector. In the presence of soft loans, the commercial rates offered by banks are not very attractive for MFIs. However, some banks such as the People's Bank have given such loans to MFIs such as SEEDS. SEEDS obtained Rs 100 mn from Peoples Bank Country. Under this SEEDs gave corporate indemnity of Sarvodaya movements and promissory note as collateral. The interest rate varies between 20-25% for bulk loans.

The main concern regarding obtaining the wholesale fund from the state owned NDTF is the interest rate ceiling pf 15% (reducing) which has been applied to MFIs borrowing from the NDTF. This leaves margin of around 8% for MFIs to cover all the administrative costs within that range, which is not sufficient for many MFIs. Due to this many MFIs are searching for alternative sources of funding where the market rate can be charged to end clients.

DOMESTIC EQUITY INVESTMENT

LEGAL FRAMEWORK

There are no general restrictions on equity investments in Sri Lanka for domestic investments. The legal framework for domestic equity investment remains in the Financial Act. Among legal forms, MFIs registered as companies or financial companies are allowed to have equity investment from domestic financial institutions.

PRESENT SITUATION

Presently the domestic equity market in microfinance sector is very weak and there are not many examples of such investment. Considering that most MFIs are non-profit and thus not allowing for dividend or profit sharing, investors looking for commercial return are not interested.

FOREIGN DEBT INVESTMENT

LEGAL FRAMEWORK

The legal framework for domestic investment remains the Finance Act and Exchange Control Act.

Technically speaking, all legal form of MFI Providers, (MFIs, cooperatives etc.) can have debt investment from foreign financial institutions. However, any such request has to go

to Central Bank; in practical sense, MFI registered as NGOs, companies and cooperatives are not allowed to get debt from external sources.

The way to do a foreign debt investment is through intermediation of banks. Foreign investors can deposit the said amount in a commercial bank and commercial bank can then give debt in local currency to MFIs. Central Bank usually takes 3-4 months to give such approvals.

Main Sections in the Exchange Control Act

Section 5

Except with the permission of Central Bank, no person (other than an authorized dealer), shall, in Sri Lanka, and no person resident in Sri Lanka (other than an authorized dealer) shall, outside Sri Lanka buy, borrow or accept gold or foreign currency from or sell or lend any gold or foreign currency to any person other than an authorized dealer; [The term "authorized dealer" refers to licensed commercial banks in Sri Lanka all of which have been appointed by the Central Bank of Sri Lanka as authorized dealers in gold and foreign currency.]

Section 7

Except with the permission of the Central Bank, no person shall, in Sri Lanka,

a) make any payment to or for the credit of a person resident outside Sri Lanka;
b) make any payment to or for the credit of a person resident in Sri Lanka by order of or on behalf of a person resident outside Sri Lanka;
c) place or hold any sums to the credit of any person resident outside Sri Lanka;

Section 8

No person resident in Sri Lanka shall make any payment outside Sri Lanka to or for the credit of a person resident outside Sri Lanka except with the permission of the Central Bank. For the purposes of the Exchange Control Act, a company incorporated outside Sri Lanka (which does not have a branch in Sri Lanka), would be a person resident outside Sri Lanka.

Thus, approval of the Controller of Exchange is required for:- a person in Sri Lanka

- to borrow any sum in foreign currency from any person (other than a licensed commercial bank);
- to have foreign currency in his possession;
- to make any payment to or to the credit of a non- resident;
  - any person (other than a licensed commercial bank) to lend foreign currency to any person in Sri Lanka

PRESENT SITUATION

At present borrowings of a short term nature from abroad are generally not permitted while borrowings of a medium and long term nature are considered very strictly on case by case basis by Controller of Exchange taking into account the terms and conditions of loans. The major factors considered when approving such loans are whether the interest rate is comparatively low in terms of prevailing rate for local borrowings and whether such borrowings can be repaid out of foreign exchange earning for the borrowers without any significant bearing on the country's foreign exchange reserves.

In the present macro-economic context of low foreign reserves and balance of payment crisis, it is unlikely that CBSL would make any changes in this policy. Further, the Exchange Board regulations specifically bar foreign companies formed for the purpose of lending.

BRAC Sri Lanka is the only MFI (non guarantee company) which has obtained dept investments from KIVA. Apart from BRAC, the only successful institution obtaining foreign loans is LOLC Microcredit Limited. They have obtained loans from Symbiotics SA Information Consulting for EUR 10 mn. There were also certain other MFIs who have applied for foreign loans but, recently this facility has not been granted to the MFIs and several applications of the MFIs are still been processed at the Central bank.

FOREIGN EQUITY INVESTMENT

LEGAL FRAMEWORK

The Exchange Control Act prohibits any person residing outside Sri Lanka from acquiring shares in a local company except with the permission of the Controller of Exchange. This permission may be special (on a case by case basis) or general in nature. However, money lending and pawn brokering activities are excluded, and off-shore investments are not permitted to these. Since microfinance is considered as a business of money lending this Act is applicable to microfinance too. Non-licensed financial institutions cannot take foreign equity investment and therefore NGOs, companies and cooperatives do not qualify for such investment. This has a negative impact on a number of better performing MFIs, which are unable to access offshore equity capital which would enable them to scale their operations.

The prohibition on foreign investments in companies carrying on the business of money lending and pawn broking does not apply to companies carrying on the business of banking under a license issued by the Central Bank, finance companies registered under the Finance Companies Act or finance leasing companies registered under the Finance Leasing Act. There is no restriction on foreign investment in such companies.

The minimum capital requirement to start a finance company is Rs 200 mn (USD1.7 mn) and the foreign entity can have 100% equity in the finance company.

PRESENT SITUATION

Due to the prohibition placed on foreign direct investment in companies carrying on money lending, it is not possible for a foreign entity to invest in a company carrying on microfinance business in Sri Lanka unless the local company operates under a banking license or a finance company license. This is one of the main challenges which the microfinance institutions are facing.

To date the only foreign equity investment is for LOLC Micro Credit Company (LOMC) which is a part of LOLC Group from Netherlands Development Finance Company (FMO). LOMC was launched with a USD 10 mn loan and equity injection from the FMO. FMO has invested USD 2 mn in equity, USD 1.5 mn as a convertible loan and USD 6.5 mn as a senior loan. FMO owns 20% of LOMC.

Whilst there is no restriction on foreign investment in the shares of a local company

which then invests in a local microfinance institution, Sri Lankan regulatory authorities have sought to exclude such arrangements as well on the basis that such indirect foreign investment in the microfinance sector is an avoidance of the intent of the exchange control regulations.

Foreign Equity & Debt Investment: LOLC Micro Credit Limited (LOMC)

LOLC Micro Credit Limited (LOMC), promoted by Lanka Orix Leaseing Company PLC, was registered as a finance company in 2008 with the vision of becoming the private sector catalyst in promoting sustainable development in Sri Lanka by empowering people to achieve their dreams by providing access to finance and related services.

LOMC provides a successful institutional example which was able to attract foreign funding in the form of equity, dept and capacity building. In late 2007, LOLC (at that time the LOMC Business unit was not separated) partnered with GTZ for capacity building of the microfinance staff, setting up a low cost branch network and for development of micro banking system. In 2008, the LOMC Business Unit was separated and the Dutch development bank FMO took 20% stake in LOLC MF, making this company the first MFI in Sri Lanka with foreign shareholding. FMO invests USD 2 mn in equity, a convertible loan of USD 1.5 m and a senior loan of USD 6.5 mn. In late 2009, LOLC Micro Credit Ltd. (LOMC), received foreign funding totalling USD 14 mn to expand its activities in Sri Lanka. Of this, Symbiotics SA Information Consulting Services Switzerland arranged USD 10 mn while Triodos SICAV II-Triodos Microfinance Fund, Triodos Fair Share Fund and Hivos-Triodos Fund, funds under management of Triodos Investment Management, have granted a syndicated 3 mn Euro loan.

The main competitive advantage LOMC has in obtaining dept and equity is their legal status whereby the institution is registered and supervised by the Central Bank. This is the biggest hurdle the other players have to overcome, since many others are unregulated. In addition, the governance, an operational management and risk management structure, experience in hedging and managing foreign exchange risk, contributes to the success of LOMC.

KEY CONTACTS

Central Bank of Sri Lanka (CBSL)
www.cbsl.gov.lk

Lanka Microfinance Practitioner's Association (LMFPA)
www.lankamicrofinance.com

Ministry of Finance and Planning in Sri Lanka
www.treasury.gov.lk

Promotion of the Microfinance Sector (ProMiS)
www.microfinance.lk

Annex 1: SAMN Partner MFIs

	Country		(Dec 2009/Jan 2010)	
		MFIs	Active Clients	Loan Outstanding (mn USD)
1	Afghanistan	AFS	7,835	2.95
2		BRAC	201,044	32
3		CFA	12,900	2.21
4		MADRAC	15,106	2.74
5		MoFAD	13,800	1.86
6		Oxus	10,145	3.08
		Sub-total (AFG)	260,830	45
7	Bangladesh	BASTOB	9,513	1.18
8		BURO	746,938	58.21
9		IDF	78,689	6.50
10		MSS	106,065	8.47
11		UDDIPAN	263,264	25.80
		Sub-total (BDESH)	1,204,469	100
12	India	Credible	10,036	1.07
13		Gram Utthan	65,241	8.52
14		Mahashakti	24,000	2.07
15		Sonata	77,735	10.48
16		Star	30,530	4.35
17		VFS	150,354	15.50
		Sub-total (IND)	357,896	42
18	Pakistan	ASASAH	27,561	2.28
19		CWCD	10,371	1.96
20		Pak-Oman	13,351	1.39
21		SAFWCO	18,043	1.62
		Sub-total (PAK)	69,326	7
22	Sri Lanka	Agro Microfinance	7,586	1.63
23		BMI	15,350	2.37
24		LOMC	23,931	30.00
		Sub-total (SRL)	46,867	34
	SAMN Total		1,939,388	228.35

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