Summary of the Poverty and Social Impact Assessment: Pakistan Microfinance Policy

May 2006

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BACKGROUND

There is an increasingly large body of evidence which shows that microfinance (MF) can have an impact on poverty reduction and in reductions of vulnerability to poverty. In addition there is an emerging body of literature that MF can impact positively on health, nutritional status and primary school attendance.[1] It is therefore logical that MF policy should play an important role in Pakistan's Poverty Reduction Strategy (PRS).

MF can reduce poverty both directly and indirectly. Loans provided 'directly' to the poor can help to increase investment and productivity, and savings and insurance services can stabilise the consumption of poor, with savings in one period (eg a good harvest) being spent in another period (eg drought). MF can reduce poverty 'indirectly' by helping to deepen the financial sector as a whole. Moreover, financial sector growth has been shown to contribute to economic growth and on to poverty reduction.

The MF sector is relatively young and MF policy relatively new (2000-01). The MF client base is relatively small – about 0.5 million customers in 2005 – and with poverty levels at about 25% of the population (ie about 38 million people) the two big issues that this Poverty and Social Impact Analysis (PSIA)[2] sought to understand was:

- Is the MF sector small for its age and has it the potential to grow?
- Has the MF sector reached the poor?

CONCEPTUAL ISSUES

There are two important conceptual issues that are central to note if MF is to play a major role in poverty reduction.

The first issue is that MF providers need to be financially sustainable. That is, their revenues need to cover their operating costs and also the costs of loan losses and raising capital. Whilst government and their partners can use subsidies and technical assistance to act as catalysts in developing an MF market, they cannot scale up their support to cover a sector with tens of millions of clients – even if it was efficient or effective to do so.

The second issue is that whilst MF can be an effective tool for poverty reduction, it is not necessarily the case that financially sustainable MF institutions (MFIs) are effective in reaching the poor. Current thinking suggests that whilst it is possible to achieve both ie reach the poor and be financially sustainable, MFIs that make poverty reduction an explicit objective and that make

[1] Morduch, J., and Haley, B. (2002), 'Analysis of the Effects of Microfinance on Poverty Reduction', NYU Wagner, Working Paper No. 1014, June.

[2] PSIAs use available data and methods to provide a quick review of policy options and their impact on the poor.

poverty reduction part of their organisational culture are far more effective at reaching poor households than those that value financial goals above all else.[3]

MICROFINANCE POLICY

Since 2000 MF policy development has taken place against a background of substantial financial and banking sector reform, and against a background accelerating macro-economic growth.

The objectives and strategy for MF policy were summarised by the Minister of Finance in November 2000 under the Microfinance Sector Development Program (MSDP). The main aims of the MSDP were to:

- create a conducive policy environment allowing new actors to emerge and to allow greater space to existing actors;
- develop appropriate financial infrastructure;
- promote and strengthen MFIs;
- develop linkages with NGOs and community organisations;
- invest in building social capital;
- mitigate the risks faced by poor households;
- develop institutions which would enhance the capacity and efficiency of those involved in the sector.

The MSDP was taken forward through several key initiatives:

- the Microfinance Institutions Ordinance (2001) (MIO) which provides the regulatory focus for the MF sector;[4]
- the development of public – private partnerships in MF banking (eg the Khushhali Bank);
- the restructuring of a number of Development Finance Institutions (DFIs) (eg the Federal Bank of Cooperatives was closed, and the Agriculture Development Bank re-launched);
- the launch of several donor initiatives supporting MF wholesaling (eg the Pakistan Poverty Alleviation Fund); retailing (eg Khushhali Bank, the First Microfinance Bank; Kashf); training and capacity development; information (eg the Financial Sector Strengthening Programme) and communications (eg the Pakistan Microfinance Network);
- the launch of four donor supported funds that were aimed at supporting community based social mobilisation, and at risk management eg clients and natural disasters; default by MFIs.

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[3] Empirical evidence suggests that financially sustainable institutions that has a focus on poverty alleviations are more geared to meet this objective in the long term then unsustainable institutions. BRAC, Buro and ASA are prime example. See also Morduch, J., and Haley, B. (2002) op.cit.

[4] The Ordinance prescribes that 'No person other than a licensed MFI shall use with its name the words "Microfinance Bank", "MFB", "Microfinance Institution", "MFI" or derivatives of any words or letters which suggest that it is a microfinance institution.' (Article 5(2)). For the purposes of this PSIA, therefore, we have distinguished between: MFI - a microfinance institution licensed under the Ordinance, and an MFP - a microfinance provider: any institution that provides microfinance services (which includes MFIs).

A SECTOR READY AND ABLE TO SCALE UP?

The formal MF sector provides only a small proportion of the financial services used by the poor in Pakistan (see following section). In Chapter 4 of the PSIA report, secondary data and seven case studies were used to identify the constraints facing the growth of the formal MF sector.

Scale and Sustainability

MIX Market has recently published a useful survey of MF in the South Asia region (Stephens, Tazi *et al.*, 2006) from which Figures 1 to 5, below, are extracted.

The charts give a good graphical picture of the relative position of Pakistan in the South Asia region, and of the region in the world. The MIX Market paper gives a full commentary on these comparisons. For the purposes of the PSIA, the following points are highlighted:

- in terms of productivity measured by borrowers per staff member, India led the field by very long way, but Pakistan was only slightly behind Sri Lanka, ahead of Nepal and Bangladesh, and well ahead of Afghanistan (Figure 3);
- in terms of efficiency measured by costs per borrower (also Figure 3), however, Pakistan performed significantly less well than any of its neighbours except Afghanistan;
- Pakistan's write-off ratio (Figure 4) is rather higher than its neighbours, but the difference is significantly wider in terms of the ratio of loans more than 30 days overdue, where Pakistan's ratio, at 20%,is more than twice as high as any neighbour. MIX Market point out, however, that due account needs to be given to the fact that loans in Pakistan tend to be of longer duration than those in the other countries (apart from Sri Lanka), which mitigates the discrepancy to some extent (a six-month loan that is 30 days overdue, for example, being a less grave matter than a one-month loan that is 30 days overdue);
- perhaps most significantly, in financial performance (measured by the financial revenue ratio), South Asia does not perform as well as the other regions, and Pakistan is the lowest performing country in South Asia (Figure 5). The problem is highlighted by the MIX Market survey, which comments: 'the Pakistani [MF] sector posts the region's lowest returns because of a mismatch between revenues and expenses. While cost structures are on par with regional norms, many MF institutions (MFIs) in this country charge exceptionally low interest rates that are not in line with the cost of doing business' (Stephens, Tazi *et al.*, 2006, p.11).
- although Pakistan lagged behind its neighbours in terms of borrowers served by profitable MF providers (MFPs) and the number of profitable MFPs (Figure 1), the regional comparison indicates that it ranked close to India and Nepal in terms of the percentage of borrower growth from profitable MFPs, and well ahead of Sri Lanka and Afghanistan (Figure 2); MIX Market themselves, however, argue that these figures give a distorted picture of developments in Pakistan, as explained at the end of this section;

It is significant that the figures on which these charts are based are from 2003, at an early stage of the PRSP and of the Microfinance Institutions Ordinance, 2001. The differences between Pakistan and some of its neighbours, particularly India and Bangladesh, are consistent with the view that Pakistan is at an earlier stage in MF development than these countries, i.e. a late starter rather than a laggard. It is particularly encouraging to note that Pakistan ranks third in terms of the percentage of borrower growth coming from profitable institutions, even though the number of such institutions is relatively very small.

Figure 1: Sustainability and outreach of microcredit providers

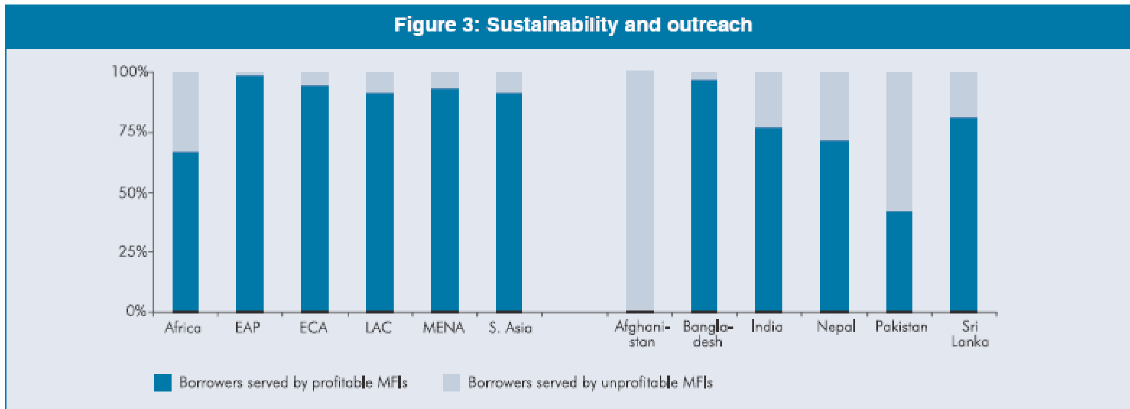


Figure 2: Share of borrower growth from sustainable institutions

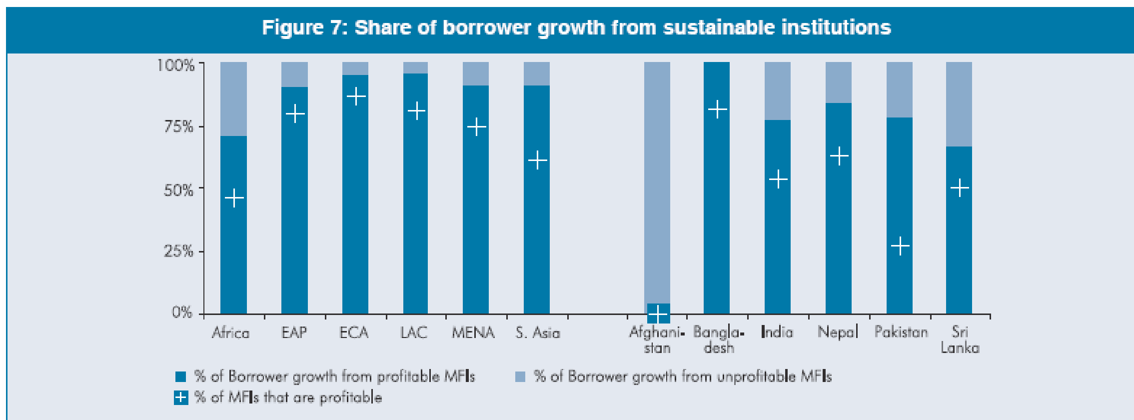


Figure 3: Efficiency and productivity

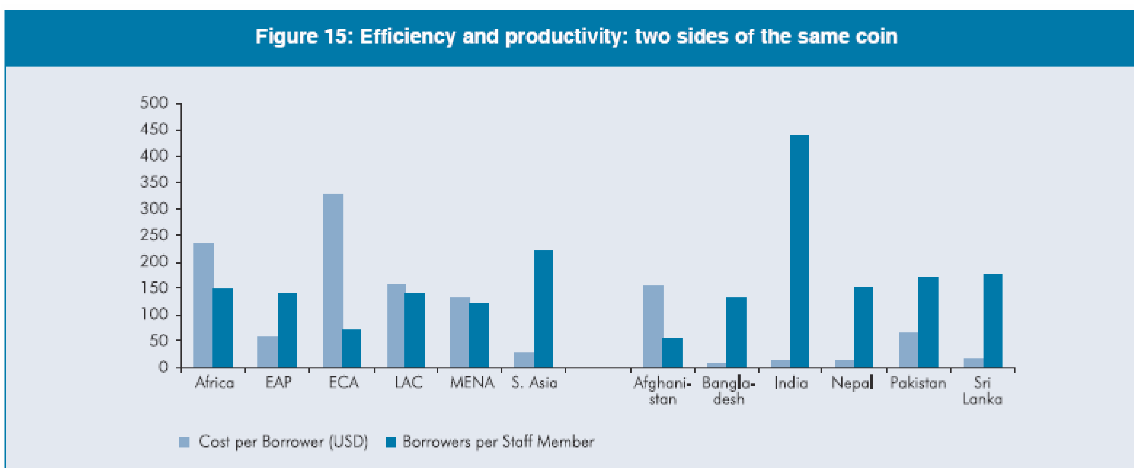
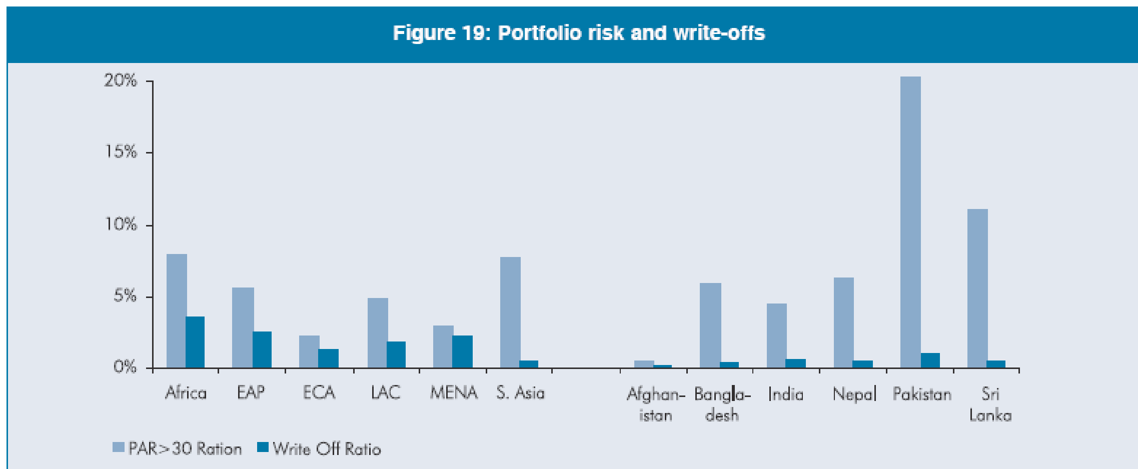
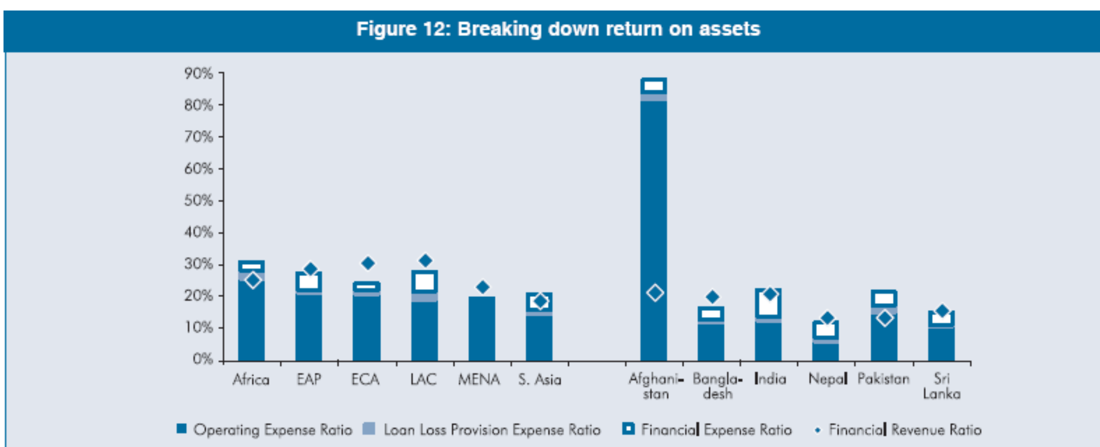


Figure 4: Portfolio risk and write-offs



Note: PAR>30 Ratio (not Ration) is the ratio of the loan portfolio that is more than 30 days overdue.

Figure 5: Breaking down return on assets



Notes: Figure 1 - 5 Source, Stephens, Tazi *et al.* (2006): MIX Market 2003 data as of October 21, 2005. Data presented are averages. EAP: East Asia and the Pacific; ECA: Eastern Europe and Central Asia; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; S. Asia: South Asia.

As has already been mentioned above, Mix Market, who generated these figures, argue that Figure 2 gives a distorted picture of the position in Pakistan.[5] This is because the figures in Figure 2 exclude Khushhali Bank and include some MFPs that were on the cusp of sustainability and have since moved from above to below the sustainability line. Indeed, the authors of the MIX Market study argue in the Pakistan country study that, 'One alarming feature of current sector growth is that it is being led by unsustainable institutions that are heavily subsidized. The poor require regular and reliable access to financial services, but the majority of MFIs are unable to generate sufficient revenues to cover their cost of operations.'[6]

[5] Stephens, Tazi *et al.* (2006), pp.69-71

[6] Op. cit., p.70

This supports the report's conclusions, cited above, about the poor financial performance of MFPs in Pakistan. The findings of the report on this point conform with the conclusions of this PSIA about the financial performance of the MF sector in Pakistan, and merit quotation at some length (pages 69-73):

> 'Future growth, however, is significantly compromised by the sector's high dependence on subsidized funds to cover costs and maintain operations. To ensure the sustainability of the industry, Pakistani MFIs should build on their exceptionally low cost structures and consider re-pricing their products and services to enhance their financial revenues and become self-sufficient. …
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> 'Moreover, the asset side of the balance sheet shows that MFIs are using their assets inefficiently. … There are several reasons why MFIs do not optimally utilize their resources. Across the country, microfinance is regarded as a charitable activity. Institutions thus charge exceptionally low interest rates and do not regard their credit operations as a significant means to raise revenue. …
>
> 'The challenge to MFI profitability in Pakistan thus appears to stem from a charitable vision of microfinance that has adverse effects on product pricing, asset allocation and credit risk throughout the sector. MFIs are averse to charging sustainable interest rates since these are perceived as usurious and counter to the movement's mission of alleviating poverty. Microfinance providers thus wind up on a low cost low yield curve, running heavily subsidized programs.'

The Voice of the Microfinance Institutions

Seven case studies were undertaken on a number of MFPs, and of some financial institutions that are not currently players in the MF sector. The purpose of the case studies was to gain an understanding of how the selected (actual and potential) providers perceived the sector: their view of the sector as a whole, their perception of their role and their poverty impact, their understanding of government MF policies, and their views about the key issues covered in this assessment.

The case study institutions, chosen to represent a cross-section of different types of institution and areas of geographical focus, were:[7]

- **Bank of Khyber** (a full services, broad-spectrum MFP, operating in NWFP);
- **Khushhali Bank** (a full service, specialist MFI, founded with public funds, operating nationally);
- **Tameer Microfinance Bank** (a full service, specialist MFI founded with private funds, operating initially in urban areas);
- **National Rural Support Programme** (a restricted service broad-spectrum MFP, operating nationally);
- **Kashf Foundation** (a restricted service specialist MFP for women, operating in Lahore);
- **Habib Bank** (a large, former state-owned commercial bank that does not undertake MF activities);

[7] As explained in section 2.3.1 of the main report, the key difference between a 'full service' and a 'restricted service' MFP is that the former are allowed to take deposits from the public, whereas the latter are not.

- **Union Bank** (a new, 'second generation' commercial bank that does not operate MF strictly defined, though it does have a group lending scheme for farmers, see below).

The results of the case study interviews were summarised along seven themes:

1. **The stage of development of MF in Pakistan -** A number of respondents believed that the MF sector in Pakistan was coming to the end of its primary stage and was in a position to take off into significant growth, given the right conditions. Others, however, feared that a lack of strategic thinking by MFPs might hamper that growth.

2. **Poverty alleviation versus business objectives -** All respondents expressed concern about what they perceived as an excessive focus on the role of MF as a poverty alleviation tool.

3. **The role of government, donors and subsidies -** MFPs agreed that it was not appropriate for governments to act as MFPs; the appropriate role for them was to lay down policy guidelines and ensure an appropriate enabling environment for MF. There was also agreement that government and donor subsides were useful at the start-up stage, but needed to be phased out as the industry matures.

4. **Microcredit interest rates -** All respondents agreed that clients were willing to pay the high interest rates required for sustainable MF, and that what mattered to clients was access to credit rather than its cost.

5. **Regulation and taxation -** Respondents agreed that there were problems with the loan limit of Rs 100,000; the taxable income limit for eligible MF clients; the tax rate imposed on MFIs registered under the Ordinance; and the supervision of the MF activities of commercial banks.

6. **The Bangladesh comparison -** Two respondents expressed frustration with constant comparisons with Bangladesh, arguing that Pakistan and Bangladesh were very different environments.

7. **Miscellaneous Points –** Respondents aslo raised issues of skill shortages, the urban / rural distinction, problems of documentation, a 'default culture' and the buoyant demand in the conventional credit market.

ACCESS TO THE POOR TO MICROFINANCE AND ITS IMPACT

Currently in Pakistan there is very limited primary data or secondary analysis with which to understand how the poor use microfinance services (both formal and informal) or to understand whether the poor had access to the services being provided by the new wave of microfinance institutions, and the study also undertook a small 'financial diaries' survey.[8]

The conclusions that can be drawn for the reanalysis of the Pakistan Integrated Household Survey (PIHS) and and the Pakistan Socio-Economic Survey (PSES) are that in 2000 the poor had very little

[8] A recent large evaluation of the Kushhali Bank lending to the poor did not provide enough reliable evidence for use in this PSIA.

access to formal and semi-formal credit markets; the vast majority of loans were used for consumption rather than investment; large loans were provided by formal and semi-formal credit providers; and lastly, the availability of credit may have played a significant role in reducing the poverty impact of the drought in NWFP and Punjab. However, in Sindh and Balochistan, covariate risks (i.e. suppliers of credit were unable to supply when the users of credit needed it most) may have severely reduced the role that credit might have played in maintaining consumption levels.

The conclusions that can be drawn from the 'financial diaries' survey are clearly constrained by its methodological limitations. The study essentially comprises four comparative case studies. Each case study focuses on a different MFP (SRSP, NRSP, Kashf Foundation and MRDO) and analyses the usage of formal and informal financial services by the relatively poorer households situated in a locality in which that MFP operates. There was some randomness involved in the selection of the surveyed localities, but none at all in the sampling of households to be interviewed. Therefore the results are in no way representative.

For this reason this study is perhaps best regarded as a pilot, highlighting the main issues and particular difficulties involved in assessing the impact of MF services. In any case, and in spite of these concerns, the study did produce some interesting findings:

- While most of the sampled households used a wide range of financial intermediation mechanisms to manage their resources, in each of the Sindh, Islamabad and NWFP localities half of non-beneficiaries interviewed reported neither having used any method of saving nor having borrowed any money in the last year. This seems a rather dubious finding and highlights the desirability of using full-blown 'financial diary' methodology, whereby extremely detailed and ongoing logging of a household's finances provides a far more reliable technique of establishing whether or not a household is using any financial mechanisms. Unfortunately, such an approach, requiring a series of interviews over a substantial period of time, was clearly beyond the scope of this study.
- The households interviewed were just as likely to use informal financial mechanisms as they were to use formal financial services. However, this finding was skewed by the focus on MF beneficiaries. In fact very few households used formal financial services other than those provided by MFPs.
- Participation in committees was by far the most common method of saving, even for those beneficiaries with MFP savings accounts. Clearly not all households could afford to save, but those who could were frequently saving for life-cycle events, such as weddings. Having said that, saving was often undertaken with multiple motivations in mind, eg a household may be saving for a wedding knowing that in a real emergency these savings could be used for another purpose.
- Almost all borrowing fell into one of the following distinct categories: MFP loans, used for investment purposes; and borrowing from family and friends, most frequently in response to an emergency event, particularly illness or accidents. This highlights the importance of MFP loans as basically the sole source of funding available to facilitate investment.
- There is some evidence of MFP loan misuse with 9 out of the 60 beneficiary households interviewed admitting to not using their most recent MFP loan for the investment project for which it was intended.
- With monthly reported profits on MFP loan financed investments averaging around Rs 5,500, MFP beneficiaries clearly benefit substantially from MFP services. However, whilst clearly satisfied in general with these services, many beneficiaries identified areas for improvement,

which could potentially increase these benefits further. It is unclear why MFPs do not make more effort to persuade beneficiaries to divert their savings away from committees and into MFP savings accounts, which could in principle pay interest, since the many beneficiaries appear to desire savings schemes which involve flexible savings deposits and withdrawals, something most committee systems cannot provide.

- MF beneficiaries appear to be relatively better off than non-beneficiaries in all four of the localities sampled for this study. Therefore one obvious possibility for increasing impact of MF services would be to extend MFP services to poorer non-beneficiaries. This would be in conflict with most MFPs' current policy of focusing on those members of a community who have a lower chance of defaulting on loan repayments, and who are therefore generally better off. Although many felt that it would be ideal if the interest rates on loans were lower, no respondents mentioned it as a particular concern. Thus, it may be that interest rates could be raised sufficiently to cover the increased costs associated with lending to those with relatively greater chance of defaulting, whilst still being below the seemingly very high rates of return on potential investment opportunities.
- Even if MFP services can be extended they will still not be reaching those in extreme poverty. However, the study highlighted the importance of those relatively better-off members of a community lending to those in need, particularly in response to an emergency. Therefore, to the extent that MFP services increase household incomes, by strengthening these informal support mechanisms the extension of MFP services may have further indirect positive effects.

CONCLUSIONS

The MF sector in Pakistan, while a late starter, is less far behind the sector in other countries in South and South-East Asia than might be apparent at first glance. Indeed, despite the fact that the mainstream MF sector in Pakistan is relatively young compared with those of other countries in the region, it is definitely in the same league as many of them in terms of some key measurements, such as the number of clients and the average size of loans.

In some areas, such as the range of types of service providers, Pakistan is actually ahead of many comparable countries. There are still some serious issues to be addressed, in areas such as access, sustainability and efficiency. Perhaps the most urgent and difficult area to address is that of financial sustainability. Also, and of particular relevance to this PSIA, the MF sector has yet to demonstrate its potential in terms of its social and poverty impact.

These issues, however, are characteristic of an early-stage MF sector. The PSIA supports the view that the MF sector in Pakistan is now in a position to consolidate the gains it has made during the years since the passing of the MF Ordinance in 2001, and is ready to embark on a major expansion in size and scope, given the right conditions, as discussion below.

In terms of size, our analysis confirms the views of the providers covered in the case studies, that there is scope for a major expansion in the number of clients in the next decade, from hundreds of thousands to millions.

In terms of scope of services, the case studies and the surveys demonstrate that providers and users share similar aspirations – for example, for more access to savings and insurance products, and for more flexibility in microcredit.

So what will 'the right conditions' be? How can MF policies be maintained or adapted to provide the conditions for expansion of the MF sector and to maximise its social and poverty impact?

The broad conditions required for this expansion, at the highest level, are obviously macroeconomic stability, and continued development of the banking sector.

At the MF sector level, the analysis supports the consensus of the current providers that the sector is ready for take-off, that the GOP's catalytic role in the 'start-up' phase has been a success, and that it is now time for the GOP to step back and let the MF industry evolve under its own momentum. The GOP no longer needs to be a provider of MF services, nor the main financier of those services, not does it need to take an interventionist approach to the scope and nature of the services provided by NGOs, MFIs and banks. The time has also come when the role of subsidies needs to be changed to ensure that any future subsidies are used to build the efficiency and financial sustainability of the institutions. The key role of MF policies at this stage of the development of the sector is to provide an enabling environment in which the sector can grow.

It would therefore be appropriate for consideration to be given to a number of policy options aimed at liberalising regulations and restrictions that were useful in the early stages of MF development, but that are now in danger of creating an artificial segmentation of the sector that might inhibit its growth. Particular consideration might be given to the following issues:

- **regulating by function or institution ?** – Currently, MF providers are regulated, or not regulated, according to what kind of institution they are (bank, MFI, NGO etc). Consideration might be given to regulating MFPs according to the kind of service provided (MF loans, deposits, transfers etc). This would mean, for example, that the regulation of MF services provided by MFIs under the Ordinance would be the same as, or comparable to, the regulation of the same services provided by commercial banks.

- **tax structures** - currently, an NGO would be penalised by becoming a deposit taking MFI under the ordinance, as it would have to pay corporation tax; this would also have a detrimental effect on the interest rates that NGOs would need to charge. However, favourable fiscal treatment to NGO MFPss could cut across the norms of fiscal policy in Pakistan, undermine the principle of regulation according to function rather than institution and prevent MF services being offered on a level playing field. - Tax is a complicated issue, but would nevertheless merit further consideration by GoP.

- **the use of subsidies -** It is a necessary condition for rapid growth in the next stage of development that microfinance services will be provided by institutions that are fully financially sustainable, or can become fully sustainable in a very short time. That requirement is undermined by subsidies that are passed straight to the borrower in the form of lower interest rates, and/or by subsidies that are used by MFIs to avoid the need to leverage lending services in order to build adequate capital. Any subsidies planned for the next few years, therefore, need to be very carefully designed to ensure that they are used purely for capacity building, or for building the MF infrastructure at the macro- and meso-level, and not used to maintain non-sustainable services and institutions.[9]

- **poverty monitoring and evaluation** – the recent literature suggests that MF providers that make poverty reduction an explicit goal and make poverty reduction a part of their organisational culture are far more effective at reaching poor households than those

[9] This would include such areas as product development, reaching out to the very poor, spinning off microfinance activities operationally and financially, the development of credit bureaus to reduce risk and over indebtedness etc

providers that do not. The same literature also suggests that MF institutions underspend on monitoring and evaluation and this failure whiling cutting costs in the short-run does so at the expense of long-term social and economic goals.[10]

- **restrictions on loan size** - after five years of experience, the loan limit of Rs 100,000 on MF credit under the Ordinance needs to be re-examined. The MFPs argue that it is a disincentive to lending to MF entrepreneurs, and in particular that it prevents an MFI from developing a relationship with a growing enterprise: as a microenterprise grows and requires larger loans, it moves outside the scope of MFIs, but its borrowing requirements are not yet large enough to interest normal commercial banks. If that is indeed the case, it would represent a significance constraint on the Micro, Small and Medium Enterprise (MSME) sector in Pakistan.

- **the definition of eligible borrowers** - The same re-examination is advisable in relation to the MFIO definition of eligible borrowers as 'poor persons', defined as 'persons who have meagre means of subsistence and whose total income or receipt during a year is less than the minimum taxable limit set out in the law relating to income-tax.' The poverty line defined in the PRSP is significantly lower than the MFIO's poverty line. Amongst other things, this leads MFIs to believe they are more poverty focused than they are in practice.

- **interest rates** - Throughout this PSIA, evidence has been cited from around the world as well as from Pakistan that demonstrates that people on low incomes continue to take out loans either from the informal or formal sector even at interest rates that, in different circumstances, might be regarded as very high. The large increases in output that result from investment at low levels of capital intensity generate the large increases in revenue that in turn can help repay investment loans at high interest rates. Access to credit is therefore usually much more important to people on low incomes than the costs of credit.

  Given the need – also demonstrated in this PSIA – for MFPs to become financially sustainable, it would be advisable to consider allowing the market to determine interest rates by removing explicit or implicit caps on interest rates.

- **services to rotating savings and credit associations (ROSCAs). using the example of NABARD?[11]** - Given the prevalence of ROSCAs in Pakistan, there is merit in considering ways in which the formal financial sector can better serve the informal. Indeed, as the case of NABARD in India demonstrates, such mechanisms can, in the right circumstances, support very rapid expansion of MF services. It would be useful for Pakistan to study the NABARD case to establish whether there is scope for facilitating a similar linkage between self-help groups and the banking sector, within or outside the MFP structure.

- **broadening the policy dialogue.** The focus of microfinance policy in Pakistan has hitherto centred around the MSDP, which has, as we acknowledge, made a significant contribution to the development of MF in Pakistan. To maximise the poverty and social impact of MF policies during the next stage of development, however, it will be necessary to broaden the scope of the policy dialogue. The current focus on MFIs will need to be widened to encompass the other important agents which impact on access by the poor and MSMEs to financial services, institutions such as the NGOs, the Post Office (a very large provider of services in remote areas), the co-operatives (about which not enough is known in relation to their outreach to poor people), Zarai Taraqiati Bank, and ROSCAs (on which, see above).

[10] Morduch and Haley, op.cit..

[11] NABARD is India's National Bank for Agriculture and Rural Development.