Shamshad Akhtar: Development of microfinance

Keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Seminar on "Beyond Charity : Commercial Opportunities in Micro and Small Lending", jointly organized by USAID and Shore Bank International, Islamabad, 6 June 2006.

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Ladies and Gentlemen, let me welcome you all to the one-day international seminar on "Commercial Opportunities in Micro and Small Business Lending", jointly organized by USAID and Shore Bank International. The seminar comes at the heels of a 'pro-poor, pro-employment' budget 2006/07, which has a special allocation of Rs. 10 billion for the Khushhal Pakistan Fund, in addition to employment generation schemes.

Pakistan has enormous potential for the development and exploitation of the microfinance industry. At the onset, the concept of Microfinance as a tool and mechanism for poverty alleviation needs to be well understood. It refers to the provision of a whole range of financial services to lower-income people, especially the poor, who can use the funding to finance their businesses, acquire household assets, improve consumption, invest in health and education and fund emergencies and social obligations. Its definition has to be broad based to include *micro-credit*[1] for tiny informal businesses and *micro-entrepreneur*s who are provided loans and a range of savings products and transfer services.[2]

A range of options exist to intermediate microfinance which goes beyond NGOs, and includes commercial banks, state-owned development banks, financial cooperatives, and a variety of other licensed and unlicensed non-bank financial institutions.

Setting aside the broader framework for microfinance, it is important to recognize that Pakistan is a late starter in developing the microfinance industry. There is a lot of work ahead to promote and systematically develop this sector.

At the same time, it is important to note that Pakistan's microfinance industry has followed a conventional route and has taken some significant initiatives to set on course the development agenda for microfinance. Moving away from the traditional reliance on nationalized banks to finance small farmers (which were seen as the primary universe in terms of being eligible for micro-credit) and the few NGOs which provided a range of special rural support or special urban slum targeted programs, Pakistan has now entered a new phase of microfinance development. The country has witnessed a wave of experimental programs. Sequentially, some sponsors promoted a number of foundations e.g. the Kashf Foundation program modeled along the Grameen Bank of Bangladesh, the Taraqi Foundation and the Damen Foundation. Other major initiatives include setting up of donor led apex arrangements such as the Pakistan Poverty Alleviation Fund (PPAF) and the Microfinance Sector Development Program (MSDP) which promotes the development of the microfinance policy framework while funding select institutions through foreign exchange credit lines. Subsequently, State Bank of Pakistan took a more holistic approach towards the development of the microfinance industry by developing the (i) policy, legal and regulatory framework of the microfinance industry, and (ii) promoting diversity and sustainability in the microfinance business. All such businesses are licensed and supervised by the State Bank of Pakistan and have to comply with Prudential Regulations for Microfinance Banks (MFBs). Today, along with the traditional NGO based programs, Pakistan has about six MFBs of which 2 have been in operation for around 4-5 years whereas four have been recently licensed with one MFB having been licensed a week or two back. In tandem, there is a formally recognized Pakistan Microfinance Network (PMN), which is self regulated. PMN members are a mix of the banks, leasing companies and focused financial services agencies along with the conventional NGOs that offer services to special segments of the society and community.

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1 Average microcredit loan balances tend be below per-capita national income.

2 Insurance is an important financial service that is often unavailable to lower-income clients and can therefore also be considered to be a component of 'microfinance.' However, insurance involves different regulatory issues that are beyond the scope of this paper.

It is estimated that all told, 40 Microfinance Institutions (MFIs) operate in Pakistan out of which 19 institutions are members of PMN which capture almost 99% of the MFIs market. Today, this network offers over 400 outlets of which 308 are branches of PMN members, besides which there are 92 MFIs with 145 service centres. Cumulatively the outstanding loans of these institutions are no more that Rs 3 billion and deposits of Rs 6.6 billion of which the bulk is so far intermediated through PMN members. Unlike some countries, Pakistan has lifted prohibitions and limitations on the participation of foreign equity holders (or founders / members in case of NGOs), borrowing from foreign sources, and employment of non-citizens in management or technical positions. This should go a long way to help set up businesses on modern lines and will also bring with it the necessary experience and technological support for this industry.

While development is underway, it is important to recognize the challenges we are beset with. Of principal concern is the low coverage of Microfinance services. The Microfinance institutional framework currently supports barely 600,000 active borrowers.

Existing coverage of the formal microfinance sector is only 10% of the estimated 6 million households in need of Microfinance. The requirements clearly are above these norms as currently one fourth of the population of Pakistan is below the poverty line.

Another feature is the high concentration across institutions, in lending and among clients. Khushhali Bank and PMN provide the bulk of the services given their edge in starting business early on. But these institutions have only provided lending facilities without adequately tapping the deposit base of their clients. Also, their lending profiles reflect a degree of concentration in select regions and sectors. As of March 2006, 41% of loans distributed by the MFBs are for agri-inputs, 24% for livestock, 26% for small enterprises and 9% for other purposes. This is because Khushhali Bank which accounts for the bulk of this business is rural focused. An analysis of gender-wise loans granted reveals that 84% of borrowers are male. Average loan size of MFBs is Rs 9,300.

The microfinance business further faces difficulty in accessing alternative sources of investment - particularly equity investment - which is a world wide problem.

Knowing how to conduct micro-businesses is an additional challenge in Pakistan given its low financial and accounting literacy.

The newly licensed institutions will not only help in diversifying the institutional risk and provide better coverage, but also introduce the much needed competition in this area. SBP has further developed the legal framework for microfinance institutions. MFIs are governed and regulated by the MFIs Ordinance, 2001, the promulgation of which resulted in a paradigm shift in the microfinance industry, and has laid the foundation for the systematic growth of the sector. Microfinance is now seen as a major tool for eradicating poverty. MFIs' paid up capital requirements are lower than commercial banks at Rs 250 million,[3] and to promote flexibility and innovation, SBP has adopted international standards in establishing requirements for capital adequacy, maximum loan size, credit and operational risks, KYC norms etc. The Finance Bill for 2006 now includes the long awaited amendments and refinements in the MFI Ordinance of 2001. Among others, the amendments;

(i) empower SBP to introduce flexibility and broadening of Microfinance Institutions to include Microfinance Banks,

(ii) give SBP flexibility in the determination of CRR and SLR with a flexible monitoring system,

(iii) provide SBP the option of determining the definition/threshold income level of the poor,

(iv) strengthen provisions to introduce explicit clauses regarding licensing of new MFIs, separate licensing requirements for existing NGO-MFIs, new start-up MFBs as well as improving provisions related to suspension of licenses,

(v) bring in line with SECP guidelines on corporate governance, the terms of external auditors and extending period of submission of accounts, and

(vi) strengthen regulatory powers of SBP.

These amendments are quite far reaching, are in line with the stakeholder's demands and hold the promise of providing the desired level of flexibility both at the regulatory cum supervisory level, while

[3] For provincial level MFB. The minimum requirements are Rs 100 million for district level, 500 million for national level.

easing constraints of the industry. Microfinance Institutions will now be able to tailor their products to meet the needs of their customers as they move along the prosperity continuum. The amendments have also made it possible to increase the business viability and diversity of institutions by the emergence of Regional Microfinance Banks that might obtain license for five adjacent districts with the prescribed minimum capital requirements.[4] The enhanced regulatory powers of SBP are aimed to ensure proper regulatory and supervisory oversight of the licensed MFBs. The amendments would also help improve the corporate governance of microfinance banks to become socially responsible and financially sustainable institutions.

As an additional feature, mobile banking guidelines have been designed to facilitate MFBs to penetrate their target market. SBP has issued NGOs/Rural Support Programs/Cooperative Transformation guidelines. Fit and proper criteria has been laid down for CEOs and Management of MFBs. Guidelines have also been issued for commercial banks interested in engaging in microfinance business.

Some unfounded myths often complicate the development and understandings of microfinance. Recognizing this, in Pakistan we need to encourage a paradigm shift in the rapidly evolving operating environment for the microfinance sector.

- First, there is a need to move away from subsidization of microfinance services to commercialization of such financial services. This, among others, involves looking beyond the government or donor subsidized credit delivery systems to self sufficient institutions providing commercial finance. Bank Rakyat Indonesia (BRI) and Bolivia's fini institutions BancoSol, both leaders in the microfinance revolution, are good examples among others to study what it means to be a financially self-sufficient microfinance institution. Both banks provide wide outreach to low-income clients, encourage commercialization, and both have been profitable. BRI finances its loan portfolio with locally mobilized savings; and BancoSol finances its loans with savings, commercial debt, and for-profit investment. In both institutions, the relationship between sustainability and outreach is emphasized.

- Move from single to multiple products is key to financial and social sustainability of microfinance industry. There are three basic microfinance products: loans, savings and insurance;

  Loans

  - Mostly short term working capital
  - Larger loans for fixed assets
  - Housing

  Savings

  - Mostly compulsory savings used a loan guarantee as protection to the lender. Most microcredit operations and MFIs cannot mobilize deposits without a license from the Central Bank. Member societies can mobilize savings from their members.
  - Savings are often a more appropriate financial product for the very poor than credit. This implies working with formal financial sector institutions, ROSCAS[5] and member societies.

  Insurance

  - Loan insurance is most common.
  - Common ways of providing loan insurance are:
    - purchased by the borrower when taking a loan as a percentage of the loan;

[4] Rs. 150 million.

[5] Rotating Savings and Credit Associations

- establishing an emergency fund in village banks, community loan associations and other groups; and
- compulsory savings.

➢ Third, financially sustainability of microfinance is contingent on recognizing that the credit has to be priced effectively. The administrative cost of delivery, disbursing and collecting a micro or tiny loan portfolio is much higher in comparison with conventional loan portfolios. So the borrowers end up paying interest rates that are substantially higher than the rates banks charge to their traditional borrowers. According to a recent ADB study, the nominal interest rate charged by MFIs in the Asia region ranges between 30-70% (on reducing balance) which is excessively high given that the inflationary trends are relatively low. The key to reducing costs is to introduce market competition, innovation and efficiency. Further, MFIs should disclose their effective interest rates to loan applicants on standard guidelines. The mandated discipline of disclosing effective interest rates may help micro lenders in focusing on steps they can take to increase their efficiency and thus lower their rates.

➢ Fourth, options to enhance the access to credit for the lower income group can be augmented by the combination of credit bureaus and statistical risk-scoring techniques. In the context of Pakistan, simpler solutions involve verification based on the national identity card (NIC) or new technology popularly adopted by NADRA i.e. thumbprint readers and retinal scanners. When MFIs begin to compete with each other for customers, over-indebtedness and default will rise sharply unless they have access to a database that captures relevant aspects of their clients' borrowing behavior.

➢ Fifth, Know Your Customer, Educate and Give Voice to Clients. MFBs/MFIs need to know their customer, know their market and design products to fit the financial requirements of the people they serve. The design of products is based on the financial requirements of the household and the economic activities the household supports. Successful MFIs are responsive to the market. They listen to their customers.

To conclude, it is important to recognize that recent initiatives and developments in Pakistan's microfinance sector are impressive and there is enormous potential for the industry to expand and for the population to exploit these financial services to their benefit. The outreach of these institutions has grown recently, albeit at a slow rate, and the numbers and beneficiaries remain much below our requirements as well as the standards prevailing in other developing countries.