

MICROFINANCE IN PAKISTAN



Possible
solutions to
Enterprise

Financing



**Center for
International
Private Enterprise**



Center for International Private Enterprise (CIPE) which is a non-profit organization, founded by U.S. Chamber of Commerce in 1983 has now established a field office in Karachi. In Pakistan, CIPE's primary role is to support efforts to improve the business environment through advocacy and policy dialogue. CIPE also coordinates the provision of small project grants to associations and think tanks as well as assist in public outreach and educational programs that provides material on corporate governance, entrepreneurship & market economics to policymakers, educators, entrepreneurs, & the business community. Since its inception, CIPE has supported more than 1000 local initiatives in 100 developing countries, involving the private sector in policy advocacy and institutional reform, improving governance, and building understanding of market-based democratic systems.

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Concept Paper

Business Policy Roundtable on "Improving Outreach and Possible Solutions to Enterprise Financing"

Preamble

This concept paper serves as basis for initiating dialogue on issues related to increase in microfinance outreach and possible solutions for improvement in micro-enterprise financing. This paper has been prepared in consultation with the private sector stakeholders through two focus group meetings organized by the Center for International Private Enterprise (CIPE) in May this year in Karachi and Islamabad respectively.

The Business Policy Roundtable being organized on August 1, 2007 is aimed to provide a platform for the microfinance institutions to discuss the impediments in increasing institutional outreach and deepening of the micro financing into the masses. Additionally, participants will also discuss other points such as improvement in the regulatory framework; product and process innovation; relationship management and monitoring; and gathering reliable market intelligence data as these are vitally important to the growth of microfinance sector in Pakistan.

In view of the significance of the subject, the Governor, State Bank of Pakistan (SBP) made a presentation in February 2007 to the Prime Minister. This paper also contains a tabulation of SBP's recommendations and those that were discussed at the CIPE focus group meetings. This roundtable will also provide an opportunity for the private sector to discuss the way forward in the implementation process of these joint recommendations.

Challenges

In Pakistan about one third of total population and about 96% of the potential MSE customers are un-banked¹. This situation, coupled with low literacy rate and lack of access to information to the masses on the availability of microfinance makes the challenge more complicated for the stakeholders to bring such potential customers into the mainstream economic activities.

As a step towards mainstreaming of the un-banked, Prime Minister has approved a strategy presented by the State Bank of Pakistan for increasing the size of MSE financing from one million borrowers to three million borrowers by the year 2010.

The growth of this sector depends on the financial viability and commercial sustainability, hence it is also vital that microfinance industry should find avenues to operate on terms which are beneficial to the stakeholders.

Capacity constraints of the microfinance institutions such as trained human resource, technology utilization and innovative delivery channels to tap the widely scattered clusters, are also being considered as a major challenges to this sector.

¹ State Bank of Pakistan: 2007 - SBP Governor's presentation to Prime Minister

Current Outreach of Microfinance and Market Characteristics in Pakistan

The current outreach is dependent on a network of only six microfinance banks, a handful of specialized NGOs, a national rural support program and a leasing company.

With an estimated market of 25-30 million borrowers², the above institutions are providing services to a little over one million borrowers of which MFBs are outreaching to the largest segment followed by the rural support programs and MFIs. Whereas share of NGOs and commercial institutions is relatively smaller.

In Pakistan, the microfinance market has dual characteristics. In the urban areas the market is fragmented and most borrowers are in the informal sector, hence assessing the risks associated with lending in this market are challenging. On the other hand in the rural area the market is primarily agriculture and livestock, offering marginal opportunities beyond the farming sector.

Impediments – Feedback from the Focus Groups

Following narrative provides a condensed version of feedback captured through CIPE's focus group meetings on microfinance.

The focus group participants agreed that there is huge untapped market in the MSE sector and that the MSE sector offers more sustainable growth potential and employment to marginalized populations, including women and those with no or little formal training or education. Furthermore, a large number of potential customers in the MSE sector are capable of using the credit responsibly and will offer fair returns to the lenders as their share of profits. Last, recovery percentages in this sector have been encouragingly positive to date.

The challenges faced by the microfinance sector can be grouped as external or internal and converting external challenges into enabling factors needs a joint effort of all the stakeholders. Whereas addressing the internal challenges entails broadening the vision of stakeholders towards the potential market by focusing on micro enterprise development, improved access to information to potential borrowers, redefining the business policies, product alignment and capacity building.

External challenges as identified by the stakeholders in the two focus group discussions broadly include: evolving policy environment and market infrastructure; undocumented segment of the economy; higher enterprise vulnerability to socioeconomic contingencies, primarily due to lack of fiscal protection available to the MSEs against cutthroat competition and potentially exploitative practices of the local conglomerates and international businesses; lack of access to technology; unavailability of the full range of financial services to the sector; and the non-commercial attitude of entrepreneurs towards their businesses and especially towards loans.

² Microwatch: Jan-Mar 2007 - Pakistan Microfinance Network

Among the internal challenges the foremost are:

- ⊙ inadequate flow of cheap funds to private sector institutions;
- ⊙ limited outreach;
- ⊙ institutions' general inability to assess and therefore mitigate the risk factors of standard practices in finance and banking;
- ⊙ lending orientation;
- ⊙ incompatibility of conventional banking processes and products with microfinance needs;
- ⊙ constraint to compete for quality human resources within the overall financial services industry with scarce funds;
- ⊙ inadequate use of technology, especially in the financial services delivery process and customer relationship management;
- ⊙ and lack of effective alliances along the microfinance product development, delivery, and relationship management value chains.

Conclusion

The feedback from the focus group concludes that the microfinance programs in Pakistan have reached a point that warrants consolidation, if outreach has to be increased within a short period of time to meet the stiff challenge of multiplying by three folds. Simultaneously, issues such as: deepening the microfinance system into the MSE sector; creating an enabling environment both for the enterprises and microfinance banks and institutions; developing home grown models for MFIs to suite Pakistan's norms, processes, and products to achieve higher organizational and financial stability; and strengthening coordination (value chains) between various stakeholders for higher synergy for all are ought to be addressed to ensure the wider impact of microfinance in the country.

Recommendations

Following is a compendium of recommendations by the State Bank of Pakistan which were drawn from joint working of the Pakistan Microfinance Network (PMN) and Consultative Group to Assist Poor (CGAP) and also feedback received through the two focus groups organized by the Center for International Private Enterprise (CIPE) in May in Karachi and Islamabad respectively.

Area	State Bank of Pakistan	Focus Group
Sustainability	<ul style="list-style-type: none"> Focus on improving access to finance – i.e. key to poverty reduction Financially unsustainable model will hinder the growth prospects of the MF Sector Demand for formal microfinance industry will be there as money lenders charge higher interest rates relative to formal microfinance industry Sustainability comes through effective cost recovery that calls for pricing loans in line with the transaction costs which could vary from client to client and from one region to another 	<ul style="list-style-type: none"> Limited and costlier funds. High hidden cost of operations – the larger the number of customers, the greater the cost of documentation and maintenance. The ratio of operating cost to operating profit is greater than 1, meaning that as the number of customers increases, the operating cost increases by a larger proportion to revenue, because the profit is same on PKR 1000,000 if it is given to one customer or to ten customers. However, the operating cost multiplies by the number of customers. Private microfinance banks / institutions lack access to competitive funding
Regulatory Measures	<ul style="list-style-type: none"> Bring Khushali Bank (KB) under MFI Ordinance 2001 to offer a level playing field to all MFIs and to enhance KBs competitiveness KB to be sold to a strategic partner and Government to exit from its shareholding KB to enhance its operational efficiencies and align its prices in conformity with its cost structure KB to ensure effective and efficient use of the available liquidity to increase outreach. Allowing MFIs to mobilize deposit and raise funding against its own balance sheet Allowing it corporate flexibility to segregate business lines of MFIs and to seek blended financing with grant component for operations in difficult terrain 	<ul style="list-style-type: none"> Regulations do not offer a level playing field for MFIs vs. scheduled financial institutions, which is an impediment to their business growth. For instance, mark-up on NBP Rozgar scheme is 50% subsidized by the SBP; however, no such facility is available to others. Anomalies in existing regulatory framework (E.g. the time limit for the classification of a commercial loan is three months default, but in the case of micro-loans, the limit is only one month. Considering the hardships faced by MSEs, especially in managing their cash flows, this needs to be addressed)

Area	State Bank of Pakistan	Focus Group
Regulatory Measures (Contd.)	<ul style="list-style-type: none"> • Developing its capacities to better reach unbankable areas through mobile banking • Incentive through different capital requirements- Lower for smaller districts, higher where MFBs require higher loan ceiling per borrower • Set performance criteria for MFBs to gain access to clearing house as members as well as having access to ATM Switches for their clients • To evaluate the possibility of giving scheduled bank status to MFBs to enable mobilization of institutional deposit • Encourage setting up of Islamic microfinance banks and Shariah compliant products • Modify existing guidelines to support introduction of new business lines and products 	
Institutional Capacity	<ul style="list-style-type: none"> • Restrict subsidies only for poorer and resource deficit regions, capacity enhancement, innovation and growth rather than normal operational costs 	<ul style="list-style-type: none"> • Inadequate (regulatory and physical) infrastructure for the MFBs to operate effectively and efficiently. E.g. lack of backward and forward linkages, lack of market intelligence (data) especially of the borrowers and their businesses, limited sources of funds mobilization, etc. • Inability to efficiently identify and assess viable MSE customers, hence lose many opportunities of selling microfinance products and services profitably. • Lack of credible information on potential borrowers. • Limited infrastructure to support micro banking activities such as branch network and resource mobilization etc. • Subsidy / Technical assistance will continue to be required for building institutional capacity and infrastructure.

Area	State Bank of Pakistan	Focus Group
Human Resource Competence	<ul style="list-style-type: none"> • Ensure organizations build strong in house training and develop management training track at recognized centers 	<ul style="list-style-type: none"> • Inability to attract, develop, and retain professionals due to financial constraints and lack of competitive career prospects (personal opinion of the facilitator) • MFB field staff lack professional skills and standard methodologies. Instead, they operate on thumb rule basis while taking some leads from their counterparts in the informal sector • Skill set is not available because no formal, focused training or certification in micro-financing exists. • MFBs strain to pay competitive salaries until they start making comparable profits.

Some additional recommendations from SBP

- ⊙ SBP to allow the subordinated debt as tier II capital for the MFBs
- ⊙ MFBs to undertake the market research for designing the saving products for their customers- government to assist their capacity building through the PPAF
- ⊙ Procedures to access to wholesale deposit windows of the commercial banks
Require sustainability
- ⊙ Partially guarantee private debt transactions of MFBs MFIs (source funds from Khushhali Pakistan Fund-PPAF to provide Guarantee for raising commercial debt only for viable and financially sustainable institutions)

Some additional recommendations from CIPE Focus Groups

Institutional outreach

- Limited potentials (expensive) to extend institutional outreach, thereby expanding the number of MSE customers.
- No outreach - It is relatively low compared to the number of potential micro-enterprises/ entrepreneurs, especially in the rural areas and with women entrepreneurs.
- Huge (extremely dispersed) informal sector.
- Private money lenders hold the market, even though lending at higher cost.

Analysis of the Underlying Causes

- Non-availability of home grown models due to lack of research and development culture.
- MSE sector is operating in unstructured environment
- Entrepreneurs are naive of prudent modern business practices and processes
- MSEs are vulnerable due to lack of due market protection and linkages, as made available in other countries
- Microfinance providers and intermediaries are hesitant to share their individual learning and exchange non-critical information on a wider basis.

Legend

CGAP	Consultative Group to Assist Poor
CIPE	Center for International Private Enterprise
KB	Khushhali Bank
MFB	Microfinance Banks
MFI	Microfinance Institutions
MSE	Micro and Small Enterprises
NGO	Non-Governmental Organization
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
SBP	State Bank of Pakistan



**INTERNATIONAL
CONFERENCE
IN PAKISTAN**

Possible solutions to Enterprise Financing

**A Business Policy Roundtable
August 1, 2007, Karachi**

PROGRAM

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| 10:00 a.m. | Registration & Tea |
| 10:30 a.m. | Recitation from the Holy Quran |
| 10:32 a.m. | Welcomes by Ms. Moira M. Fudda, Country Director,
CPE Pakistan |
| 10:37 a.m. | Introduction of participants |
| 10:50 a.m. | CPE's Global Perspective – Ms. Andrew Wilson,
Senior Program Office for South Asia
CPE Washington |
| 11:00 a.m. | State of Microfinance Industry in Pakistan –
Syed Mohsin Ahmed, General Manager,
Pakistan Microfinance Network |
| 11:15 a.m. | Address by the Chief Guest –
Dr. Shamshad Akhtar, Governor,
State Bank of Pakistan |
| 11:35 a.m. | Discussions |
| 12:35 p.m. | Findings & Recommendations |
| 12:50 p.m. | Concluding Remarks by the Chief Guest |
| 1:30 p.m. | Lunch |