

# 1. Overview, Financial Market Structure, Regulations, and Policies

## 1.1. Expanding Access to Finance, Links to Growth, and Poverty Reduction

Financial access is now widely acknowledged as a path to meaningful inclusion and reduction in poverty. Increased access to financial services has a significant impact on poverty (Claessens and Tzioumis, 2006) (Box 1.1). Access to finance in Pakistan has an important potential for significant improvements. Credit to the private sector amounts to 29 percent of gross domestic product (GDP), as individuals and SMEs prefer to rely on retained earnings to finance their working capital, investment, housing financing, and other financial needs. Of the total population, 14 percent have access to formal finance, and about 40 percent have no financial access to formal or informal financial systems altogether. In comparison, 32 percent of the population in Bangladesh has access to the formal financial system, as do 48 percent in India and 59 percent in Sri Lanka (World Bank, 2008c). Policy efforts to increase access to finance in Pakistan have taken time to bear fruit, but access now is expanding quickly in certain financial sectors, albeit from a very low base. To understand the difficulties in policy measures to single-handedly raise financial access, one has to recognize the importance of socioeconomic conditions, basic education, and financial literacy on access. Lack of information on available financial services, combined with high levels of poverty, low literacy rates, and gender bias, result in low levels of financial inclusion.

Access to a savings account, to credit, to insurance, to micro- and small and medium enterprise (SME) finance, and to remittances reduces risk and vulnerability by allowing households to better manage fluctuations in income, and it enables the poor to invest in microenterprises or in essential services like health and education. Lack of access to the formal financial sector perpetuates the poverty trap. Lack of well-functioning financial markets has disproportionately adverse consequences for the poor, who have credit requirements but few assets that can serve as collateral. They are thus shut out of formal finance markets. Poorer households depend mainly on expensive informal or noninstitutional sources.

### BOX 1.1: FINANCE AND LINK TO GROWTH

The importance of broad financial services outreach can be justified in several ways. The first argument builds on the theoretical and empirical finance and growth literature, as surveyed by Levine (2005) and the importance of a well-developed financial system for economic development and poverty alleviation (Beck, Demirguc-Kunt, and Levine 2004 and Honohan 2004a). Financial market imperfections such as informational asymmetries, transaction costs and contract enforcement costs are particularly binding on poor or small entrepreneurs who lack collateral, credit histories, and connections. Without broad access, such credit constraints make it difficult for poor households or small entrepreneurs to finance high return investment projects, reducing the efficiency of resource allocation and having adverse implications for growth and poverty alleviation (Galor and Zeira 1993). Second, one of the channels through which financial development fosters economic growth is the entry of new firms (Klapper, Laeven, and Rajan, 2004) and the Schumpeterian process of “creative destruction.” This implies that talented newcomers have access to the necessary financial services, including external finance. Access to finance for large parts of the population is thus seen as important to expand opportunities and assure a thriving private sector with efficient distribution of resources (Rajan and Zingales 2003).

*Source:* Beck, Demirguc-Kunt, and Peria (2005)

This report examines both the formal (regulated) financial sector, and the informal sector (moneylenders, credit from supplier of goods, *hawala/hundi* money transfers, savings and lending via committees and friends/family). Informal finance is discussed in sections 2.4 (demand), and 3.7 (supply). In the Pakistani context, the formal financial sector includes the banking sector regulated by the State Bank of Pakistan (SBP), the nonbanking financial institutions regulated by the Securities and Exchange Commission of Pakistan, Pakistan Post Office, Directorate of National Savings, microfinance institutions (MFIs), remittances through licensed exchange companies, and the insurance sector. The report suggests strategies for stronger cross-pollination between the two sectors, formalizing or adopting practices of the informal sector, and putting the sector on a more sustainable footing; it also points out lessons about

client knowledge and orientation, and (sometimes) efficiency, in the informal sector, from which the formal sector could benefit or emulate.

Recent advances in access to finance technology make it possible to reach broader groups of people at lower cost and risk. An estimated 1 billion people are currently connected to payment systems in developing countries. Yet financial institutions in many countries have been reluctant to expand into that market, including in Pakistan, due to poor information, low public awareness, inappropriate technology, and unsuitable financial processes and products. Equally widely acknowledged are the data gaps that persist when attempting to understand barriers to access. Greater availability of data in Pakistan can provide precise measures on financial access to the poor, to rural areas, as well as information on the characteristics of the financially underserved and informal finance.

## ***1.2. Objectives of the Report***

The primary purpose of this study is to measure and describe the state of financial service provision to underserved segments of the market in Pakistan, particularly those with low incomes and small enterprises, and to identify ways improve investment and create inclusive markets that meet the needs of underserved people and enterprises. The new data and study are of value to commercial providers who are able to design product strategies around the segmentation and trends highlighted by the data, to policymakers who may be considering new legislation aimed at improving the functioning of financial markets, and to donors who may be making investment and funding decisions to increase access to certain regions or population groups. Further, the data can be used to conduct cross-country comparisons and construct a baseline for future reference that will help guide policy development on financial inclusion. The survey has already been conducted in several countries, including Brazil, India, Mexico, and South Africa.

An in-depth picture of financial access was obtained by a national Access to Finance (A2F) household survey focusing on the demand side of financial markets. A specific effort was made to capture the elements of access to finance that lie outside of the formal financial systems—such as informal financing from shops, family-based business run out of the house, socially based rotating savings/lending schemes, and others that might not even be recognized as finance by survey respondents and therefore require specific techniques to elicit the data and facts. The national household survey also provides insights into regional issues, including access to finance concerns specific to urban and rural areas. The survey data on household access to finance is a first of its kind and is not currently available for the country. Combining demand and supply aspects, the findings can be of considerable benefit to those currently underserved by the financial sector.

The report focuses on the underserved population groups and enterprises, those with informal access to finance or with no such access altogether. It does not cover large corporate lending, consumer lending, and more complex financial instruments such as securities, money market instruments, and re-insurance. SBP has identified several priority areas for financial development, with a heavy emphasis on the underserved, including SMEs and microfinance. The report picks up on some of those issues, as well as on the market for remittances, the rural and urban poor, gender and income dimensions of access, and informal finance. The data gathered do not focus on a specific set of institutions or financial instruments; instead, the approach is very much demand driven: via household surveys, the data permits us to elicit the exact set of institutions and instruments in demand and those in use, by different portions of the population (by income, region, rural/urban areas, gender, age, and so forth). In order to provide a complete picture, the report also reviews the supply data, to aid policy formulation and assist with the understanding of the Pakistan-specific financial system features.<sup>1</sup>

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<sup>1</sup> A word of caution: while the household survey collects a representative sample, including upper-income households who use more sophisticated consumer finance instruments, the report does not explicitly focus on the

## BOX 1.2: HOUSEHOLD A2F SURVEY FOR PAKISTAN (DEMAND-SIDE DATA)

The A2F household survey is a comprehensive national household survey of all the main financial services (transaction banking, savings, credit and insurance), needs, and usage among consumers, in both the formal and informal sectors. The survey design is based on a joint methodology developed by FinMark Trust (South Africa) and the World Bank, and rooted in economic fundamentals. The design has benefited from continuous improvements as the survey has been used in several large countries around the world, as well as from careful customization to Pakistan conditions via focus-group discussions and piloting. The aim of this demand-side study is to establish credible benchmarks and highlight opportunities for innovation in product and delivery, as well as suggest promising avenues for deepening and broadening access to finance. The data collected permit us to:

- Measure and track the landscape of access to financial services across all the main product categories—transaction banking, savings, credit, and insurance, in both the formal and informal sectors—and institutional categories—commercial banks, other regulated institutions, semiformal nonregulated institutions, including membership-based ones, and informal or village-based institutions.
- Understand characteristics of those who are financially excluded;
- Segment the market;
- Identify opportunities for expansion of financial services to the un- and underserved segments of the market;
- Understand the scope of the population of vulnerable poor whose needed financial transactions are too small for any financial institution to provide profitably.

The data also permit us to track the diverse patterns of access to financial services across characteristics such as age, gender, ethnic group, and area of residence. Further, the data extend over a spectrum of areas of financial usage and interest, from examining quality of life and poverty, to attitudes to and the use of technology, as well as levels of financial literacy.

The survey covers 10,305 households in all regions of Pakistan excluding the tribal areas. At an initial stage, the standardized questionnaire was customized to Pakistani conditions, to ensure high-quality data. Focus interviews were held in urban and rural areas of Sindh, Punjab, North West Frontier Province (NWFP), Balochistan, and Azad Jammu and Kashmir (AJK), for purposes of calibration and gathering of supplementary qualitative information. At a second stage, households were surveyed on the following topics in detail:

- Basic household demographics; financial literacy;
- Socioeconomic characteristics; psychographics/attitudinal;
- Household income;
- Access to financial services; banks; provider differentiations;
- Savings;
- Loans/credit;
- Insurance;
- Money transfer/remittances;
- Payment and receipts.

Detailed descriptions of the survey design, methodology, sample, and data aspects, as well as the questionnaire itself, are presented in Appendix A.

The A2F household survey coverage is nationally representative and reflects both rural and urban access to finance issues (Box 1.2). In the case of rural areas, the report does not get into the technicalities of specialized agricultural finance instruments and their supply side, as this is a full topic in its own right. Farmer financing and insurance issues are significantly different from financing issues for other market participants, and a household survey would not be well suited to bring out the relevant problems and

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markets and access issues for such instruments, such as mortgage finance, automobile finance, consumer durables lending, credit cards, and sophisticated checking and saving accounts. On the other hand, it does attempt to convey best-practice and policy options as concerns simple instruments relevant for the underserved, such as debit cards, and very basic (limited) accounts such as smart cards and simplified transaction accounts.

issues (consider, for example, the issue of weather-based insurance). The data do cover rural issues and differences, and the report elicits issues of geographic and demographic access, as well as types of instruments used in rural formal and informal financing.

Finally, the A2F survey data were collected between October 2007 and March 2008, and the analysis in this report refers to this time frame. In particular, the analysis ignores subsequent events associated with the global financial crisis and its fall-out within Pakistan.

### 1.3. Pakistan – A Brief Market Overview

Pakistan’s financial system grew significantly in the past few years. At present, total financial assets have reached \$215 billion (150 percent of GDP). While this ratio compares favorably with regional benchmarks (Table 1.1), it is modest compared with countries like China (543 percent), India (298 percent of GDP), Malaysia (384 percent), and Thailand (211 percent). Nevertheless, Pakistan’s banking sector has gained dynamism, profitability, and strength, with a deposit base reaching \$62 billion and gross advances \$47 billion nationally in August 2008. Supported by a growing financial intermediation process, banks’ aggregate profitability rose to \$1.8 billion in 2008. The banking system constituted 44.5 percent of the total assets of financial institutions on March 31, 2008.

**Table 1.1: Basic Financial Indicators, International Comparison**

	Credit to Private Sector (% of GDP)	Equity Market Capitalization (% of GDP)	Stocks Value Traded (% GDP)	Private, Bonds (% GDP)	Public Bonds (% GDP)	Total Financial Assets/GDP	GNI Per Capita, (\$)
Bangladesh	37.7%	10.0%	7.1%	..	..	54.8%	470
Brazil	49.8%	104.3%	44.5%	2.9%	3.6%	205.1%	5910
China	114.5%	189.8%	237.5%	0.2%	0.4%	542.5%	2360
India	47.4%	155.4%	94.6%	0.7%	0.2%	298.3%	950
Indonesia	25.4%	48.9%	26.1%	2.1%	1.1%	103.6%	1650
Malaysia	108.8%	180.2%	83.0%	4.4%	7.1%	383.5%	6540
Pakistan	29.4%	48.9%	70.0%	0.6%	1.3%	150.2%	870
Philippines	23.8%	71.6%	20.3%	1.7%	11.3%	128.7%	1620
Sri Lanka	34.0%	23.3%	2.9%	0.3%	0.2%	60.8%	1540
Thailand	84.2%	79.8%	44.0%	1.4%	1.2%	210.6%	3400

Source: World Development Indicators 2008, data for 2007.

Note: GNI=gross national income. Total financial assets are defined in a simplified manner, based on aggregate of assets described in this table.

Pakistan has successfully implemented significant financial sector reforms over the past about 15 years, starting with grant of licenses to a number of new private banks in the early 1990s, modernization of the governance and regulatory framework of the banking sector in the late 1990s, and the privatization of major public sector banks since the early to mid-2000s. The authorities have taken steps to phase out or reorganize most of the government-owned development finance institutions, have put in place several initiatives to promote the growth of the microfinance sector, and have allowed more freedom to insurance companies. The active pace of reform created a reasonably well-developed, diverse, and sophisticated financial market, given Pakistan’s income level.

In line with these reforms, the private sector credit touched the figure of Rs 2,523 billion in May 2008, as compared with Rs. 356.3 billion a year earlier. SME credit has increased from Rs 18 billion in fiscal 2000 to Rs 403 billion on March 31, 2008, though the increase is entirely accounted for by medium, not small, enterprises (SBP 2008d). Consumer credit accounted for 14 percent of total outstanding advances at the end of March 2008. Agriculture credit rose from less than Rs 40 billion in fiscal 2000 to Rs 200 billion in

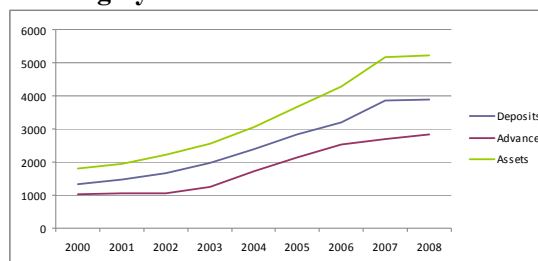
fiscal 2008. The aggregate number of borrowers has risen, from 2.7 million in 2003 to about 5.5 million by December 2006. House building loans stood at Rs 64.94 billion in May 2008 whereas the total housing finance market of Pakistan stood at Rs 126 billion on December 31, 2007 (SBP 2008e), doubling its size from 2005. Microfinance loans (microcredit, microsavings, and microinsurance) worth Rs 22.6 billion were disbursed in 2007 through extension of 1.8 million microloans. Presently, the active clients of microcredit are around 1.7 million.

In spite of recent achievements, access to financial services remains quite limited in Pakistan. The predominant share of the financial system, the banking sector, is mostly focused on large enterprise lending, with an increasing interest in consumer financing (though still on a very small scale), to the relative neglect of SMEs, rural areas, microfinance, and the poor. There is little understanding of the main barriers to wider provision of financial services, or the opportunities that exist for financial companies in underserved market segments. One of the reasons for the lack of improvements in access provision is the limited availability of data on patterns of access to and usage of financial services among different population groups.

#### 1.4. Banking Sector

Total deposits (excluding interbank) stood at Rs 3,202 billion at the end of 2006 and Rs 3,779 billion in August 2008. The public sector banks accounted for 21 percent of deposits, domestic private banks for 74 percent, and foreign banks for 5 percent. The loan portfolio of the banking system is also growing and reached Rs 2,336 billion in 2006. It stood at Rs 2,853 billion in August 2008. The major chunk of growth in loans portfolio could be attributed to local commercial private banks.

**Figure 1.1: Deposits, Loans, and Assets of the Banking System**



Source: SBP (2008f)

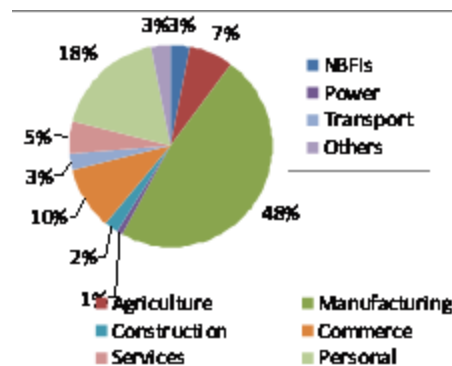
Note: 2008 data are for March 31, 2008.

**Table 1.2: Breakdown of Loans (Domestic Operations) by Sector**      **Figure 1.2: Credit by Sector**

	Loans Outstanding		Number of Borrowers	
	Amount (Rs Bn)	Share (%)	Number (Rs 000)	Share (%)
Corporate sector	1647.1	58.4%	25.9	0.6%
SMEs	409.5	14.5%	198.4	4.3%
Agriculture production	147.6	5.2%	1354.3	29.3%
Consumer finance	365.3	12.9%	2918.5	63.1%
Commodity operations	182.0	6.4%	3.0	0.1%
Staff loans	53.8	1.9%	92.0	2.0%
Other	17.1	0.6%	34.4	0.7%
<b>Total</b>	<b>2822.5</b>	<b>100.0%</b>	<b>4626.4</b>	<b>100.0%</b>

Source: SBP figures for March 2008

Note: SBP regulations define SME loans as loans to enterprises or sole proprietors up to Rs 75 million.



The banking system continues to grow with its balance sheet size passing the level of Rs 5.2 trillion in March 2008.<sup>2</sup> The share of local commercial private banks in total assets increased to 74.8 percent. In

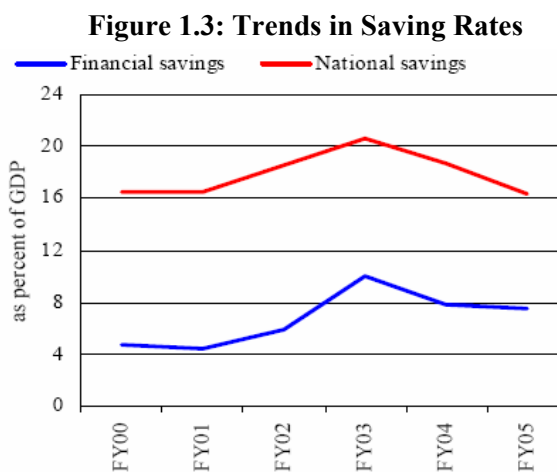
<sup>2</sup> Provisional figure (SBP 2008g: Table 5.3)

contrast, the shares of public sector commercial banks, specialized banks, and foreign banks stood at 19.3 percent, 2.4 percent, and 3.6 percent, respectively.

Table 1.2 shows the limited access to bank finance of enterprises and individuals. Focusing only on the consumer side, according to latest (unpublished) SBP figures, there are only 16 million personal (nonbusiness) bank accounts and 5.5 million personal loans. Moreover, only 25 percent of the total bank deposits and 17 percent of the total borrowers are from rural areas. In value terms their shares are even smaller, 10 percent and 7 percent of the total value of deposits and advances, respectively (Akhtar 2008). The Pakistan Post Office manages 3.6 million savings accounts, through 12,343 branches, with 70 percent of such accounts holding savings below Rs 10,000 (\$128). Most of the bank lending is concentrated in a few large manufacturing companies (Figure 1.2). Aggregate data for all credit by borrower size shows a skewed distribution: 0.4 percent of bank borrowers account for 65 percent of all bank credit—and more than 5 million borrowers account for the remaining one-third of loans.

At the very top there is even more concentration; the largest 50 borrowers account for 37 percent of all credit outstanding. Limited access to services is captured by the low level of branch penetration, especially in rural areas, which has held back the growth of savings and impacted credit distribution systems (Figure 1.3).

Consumer lending has been the fastest-growing segment in the past several years, by a wide margin, at 320 percent in terms of number of borrowers and slightly less than 500 percent in loan amount, with 2.9 million clients currently between 2003 and 2007. Mortgage lending grew from Rs 4 billion in 2003 to Rs 67.4 billion in 2007. In tandem with growth, the sector has improved its efficiency dramatically. Application fees for start-up personal loans in Pakistan are found to be around 7 percent, one of the lowest in a broad spectrum of countries (World Bank 2008a). Similarly, Pakistan ranks well among the countries with very low complexity of personal loan applications, and ranks high among the countries with many free usage features for bank accounts.



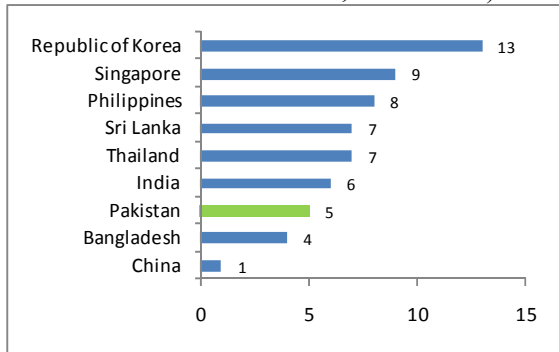
Source: SBP

Such positive effects of competition and efficiency improvements have not appeared yet in the SME lending sector, though the sector experienced a doubling of SME credit in 2004–07. Internationally, Pakistan compares unfavorably on business loan processing times and collateral to loan ratio, but does compete successfully on direct processing cost (Annex Table A1.1). Similarly, 3.6 percent of firms use loans for investment (as compared with 12.7 percent for South Asia), and only 13.9 percent use them for expenses (versus 34.5 percent in South Asia). Overall, 37.6 percent of firms consider access to finance a constraint, as compared with 27.8 percent in South Asia (Annex Table A1.1).

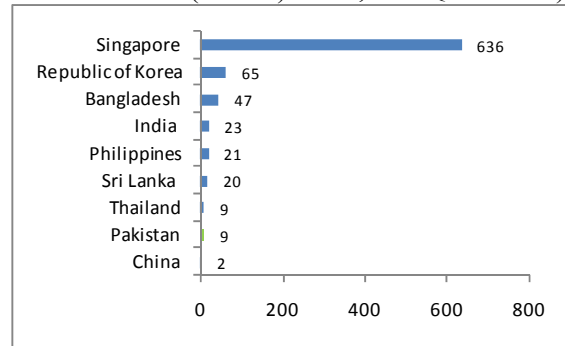
Agricultural disbursement has increased substantially (by 44 percent between 2003 and 2007, to 1.35 million borrowers) because of greater access, and holds considerable promise for medium-term development—commercial banks have aggressively lent, to the result of meeting SBP’s target of Rs 200 billion set for fiscal 2008. Outstanding agriculture advances account for 6 percent of total advances and service 2 million clients. However, current credit meets only 45 percent of the agriculture requirements.

**Figure 1.4: Banking Sector Penetration**

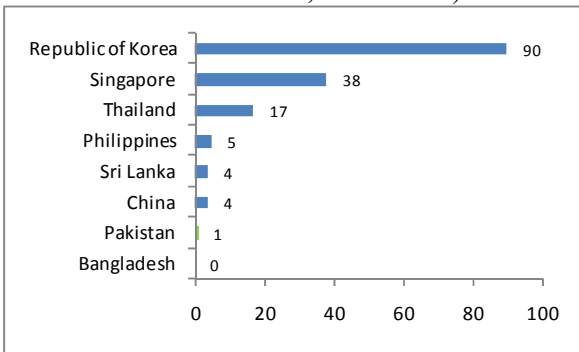
DEMOGRAPHIC BRANCH PENETRATION (NUMBER OF BRANCHES PER 100,000 PEOPLE)



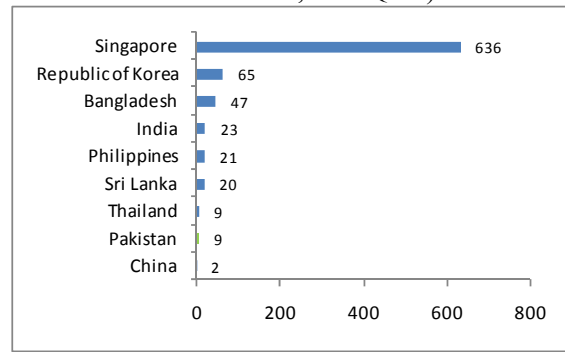
GEOGRAPHIC BRANCH PENETRATION (NUMBER OF BRANCHES (ATMS) PER 1,000 SQUARE KM)



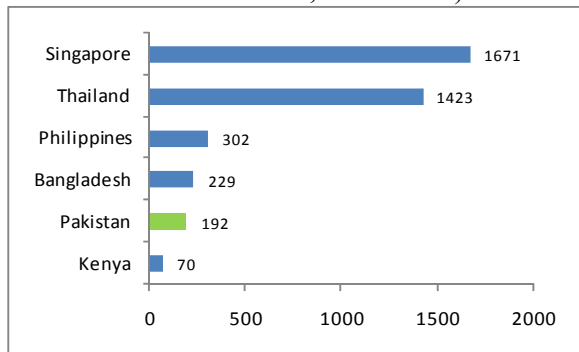
DEMOGRAPHIC ATM PENETRATION (NUMBER OF ATMS PER 100,000 PEOPLE)



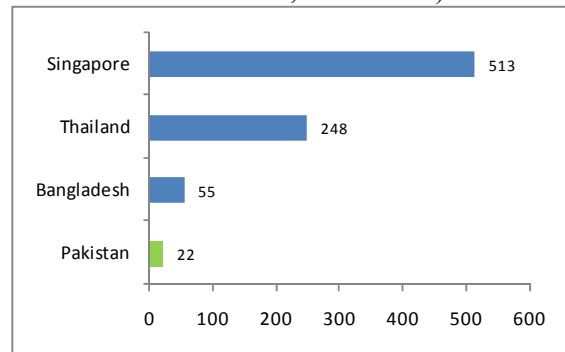
GEOGRAPHIC ATM PENETRATION (NUMBER OF ATMS PER 1,000 SQKM)



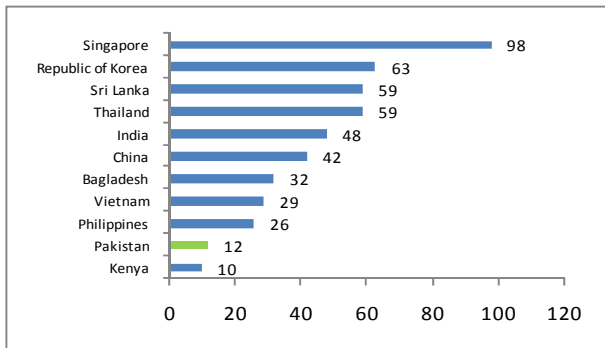
DEPOSIT ACCOUNTS PER CAPITA (NUMBER OF DEPOSITS PER 1,000 PEOPLE)



LOAN ACCOUNTS PER CAPITA (NUMBER OF LOANS PER 1,000 PEOPLE)



PERCENT OF ADULTS WITH ACCESS TO AN ACCOUNT WITH A FINANCIAL INTERMEDIARY



Source: WB Development Indicators 2008. ATM=Automated Teller Machine.

### 1.4.1. Banking Sector Penetration

Indicators of physical access to finance in Pakistan suggest a need to further improve the banking infrastructure (Figure 1.4). Specifically, the number of automated teller machines (ATMs) is at less than 0.53 ATMs per 100,000 people. Compare this with the demographic ATM penetration figure for Sri Lanka, which is four ATMs per 100,000 people, and to the world median figure of 10. In terms of demographic penetration of bank branches, Pakistan is close to the world median levels at 5 branches per 100,000 people. This is still considerably lower than the figures of 6 for India and 7 for Sri Lanka.

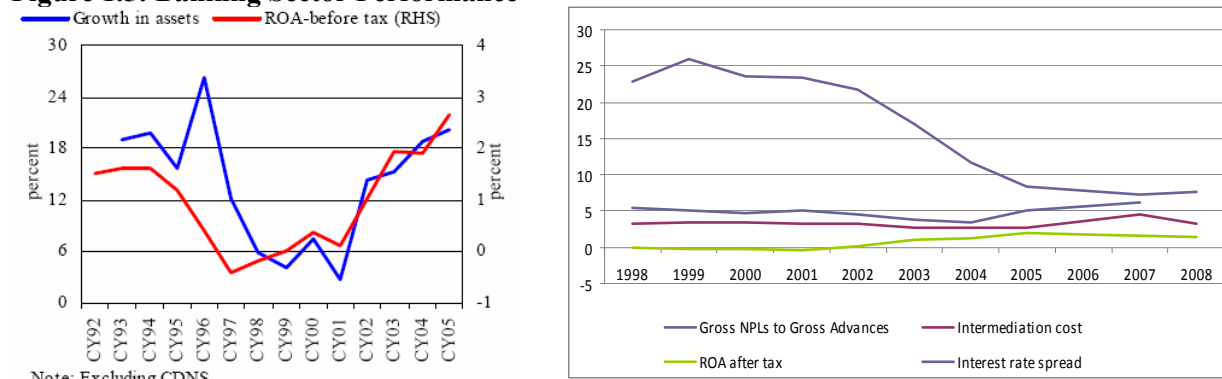
The country records about 22 loan accounts per 1,000 people, compared with Bangladesh’s 55 and the world median of 81. The use of deposit services is equally low — the country has 192 deposit accounts per 1,000 people, as compared with 229 in Bangladesh and 529 for the world median. A new focus is needed on a strategy to remove barriers to financial services access and actively encourage wider penetration by banks and other commercial providers. For this, better information is required on current levels of access to financial services as well as on impediments to wider access.

Doing Business 2008 indicators show that only 46 percent of adults in Pakistan are covered by the public registry (compared with 86 percent in countries of the Organization for Economic Co-operation and Development [OECD] and 49 percent in China), while the private bureaus cover less than 1.4 percent (compared with 59 percent in OECD countries).

### 1.4.2. Banking Sector Performance

Pakistan’s banking sector has gained dynamism, profitability, and strength with a deposit base reaching \$62 billion and advances of \$47 billion nationally. Supported by a growing financial intermediation process, banks aggregate profitability rose to \$1.8 billion in 2008. Minimum capital requirements for banks were raised to Rs 1.5 billion by December 2004 and Rs 2 billion by December 2005. SBP has also required banks to increase their paid-up capital by Rs 1 billion a year, to reach Rs 6 billion by the end of December 2009. As a result, a consolidation of the banking market has taken place, and stronger banks have emerged. Banks capitalization and quality of assets have helped raise the risk weighted capital adequacy ratio to 13.2 percent. All banks maintain capital adequacy ratios well above the minimum international standard of 8 percent, except for state banks.

**Figure 1.5: Banking Sector Performance**



Source: *Pakistan Financial Sector Assessment 2005*, SBP (2005b) with SBP data update as of March 31, 2008.

Note: Interest rate spread defined as return on loans and advances minus cost of deposits.

Growth of bank assets has picked up considerably since the late 1990s (Figure 1.5a), up to 18.8 percent and 17.25 percent most recently (December 2007 and March 2008, respectively). Nonperforming loans of the banking system have been declining overall, though they are still high for the specialized banks (Figure 1.5b). The capital adequacy ratios of the banking system show an increasing trend. They declined for all types of banks (except for specialized ones) over the period of 2002–03 but have shown an increasing trend since then. For public sector commercial banks, the capital adequacy ratio reached 15.2 in 2006 from -1.3 in 1997. Specialized banks, however, have been reporting negative capital adequacy ratios. In addition, the strengthening profitability of the banking sector can be assessed through increasing returns on assets (ROAs). As a group, all of the commercial banking groups except foreign banks have witnessed increase in ROA. Intermediation costs have stayed stable, while interest rate spreads have been on the increase.

Although the ROAs have been positive and growing for most of the period under consideration, return on equity of the banking system experienced a slight decline over 2005-06 due to the increase in capital to meet minimum capital requirement and the higher appropriation of profits by the banks. State-owned banks, however, have performed very poorly in terms of the profitability.

#### ***1.4.3. Overview of Market Players in the Banking Sector***

The number of scheduled banks in Pakistan was 40 at end December 2007 (Table 1.3). The number of commercial banks has declined from 41 to 26 through mergers, acquisitions and closures. In the banking sector, specialized government-owned banks have made only a limited contribution in their niche markets. As of December 2007, there were 18 banks involved in Islamic banking with a network of 288 branches in the country. Of these, six are full-fledged Islamic banks with 185 branches and 12 of the existing commercial banks have 103 branches that are offering Islamic banking services (SBP 2008i:2).

**Table 1.3: Comparative Position of Number of Branches in Pakistan (June 2008)**

	<b>Rural</b>	<b>Urban</b>
Five big banks	2,247	3,315
Private banks	143	1,830
Specialized banks	179	360
Islamic banks	11	207
Foreign banks	-	51
<b>Total</b>	<b>2,580</b>	<b>5,763</b>

*Source:* SBP, September 2008.

#### ***1.4.4. Pakistan Post Office***

Another potentially major player in access to finance for the underserved is the **Pakistan Post Office**. It has a network of 13,419 branches throughout the country and is a significant provider of financial services, including savings, insurance, and remittances, through 7,276 bank branches. The Pakistan Post Savings Bank (PPSB) serves as an agent of the Ministry of Finance for a range of financial services including savings mobilization, life insurance, postal giro accounts, and money transfers. It is present throughout the country and is the only banking service available in some remote areas. Pakistan Post has been able to upgrade the technology for its operations with help from the Islamic Development Bank. Internet services were launched in the late 1990s and are widely available at post offices, attracting the interest of small entrepreneurs and providing limited financial services. The PPSB offers several savings schemes, and in 2006 it had 3.6 million savings account holders. In addition, Pakistan Post acts as an agent to sell government-backed savings instruments. The Postal Life Insurance offers 10 insurance options and had 252,810 active policies in 2004. Pakistan Post provides several options for national and

international remittances in addition to hosting Western Union in some of its branches, and acting as an agent to Western Union for international remittances.

Government policy has been to encourage financial institutions to use the extensive network of post office branches to extend outreach to more people. In recent years two MFBs, Khushhali Bank and First MicroFinanceBank, have linked up with the Pakistan Post to offer services at their branch offices. To date, though, the volume of this business has remained small. Given the significant developmental potential of Pakistan Post to enhance financial access, especially geographical penetration, it is important to pay specific attention to capacity building and strengthening of its performance and modernization, as well as standards. Since Pakistan Post dates back to the year 1873 when the Government Savings Bank Act, 1873 was promulgated, its financial services are not under SBP regulation, and thus have limited potential for technical supervision and performance improvement. A notable lesson from the East Asian Experience is the considerable advancement of postal financial operations once they move under central bank supervision and regulation. Box 3.2 presents successful experiences from Brazil and China and lessons learned from international case studies on postal financial systems.

#### 1.4.5. Unmet Rural Credit Demand

Only 25 percent of the total bank deposits and 17 percent of the total borrowers are from rural areas. In value terms, their shares are even smaller, 10 percent and 7 percent of the total value of deposits and advances, respectively (Akhtar 2008). Only 15 percent of farmers are reached by the financial system as a whole (including the commercial banks, agricultural banks, and other financial institutions). Total credit to rural areas is Rs 130.7 billion, while rural credit demand is estimated as twice this volume (Rs 250 billion). The bulk of rural finance volumes are in agricultural finance (Rs 108.7 billion), with a balanced share of farm and nonfarm credit. While microcredit volumes are skewed toward rural areas, rural microcredit currently represents merely 17 percent of total rural credit.

**Table 1.4: Rural Credit Market (Rs)**

Total rural population of Pakistan	97.0 million
Total rural households	15.0 million
Farm	9.2 million
Nonfarm	5.8 million
Estimated credit demand	250.0 billion
Total agricultural credit supplied (Rs)	109.7 billion
Farm credit	51.5 billion
Nonfarm credit	58.2 billion
Total microcredit	28.4 billion
Total microcredit (rural)	22.0 billion
Total microcredit (urban)	6.4 billion

Source: [www.pmn.org.pk/downloads/start.download.ruralperspective.php](http://www.pmn.org.pk/downloads/start.download.ruralperspective.php)

The access to finance gap is even starker in the case of farmers. The few upper-income large farmers enjoy almost 10 times higher access to formal finance (38.7 percent) than the farmers in the poorest quintile (6.5 percent). Large farmers get even more informal credit than their less-fortunate counterparts—82.0 percent vs. 70.2 percent. Such skewed distribution of farm credit negatively affects the poverty level of agricultural households, and prevents faster development in rural areas.

**Table 1.5: Farmer Access to Finance**

	Financially Included	Formally Included	Informally Included	Financially Excluded
Poorest	70.7%	6.5%	70.2%	29.3%
2 <sup>nd</sup> quintile	81.8%	11.5%	80.6%	18.2%
3 <sup>rd</sup> quintile	83.5%	13.2%	82.9%	16.5%
4 <sup>th</sup> quintile	82.0%	24.9%	81.7%	10.0%
Richest	89.6%	38.7%	82.0%	10.4%

Source: Pakistan Access to Finance Database, 2008.

## 1.5. Microfinance (Chapter 3)

Outside of the banking system, little financing is available for the underserved (Table 1.6), though this is a promising area for long-term growth. Though access to finance has steadily improved over the years, it remains too low to make a real difference in terms of the poverty impact of growth. Various estimates of potential market demand for microfinance place potential client figures in the tens of millions, as compared with actual client figures of 1.7 million currently (out of a total population of over 160 million). Microfinance penetration in the region is higher, at 35 percent in Bangladesh, 25 percent in India, and 29 percent in Sri Lanka. Afghanistan has a relatively new microfinance industry with about 437,000 active clients as of March 2008.

**Table 1.6: Microfinance Outreach in Pakistan**

	2007
No. of branches	1,343
Total no. of borrowers	1,471,295
Average loan size (Rs)	13,520
Average loan balance (Rs)	10,286
Gross loan portfolio (Rs in million)	15,134

Currently, the network of microfinance providers is 1,343 branches with about Rs 15 billion portfolio. Among microfinance providers, Khushali Bank alone provides coverage in 86 districts, hence accounting for 47 percent of this network. The three microfinance entities, namely, National Rural Support Program (NRSP), Khushali Bank, and Kashf Foundation accounted for approximately 70 percent of the sector's active clients. In the middle

*Source: MicroWatch. Issue 6, Annual (2007).*

of 2008, total outreach measured by active borrowers was about 1.7 million in a market where it is estimated that there are 7 million poor households. In fact, based on experience in more mature microfinance markets like Bangladesh, the size of the potential market in Pakistan could be as high as 12–15 million since the vulnerable poor, those living above the poverty line but without access to most formal financial services, also use microfinance services. Some estimates of potential demand by women place the potentially viable savings clients at 35 million, and viable borrowers at 22 million. Much remains to be done to capture a potential market of such proportions, including in terms of literacy improvement, awareness-raising, and cost reduction of access via technology improvements, as well as reliance on tried and tested low-tech solutions such as the Grameen model.

A second challenge for microfinance is for service providers to become profitable so that service provision to poor people can grow on a sustainable basis. A study of South Asian MFIs done in 2005 showed that only 42 percent of microcredit borrowers in Pakistan received services from profitable MFIs, the lowest percentage in South Asia (Microfinance Information Exchange, Consultative Group to Assist the Poor, and the World Bank (2006). Most microfinance providers rely on a combination of donor/noncommercial funding, and cannot claim commercial viability, with the exception of the recently formed Microfinance Banks (MFBs). Retail providers such as the six recently licensed MFBs operate on a sustainable footing and are expected to solidify their position further by increasing reliance on client deposits. The remaining microfinance providers are largely not expected to become sustainable as a class. Those include (1) the national and provincial rural support programs and charitable or specialized nongovernmental organizations (NGOs); (2) the wholesale apex institution, the principal being the Pakistan Poverty Alleviation Fund (PPAF), which relies on donor and government financing support to refinance community organization whose number has reached 60,000; and (3) the NGOs and the cooperatives, which are now mostly closed except for one principal operator, the Punjab Cooperative Bank, which has managed to be proactive but relies on SBP credit lines (quite an unsustainable approach) and provincial government support and has to be eventually restructured to be more financially viable.

A third challenge is that microfinance is almost exclusively focused on loans, while other financial services, savings, transfers/remittances, and insurance are often more in demand by poorer households. Indeed, this report finds that demand for savings, not credit, predominates, and is largely untapped. Unlike most other countries, the microfinance sector has historically focused more on men than women, as product delivery methods have been poorly suited to women and established cultural mores.

## 1.6. Islamic Finance

In 2002, the first Islamic banking license was issued to Meezan Bank. Currently there are six licensed, full-fledged Islamic Banks and 12 conventional banks with stand-alone Islamic banking branches (Table 1.7). As of December 31, 2007, the number of Islamic banking branches stood at 288 in 47 cities in all four provinces of the country. These also include international banks such as ABN Amro and Standard Chartered. Applications for a few more players are under consideration. The most popular Islamic products currently include *murabaha*, *ijarah*, and diminishing *musharaka* financing.<sup>3</sup> The total assets portfolio in the Islamic Banking sector stands at Rs 200 billion as of March 31, 2008; deposits were at Rs 142 billion and financing and investment at Rs 114 billion. Total number of borrowers/finances is about 25,000.

**Table 1.7: Islamic Banking Players**

	Dec-04	Dec-05	Dec-06	Dec-07
No. of Islamic banks	2	2	4	6
No. of branches	23	37	N.A.	185
No. of conventional banks offering Islamic banking	7	9	12	12
No. of conventional banks branches offering Islamic banking	21	33	N.A.	103
Total number of branches offering Islamic banking	<b>44</b>	<b>70</b>	<b>150</b>	<b>288</b>

Source: SBP Banking System Review for the year ending Dec 2005

Despite their rapid growth over the past few years, the Islamic banks are facing a number of problems, including the lack of liquidity management instruments,<sup>4</sup> specific Islamic-bank prudential regulations, depositor risk for Islamic depositors, and a certain lack of clarity with more complex financial instruments, such as foreign currency accounts, letters of credit, and assets to be generated in the future.

## 1.7. SME Finance (Chapter 4)

There are 3.2 million SMEs in Pakistan. SMEs account for over 90 percent of all private enterprises, contribute to 30 percent of GDP, and account for 25 percent of exports of manufactured goods. In spite of their importance in the economy, lending to SME still accounts for only 16 percent of total lending in volumes and only 4 percent of total customers. While international comparisons of SME lending are difficult because of inconsistent SME definitions, credit to Pakistan small enterprises has much potential to expand, relative to the international experience.

Lending to SMEs (as defined by the Prudential Regulations of SBP<sup>5</sup>), despite the importance of SMEs in the Pakistani economy, has shown a slightly downward trend over the period 2004–07. Although the development of the SME sector rests crucially on the availability and access to finance at an affordable

<sup>3</sup> Murabaha financing is an investment partnership, as of 2007 at about 40 percent of the total financing by the Islamic banking institutions. Ijarah financing is an Islamic lease agreement, accounting for about 30 percent of the total financing. Diminishing musharaka financing is profit and loss sharing, whereby the client purchases financier's share gradually, until all of financier's share is purchased by the client, making him sole owner, at about 17 percent of the total financing by the Islamic banking institutions.

<sup>4</sup> The issuance of two *sukuks* (asset-backed Islamic bonds), both by the Water and Power Development Authority (WAPDA), have somewhat eased the situation for some of the Islamic banks, but there are no proper institutional arrangements available.

<sup>5</sup> Prudential Regulations for Small and Medium Enterprises Financing: Banking Policy and Regulations Department, SBP (<http://www.sbp.org.pk/publications/prudential/PRs-SMEs.pdf>). The SBP data on SMEs provided in this section are based on this definition.

cost, especially through the formal institutional setup, private sector credit to SMEs accounted only for 16.2 percent of total credit to the private sector in December 2007 (Table 1.8). SME lending grew much more slowly than other lending market segments, such as consumer loans, especially credit to small, as opposed to medium, enterprises. One reason for such disappointing expansion of credit to SMEs is that the risk-assessment process for SMEs is more complex, especially in a dynamic business environment with little reliable information. Another reason is that banks consider SMEs as part of their business (corporate) finance activities, whereas SMEs should be part of their retail business, because SME lending will only work if less attention is paid to risk-assessment processes and more to efficiency and speed of delivery to produce scale of operations. In fact, many banks view SMEs as mini-corporations and use more or less the same tools to assess risks. This proves to be too expensive as well as ineffective.

**Table 1.8: Credit to Private Sector, and Growth in Lending**

Sectors of the Economy	Credit to Private Sector (Dec 2007, Rs, billion)		Growth in % during Dec CY03- Dec CY07	
	Amount	Number of Borrowers	Number of Borrowers	Loans
<b>Corporate sector</b>	1,520.1	56.3	n.a.	n.a.
<b>SMEs</b>	437.4	16.2	101.9	103.4
<b>Agriculture</b>	150.8	5.6	0.3	43.6
<b>Consumer finance</b>	371.4	13.8	319.5	499.1
<b>Total</b>	2,700.9	100.0	114.9	599.7

Source: SBP

The reluctance of banks to perceive SMEs as a profitable business venture is compounded by the fact that many potential SME clients do not have immovable assets, which are the most-used form of collateral. Weaknesses in the existing collateral regime, especially for movable property, complicate matters further. Moreover, as the majority of the SMEs are sole proprietors, banks cannot secure their loans with movable assets either. In fact, on the basis of the existing law, only limited liability companies can register a lien over a movable asset in the company registry. Other reasons for the reluctance of banks to lend to SMEs are the general lack of reliable formal credit information, given that credit bureaus are still in an early stage of development, and the fact that most SMEs do not maintain proper books of accounts, making it difficult for traditional bankers to assess the viability of a going concern.

## 1.8. Remittances (Chapter 5)

International remittances have grown at impressive rates in Pakistan, in part because of a broad formalization effort by SBP, which has brought in over 70 percent of international flows into the formal net. Not so the domestic remittance market, which has not enjoyed such policy attention, and on which official data are limited. Rough unofficial evidence exists that domestic flows are of considerable magnitude, and, as with international flows, most of the transfer happens in the informal sector.

Figures from the SBP indicate that international formal remittances into Pakistan for 2007–08 were \$6.45 billion, up from \$2 billion in 2002. Recent studies suggest that, in most cases, the macroeconomic benefits of remittances in a developing country are likely to be positive, and there are also considerable household-level benefits that have economic growth and poverty reduction effects. However, in Pakistan, remittances do not appear to make a significant portion of household income for the poorest quintile. Interestingly, domestic remittances constitute a larger share of income than international flows for poorer households, while the trend reverses among richer households. In part, this is because most migrant workers do not pertain to the lowest income groups. However, much more importantly, limited access to

remittances by the poorest population is mostly to blame for the weakened poverty effect of remittances, in spite of the sector's spectacular recent growth and performance.

Remittances to Pakistan have been growing at an impressive rate in recent years (29 percent between fiscal 2001 and fiscal 2008). The largest amount remitted is from the United States (27.3 percent) followed by Saudi Arabia (19.4 percent). Increased remittances have supplemented foreign exchange earnings and have helped maintain the rupee exchange rate (though higher exchange rates also tend to suppress export-led growth). The steps taken by SBP to formalize the remittance market through formation of exchange companies (ECs), and reduction in the curb and interbank exchange rate, have helped increase formal remittance flows.

Over 80 percent of formal remittances come through the formal banks, Habib Bank Limited and United Bank Limited being the two main players, while 17 percent come through ECs and about 2.5 percent through the Pakistan Post Office. Western Union is very active in the market and has set up partnerships with various banks, ECs, and Pakistan Post. Fees for sending remittances from abroad vary from free transfer to over \$50, while the time taken for the transfer is from under 10 minutes to more than two months.

The biggest challenge is to increase rural outreach of remittances. International success stories in this respect include mobile phone banking strategies based on the G-Cash model of the Philippines or the M-Pesa model of Kenya. Another strategy is to partner more closely with players who have better rural networks. While the current regulatory set-up does not allow telecom operators to provide financial services, lessons can be learned from these telecom-led models and applied through partnership arrangements between banks and nonbanks. Other steps that can be taken include forming partnerships with banks abroad, as well as expanding the outreach of Pakistani banks abroad, informing, increasing awareness, and facilitating remittances by Pakistani workers abroad.

## **1.9. Financial Inclusion and the New Financial Regulatory and Technological Infrastructure**

### ***1.9.1. National Policies to Enhance Financial Inclusion***

SBP has adopted a coordinating role with the Government of Pakistan (GOP) and private sector to implement a financial inclusion strategy, focusing on microfinance, SMEs, remittances, Islamic banking, agriculture finance, and insurance, among other areas. Many new SBP regulations have been issued to encourage financial development and inclusion, for example electronic banking, branchless banking, the SME policy framework, and others<sup>6</sup>. The newly created Development Finance Group with SBP in September 2006 steers and helps policy implementation, in the areas of the legal and regulatory framework for SMEs, agriculture and rural credit, housing and infrastructure finance, and Islamic finance. The Financial Inclusion Program (FIP)<sup>7</sup>, developed with considerable donor backing (from the U.K. Department for International Development, or DFID) and adopted in 2008, will constitute an important and promising initiative in this regard, over the long term.

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<sup>6</sup> BPRD Circular No. 02 of 2008, Branchless Banking Regulations for Financial Institutions desirous to undertake branchless banking ([http://www.sbp.org.pk/bprd/2008/Annex\\_C2.pdf](http://www.sbp.org.pk/bprd/2008/Annex_C2.pdf)), Prudential Regulations for Small and Medium Enterprises Financing: Banking Policy and Regulations Department, SBP (<http://www.sbp.org.pk/publications/prudential/PRs-SMEs.pdf>)

<sup>7</sup> <http://www.sbp.org.pk/MFD/FIP/inclusion.htm>

SBP has further introduced the **Annual Branch Licensing Policy**<sup>8</sup> with a road map for 2008 and beyond. This policy requires commercial banks with 100 branches or more to open at least 20 percent of their branches outside big cities and set up branches in *tehsil* headquarters, where no branch of any bank exists. The five big banks have, as a result, more than 40 percent of their branches in rural areas. However, due to this policy, smaller banks are keeping the number of branches at less than 100—only after they make a conscious decision to go into rural areas do they exceed 100 branches. In addition, SBP has allowed banks to establish sub-branches, booth and service centers of commercial banks in inner regions where it is costly to maintain a full-fledged branch. These sub-branches can be managed by skeleton staff and can act as an extended arm of the near-by branch for performing limited banking functions, such as deposits, withdrawals, issuance of demand drafts, and telegraphic transfers, and also facilitate payment of home remittances to their beneficiaries. Other cautionary lessons should be taken into account while applying this policy. The recent World Bank study on Banking the Poor suggests that mandatory regional requirements for new branches may reduce the total number of branches (incremental costs might translate into increase in the cost of providing the additional services, thus making access prohibitively expensive even when the services are available), and while encouraging sub-branches or booths, may fall short of encouraging agency relationships or correspondents, where present mandates appear “unclear.”

Since November 2005, all commercial banks operating in Pakistan are required to offer **Basic Banking Accounts**<sup>9</sup> to improve financing access for the low-income Pakistanis. Such an account can be opened, for example, with a maximum deposit of Rs 1,000 carrying no fee, no minimum balance, and full ATM access. As of March 2007, about 120,000 basic accounts had been opened. Those are still associated with high transaction costs for banks, and low demand from account holders who tend to stay with existing instruments in spite of low interest rates. Competition is expected to weaken these disadvantages in the longer term. Such regulatory measures should be treated with caution, however. The Banking the Poor study suggests that regulation in this area on its own is not enough and indeed there is a limited association with better access. However, in many places where banks have voluntarily offered commercial products of a basic banking character, there is a positive association with access.

The central bank with the support of its two principal training institutions, National Institute of Banking and Finance (NIBAF) and the Institute of Bankers Pakistan (IBP), is implementing an initiative for **financial literacy and capacity building** for financial institutions and the public, to leverage available financial services while building momentum for the community to appreciate the available lending opportunities. This agenda is important, and this report also finds low access to finance among individuals with lower levels of literacy. Causality has been debated by practitioners and policymakers, however. While financial literacy arguments are quite compelling, empirical evidence from Indonesia (Cole, Zia and Sampson 2008) suggests that financial incentives (which remove or reduce affordability barriers of opening a bank account), not financial literacy, have an impact on the use and uptake of financial services among households. Nonetheless, this report contends that awareness of financial options and service providers, as well as development of trust in such providers, rather than literacy per se, hold the promise of increasing financial access nationwide. The evidence on SMEs also suggests that there may be an important role for business training — results of business development assistance have been very promising, per international experience.

In 2001, the *Microfinance Institutions Ordinance and Supportive Prudential Regulations* was adopted, allowing for the creation of national and regional MFBs. SBP published new guidelines in 2006 for commercial bank provision of microfinance services<sup>10</sup>. The microfinance ordinance was amended in 2007

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<sup>8</sup> Annual Branch Licensing Policy, Banking Policy and Regulations Department, SBP ([http://www.sbp.org.pk/bprd/2007/Annex\\_C15.pdf](http://www.sbp.org.pk/bprd/2007/Annex_C15.pdf))

<sup>9</sup> BPD Circular number 30 of 2005 (<http://www.sbp.org.pk/bpd/2005/C30.htm>)

<sup>10</sup> SMED Circular number 11 of 2006 (<http://www.sbp.org.pk/mfd/2006/C11.htm>)

(Finance Bill 2007-08) to ensure that minimum loan size is raised to Rs 150,000 to allow providers to tailor their services to microbusiness needs. Further, microfinance providers are now allowed to engage in the remittance sector. With a focus on expanding microfinance to 3 million borrowers by 2010, a strategy for Expanding Microfinance Outreach has been developed by the SBP and was approved by the GOP in February 2007. The strategy stresses commercialization of the sector as a key to financial and social sustainability, and benefits from extensive support by donors (DFID), via the overall FIP initiative, in terms of credit as well as capacity-building and technology initiatives support. While the long-term impact of the program, adopted in 2008, remains to be assessed, it will undoubtedly encounter short-term difficulties associated with the global financial turmoil and its fall-out in Pakistan.

SBP introduced *Prudential Regulations for Agricultural Financing and Guidelines for Livestock and Fisheries Financing*, as well as simplified and standardized loan documents<sup>11</sup>. It has further focused on encouraging a revolving credit scheme for three years, under which farmers can borrow for one year and continue to borrow without providing documentation each year; guidelines have been issued on lending for livestock, fisheries, and horticulture subsectors, and programs are being launched for the dairy sector. In addition, a small farmer financing scheme has been promoted based on group lending and a crop loan insurance scheme has been structured that is now being offered by some insurance companies. SBP has further allowed banks to finance against market/realizable/forced sale value of the agriculture land, urban properties, gold/silver ornaments, and so forth, and also against two personal sureties (up to Rs 500,000, or \$8,333), in addition to the passbook to the land, and so forth. These initiatives have contributed significantly to enhancing formal institutional agricultural credit disbursement for small borrowers.

SBP has also laid out an elaborate prudential regulatory and supervisory framework that conforms to the International Islamic Financial Service Board's (IFSB) framework, by way of enabling **Islamic finance**, which SBP expects will constitute almost 12 percent of the Pakistan financial system in the next five years. In 2004, SBP issued detailed criteria for (1) setting up of scheduled Islamic commercial banks based on the principles of *Shariah* (Islamic law) in the private sector, and (2) for setting up of Islamic banking subsidiaries by existing commercial banks. In the same year, SBP also issued guidelines for opening of stand-alone Islamic banking branches by existing banks. Islamic finance is still in its infancy worldwide and in Pakistan. Basic regulations are outstanding, as are estimates of potential demand among various population groups, and models for sustainable product delivery. The sector has much growth potential.

SBP has published new prudential guidelines for **SME financing**, wherein banks can issue unsecured loans to SMEs up to Rs 3 million<sup>12</sup>. A new SME Policy 2007 was launched in fiscal 2008, attempting to define uniformly SMEs in the manufacturing, trade, and services sectors for all the stakeholders. The policy document gives a broad framework for promotion of SMEs by improving the regulatory, fiscal, and business environment, as well as institutionalization of the support structure. The document further outlines a strategy for SME-led private sector growth, poverty reduction, and job creation. Sector Development Companies have already been set up for various industries, including gems and jewelry, marble and granite, furniture, dairy products, and the hunting and sporting arms sector. These companies work on a public-private partnership basis with the private sector having a leading role in decision making. In parallel, there are several initiatives to extend financial services to small borrowers. These

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<sup>11</sup> Prudential Regulations for Agriculture Financing, Banking Policy and Regulations Department, SBP (<http://www.sbp.org.pk/publications/prudential/prs-agriculture.pdf>), Guidelines for Fisheries Financing, Agricultural Credit Department, SBP (<http://www.sbp.org.pk/acd/2007/Guidelines-for-Fisheries-Financing.pdf>), Guidelines for Livestock Financing, Agricultural Credit Department, SBP ([http://www.sbp.org.pk/acd/2006/Guidelines\\_Livestock\\_C1.pdf](http://www.sbp.org.pk/acd/2006/Guidelines_Livestock_C1.pdf))

<sup>12</sup> Prudential Regulations for Small and Medium Enterprises Financing: Banking Policy and Regulations Department, SBP (<http://www.sbp.org.pk/publications/prudential/PRs-SMEs.pdf>).

include: SBP's SME financing strategy that advocates promotion of credit guarantee schemes and venture capital funds, establishment of SME training centers and capacity building of banks' SME loan officers, SME credit-risk scoring and competitiveness benchmarking, as well as a triennial survey on SMEs to estimate their finance demand<sup>13</sup>. Work is underway to develop an appropriate credit enhancement mechanism that will facilitate bank lending to the sector. SME credit policies have had mixed success, especially as concerns the small enterprises market, and more work is needed in the collateral and credit information aspects of SME lending.

### **BOX 1.3: OTHER PROGRAMS IN PAKISTAN FOR FINANCIAL INCLUSION**

**National Rural Support Program:** Established in 1991, NRSP is the largest rural support program in the country in terms of outreach, staff and development activities. It is a not-for-profit organization registered under Section 42 of Companies Ordinance 1984. NRSP's mandate is to alleviate poverty by harnessing people's potential and undertake development activities in Pakistan. It has a presence in 46 districts in all the four provinces including Azad Jammu and Kashmir. NRSP is currently working with more than half a million poor households organized into a network of more than 55,366 community organizations. With sustained incremental growth, it is emerging as Pakistan's leading engine for poverty reduction and rural development. NRSP manages one of the largest microcredit portfolios in Pakistan, with 282,421 active loans as of March 2007, and holds 25 percent of the microfinance market. NRSP provides various financial services to the community organization members in rural areas, to help them implement their microinvestment plans, including microcredit, microinsurance, and savings products.

**Rozgar Scheme:** The National Bank of Pakistan, the largest nationwide bank, is offering small loans to the unemployed and the poor to finance purchases of auto rickshaws, set up utility stores under franchise of the Utility Corporation, set up public call offices, and so forth. Interest on these loans is fixed at 12 percent: half of the interest charges are to be borne by the GOP and the remaining half by the borrowers. The government picks up first 10 percent of all losses and shares in the credit risk. External and internal verification of borrowers, references, and guarantees are handled by ICIL, a representative firm of Dun and Bradstreet. This scheme is anticipated to deliver about Rs 105 billion (\$1.34 billion in lending) over a five-year period. Since its launch this year, the scheme has delivered Rs 2 billion to about 22,136 borrowers.

**Pakistan Poverty Alleviation Fund:** The PPAF was created in 2008 as a private sector apex fund to provide capacity building and loan funds to MFIs, primarily NGOs. By the end of 2005, it was supporting about 35 organizations, almost all NGOs that provide microfinance services. Sponsored by the GOP and funded by the World Bank and leading donors, the PPAF follows a model of public-private partnership through lending of wholesale funds to civil society organizations committed to community outreach programs for enhancing income and economic welfare of the disadvantaged. Specifically, the PPAF provides funding for projects that help generate income, and improve the physical and social infrastructure and the skills of the vulnerable. On February 28, 2007, the PPAF had a resource base of Rs 49,560.2 million (\$634.37 million).

*Source:* Akhtar (2007a)

While these initiatives are a step in the right direction, SBP needs to develop a strong and effective monitoring and evaluation system to monitor the impact of these initiatives and to bring mid-course corrections where needed to ensure that the ultimate objectives for which the initiatives have been taken are fully achieved. Other programs for financial inclusion in Pakistan are listed in Box 1.3.

#### **1.9.2. Regulatory Framework for Branchless Banking<sup>14</sup>**

SBP has been working with the Consultative Group to Assist the Poor on using information and communications technology and new branchless banking models to reach massive numbers of presently

<sup>13</sup> SME Policy 2007 (<http://www.pakistan.gov.pk/ministries/industriesandproduction-ministry/media/SMEPolicyDevelopment.pdf>)

<sup>14</sup> BPRD Circular No. 02 of 2008, Branchless Banking Regulations for Financial Institutions desirous to undertake branchless banking ([http://www.sbp.org.pk/bprd/2008/Annex\\_C2.pdf](http://www.sbp.org.pk/bprd/2008/Annex_C2.pdf)),

unserved poor people.<sup>15</sup> Branchless banking is defined as the delivery of financial services outside conventional bank branches using information and communications technologies and nonbank retail agents. Industry players, particularly mobile network operators, see the enormous potential of branchless banking as a profitable value-added service. Branchless banking can help address the low point of sale infrastructure in Pakistan, in particular the very low ATM penetration. There are, however, considerable challenges to branchless banking posed by current regulation in Pakistan that need to be addressed, while paying due regard to the new and enhanced risks that branchless banking can carry. Some potentially viable paths include bank- and telcom-led models or a combination of models. Regulatory changes would be required, along the lines of some of the following: (1) the use of agents outside bank branches, thereby increasing the number of service points; (2) easier account opening (both onsite and remotely) while maintaining adequate know-your-customer standards; and (3) permission for a range of players to provide payment services and issue e-money, thereby enabling innovation from multiple sources.

These changes are considerable. For one, the legal framework restricts the use of agents for cash-in/cash-out activities and account opening, a major impediment to correspondent banking. It is unclear whether it is legally possible for customers to withdraw money outside of bank branches, though an exception is provided for ATMs and withdrawals at “Authorized Merchant Establishments at Various Points of Sale” subject to a cash limit of Rs 10,000. However, MFBs are permitted to appoint agents and open booths for collection of cash or for making spot payments, yet those powers are restricted by regulation to specific circumstances. Further, SBP has granted permission for mobile banking (that is, the use of mobile vans and small service centers). ECs, which are also regulated by SBP, can make use of agents in remote areas; however, these agents currently are permitted to provide only one service: payment (in Pakistani rupees only) of remittances from foreign countries.

The current anti-money laundering/combating the financing of terrorism regime, which covers banks only, presents further obstacles to the potential introduction of branchless activities<sup>16</sup>. Examples include using the national identity card (approximately 20 percent of Pakistanis do not have one), as well as requirements for new customers to be introduced by existing ones, which is difficult in areas with low coverage. Other regulations on enhanced customer due diligence cause difficulties with remote account opening and other non-face-to-face transactions. The rules on establishing identity are more relaxed for MFBs, where in far-flung and remote areas where people, particularly women, do not have identity cards, the MFB may extend micro-credit by establishing identity through other appropriate means.

Access to finance in Pakistan has lagged behind the country’s growth and development needs, in spite of active policy support on the part of SBP. Part of this disappointing outcome can be explained by very high growth rates in access in the past five years, albeit from a very low client base. A second pertinent consideration suggests that financial policies alone are not sufficient to expand access, and a holistic approach linked to basic poverty reduction and financial awareness-building would be more successful. In addition to financial access expansion, the task of strengthening financial provider sustainability, especially in the microfinance sector, is of paramount importance. Competition, efficiency improvements, and exposure of financial institutions to market discipline hold the promise of commercial viability and reliability for the microfinance sector. Competition and efficiency improvements are also needed if SME lending is to become profitable. New approaches suitable for smaller enterprises, such as bank downscaling, are workable tools to achieve sustainable SME lending products. In view of limited financial infrastructure and penetration, physical access can be stepped up using a two-pronged strategy, via existing agencies with higher penetration such as Pakistan Post, as well as via new technology solutions such as branchless banking and mobile banking.

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<sup>15</sup> This section is closely based on Consultative Group to Assist the Poor (2007).

<sup>16</sup> BPD Circular Number 20 of 2004 (<http://www.sbp.org.pk/bpd/2004/C20.htm>), Anti-money Laundering Ordinance 2007 (<http://www.sbp.org.pk/about/act/AML-Ordinance-2007.pdf>)