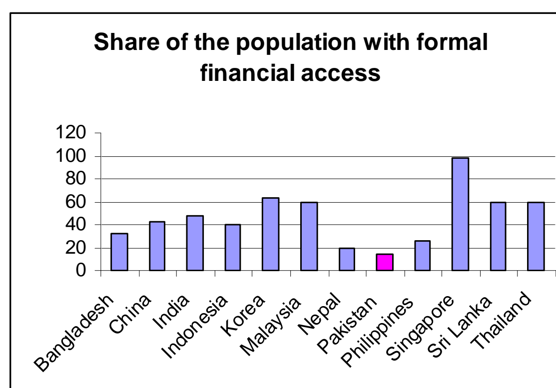
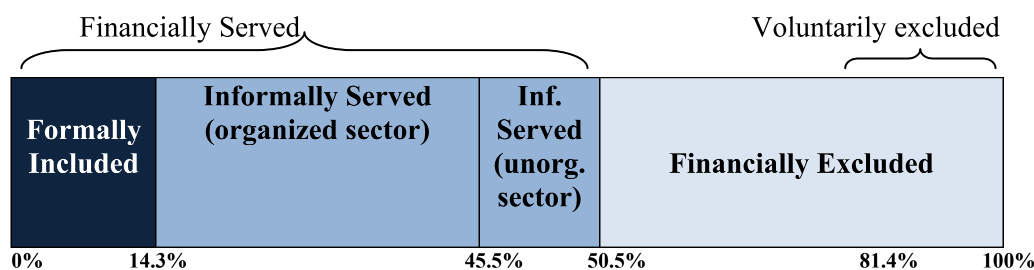
Executive Summary

Access to financing is now widely acknowledged as a path to meaningful economic inclusion and reduction in poverty. Policy efforts to increase access to finance in Pakistan have taken time to bear fruit, but now access is indeed expanding quickly in certain financial sectors (microfinance, remittances) — albeit from a very low base. Nevertheless, policy measures cannot single-handedly increase financial access; financial institution willingness to expand access in Pakistan has been stinted by slow technologic advances, weak legal foundations, and unsuitable financial processes and products. Poor socioeconomic conditions, gender bias, and low levels of basic education and financial literacy remain barriers, but perhaps the single strongest driver of low demand for financial access has been income.



The average Pakistani household remains outside the formal financial system, saving at home and borrowing from family or friends in cases of dire need. Fourteen percent of Pakistanis are using a financial product or service of a formal financial institution (including savings, credit, insurance, payments, and remittance services). When informal financial access is taken into account, 50.5 percent of Pakistanis have access to finance. Informal access can occur through the organized sector (though committees, shopkeepers, moneylenders, *hawala/hundi* money transfers, and so forth), or informally through friends and family. In comparison, 32 percent of the population has access to the formal financial system in Bangladesh, and this figure amounts to 48 percent in India and 59 percent in Sri Lanka (World Bank, 2008c). Of the nearly 50 percent of Pakistanis who do not engage in either the formal or informal financial system, we estimate about 19 percent have voluntarily excluded themselves through lack of understanding, awareness, or need, due to poverty, or for religious reasons. Financial exclusion precludes people from reducing risk, managing fluctuations in income, and investing in microenterprises or in health and education.

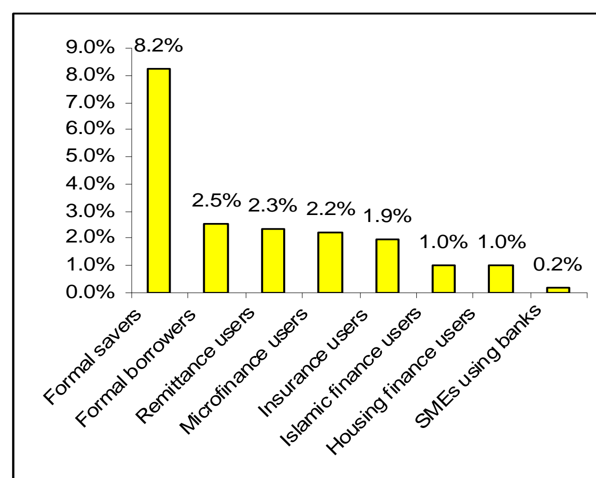


Major constraints to financial access, in spite of policy reforms, arise from the high levels of poverty, combined with low awareness of and information about available financial services, as well as gender bias. Currently, financial institutions limit their services expansion to individuals and enterprises with a high and predictable income. And yet there is nothing inherently un-serviceable about low-income, informally employed, rural, or female clients. In fact, the considerable gender bias is completely eliminated among formally-serviced individuals. Differences between urban and rural financial inclusion are completely eliminated once the effect of income and other individual characteristics is taken out. Technology can be harnessed to help expand geographical outreach, as well as overcome low literacy levels. Physical access can be stepped up using a two-pronged strategy, in view of limited financial infrastructure and penetration—via existing agencies with higher penetration such as the Pakistan Post Office, as well as via new technology solutions such as branchless banking and mobile banking. Simplified financial processes and procedures, client segmentation, and product diversification can help lower costs and manage risks better. New approaches suitable for smaller enterprises, such as

bank downscaling, are workable tools to achieve sustainable small and medium enterprise (SME) lending products. Further integration of financial services for the underserved—microfinance, remittances, small enterprise finance—would strengthen financial provider sustainability, via improved competition, efficiency, and exposure of financial institutions to market discipline. A major obstacle that has rendered product- and client- expansion difficult and unnecessarily risky has been the limited information on markets, segments, and instruments. **This report and the attendant pioneering nationwide access to finance survey, part of a considerable donor-supported State Bank of Pakistan (SBP) financial inclusion program, is meant to fill in the gap.**

Despite reforms access to financial products remains limited. The State Bank of Pakistan (SBP) has embarked on an aggressive path of expanding financial market coverage via enabling, if strict, regulation, yet outreach has lagged behind the country's growth and development needs**.** Reforms in the past decade have resulted in strong banks with a steady performance. As a result, Pakistan's financial system has grown significantly in the last few years, and access and penetration of financial products has been expanding, though again, from a very small base**:**

- Over half of the population saves, but only 8 percent entrust their money to formal financial institutions.
- One-third of the population borrows, but only 3 percent use formal financial institutions to do so.
- Microfinance has grown at 40 percent per year since 1999 - ***yet*** microfinance access extends to only 1.7 million out of an adult population of about 80 million.
- International remittances have grown at 29 percent since 2001 - ***yet*** only 2.3 percent of Pakistanis send or receive remittances, while half of remittances, including domestic flows, are transmitted informally.
- Agricultural disbursement grew by 44 percent in 2003-07 - ***yet*** rural credit demand remains unmet—the financial system reaches only 15 percent of farmers.
- Life insurance is the most used insurance product, and demand is high for crop insurance products - ***yet*** only 1.9 percent are insured.



Financial access is low among the poorer, women, small and microenterprises and in rural areas, though market studies suggest they are viable customers. Formal markets could learn from and cooperate with informal arrangements, to increase outreach. In testimony to the commercial viability of these client segments, informal finance seems to be capable of profitably serving such groups at a reasonably low premium to formal services. Most formal financial products remain high-end, limited to urban rich educated males employed in the formal sector. The formal sector could learn a lot from and partner with informal providers – their services are perceived as being more geographically accessible, less complex, with fewer requirements, and easier to understand. For one, formal finance could differentiate their products more, attuning them to the specific needs of various population segments, such as women. Requirements could be less onerous using technology and flexibility - strict documentary, guarantor, and collateral requirements for becoming a customer, and income and information/awareness constraints have obstructed more aggressive growth in formal financial access.

Disparate as formal access might be among rural and urban areas, men and women, income levels, as well as along education and employment sectors, interest in financial services is virtually identical. The challenge is to translate financial interest into formal access and usage. Poverty and lack of information on financial services predicate lack of interest—the perception of irrelevance of the financial system to the everyday lives of a considerable share of the Pakistani population. Low geographic outreach, complex procedures, and products poorly suited to client needs strengthen the perception of formal sector irrelevance for the vast majority of the population. An analysis of perceptions of financial services links the popularity of informal finance to its minimum access requirements—in direct contrast

to formal finance documentation, creditworthiness requirements, and associated fees that overburden population groups such as women, low-income or rural populations.

Microfinance

Microfinance in Pakistan represents a low 0.2 percent of total financial assets, though formal markets growth is second fastest in South Asia (after Afghanistan). The formal microfinance sector reaches less than 2 percent of the poor, as opposed to over a quarter in Bangladesh, India, and Sri Lanka. The informal sector can be competitive, and has good lessons to offer to its formal counterpart. There is still considerable room for growth of microfinance in Pakistan — the estimated potential market size is in the range of 10-20 million active borrowers, and some estimates place the number as high as 35 million. Women are a poorly explored clientele with tremendous potential. While microfinance policy and services have focused on credit, there is a considerable potential for other products, especially savings.

A key challenge to microfinance institutions (MFIs) in Pakistan is raising considerable funding to grow, attaining sustainability, and better integrating with financial markets. MFIs rely considerably on noncommercial funding—commercial liabilities to gross lending portfolio are barely 21 percent. Profitability and performance in the microfinance sector is low but improving. In 2000, microfinance was elevated to a core aspect of the government's poverty reduction program. In spite of SBP encouragement, commercial banks have shown little appetite to service microfinance clients. The SBP strategy of offering a bank license to stronger MFIs has proven more successful, though the hoped-for deposit mobilization has not materialized with the pace expected, and the outreach of microfinance banks (MFBs) remains limited. MFBs account for 31 percent of the microfinance lending portfolio, and 85 percent of its growth.

The Pakistan microfinance market has much potential for a rapid outreach expansion, and faces considerable unsatisfied demand, especially for savings products. Mobile technology can help expand access considerably, especially in the informal sector. The financial sector has not yet taken up SBP encouragement to that effect, and will unlikely change course given the recent financial crisis fallout. Yet, it is important to persevere in this agenda, which directly links into poverty reduction. Promising strategies include financial awareness campaigns, strengthening of MFI viability and commercial sustainability, inclusion of women and client segmentation, and development of savings products. Smaller size of products, and bulk service might better attract lower-income groups. The increasing use of technology will make this approach a viable business proposition for banks as well as affordable for clients. Two approaches have been used internationally to address high transaction costs due to low population density, small average loans, and low household savings—the Grameen and Brac low-tech, low-cost, high-volume models of microfinance, and the high-tech, low-cost, high-volume approaches developed in Kenya or the Philippines. With close to 90 percent coverage and 59 percent reach (and no gender divide), mobile banking holds much promise to increase access. A potentially major player in access to finance for the underserved is the Pakistan Post Office, with its over 13,000 offices, and current efforts to upgrade technology. Under government policy encouragement, some MFBs have experimented with linking up with Pakistan Post in a bid to expand outreach (such as in Brazil and China).

Small Enterprise Finance

Small and micro enterprises have seen a worsening of access to finance, while medium-size enterprises have seen improvements. SMEs are the growth engines of the economy due to their ability to create jobs, foster entrepreneurship, and provide depth to the industrial base of the economy. Yet SMEs get a disproportionately small share of credit relative to their economic importance. There are 3.2 million SMEs in Pakistan, which constitute over 90 percent of all private enterprises in the industrial sector, employ nearly 78 percent of the nonagriculture labor force, and contribute over 30 percent to gross domestic product (GDP). Yet SME lending accounts for 16 percent of total lending volume and only 4 percent of total customers. 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 (34.5 percent in South Asia).

Small and micro firms finance internally 90 percent of working capital and 81 percent of new investment. Studies estimate a small enterprise credit demand gap of Rs 277 billion (compared with total current SME credit at Rs 400 billion).

Enterprises do not seem to be excluded from financial markets due to poor performance. Instead, an incomplete legal and regulatory framework and non-SME-friendly products and procedures hamper increased SME lending. Indirect costs—legal fees, collateral registration, and documentation—make bank lending expensive for SMEs. A typical small business loan requires up to 27 steps for the bank and nine meeting with clients. An enabling role has been played by the expansion of the Credit Investment Bureau's (CIB's) scope in 2006, the SME Policy 2007, which emphasized SME access to finance, and above all the new SBP Prudential Regulations for SMEs. However, banks continue to find it difficult to serve SMEs profitably for several reasons. First, the legal framework (namely, the secured transactions regime and, to a lesser extent, the credit information infrastructure) limits the pool of potential applicants. Further regulatory challenges include a slow court, the stalled "SME Act" of 2006, and a problematic tax system. Second, bank products are not tailored to SMEs, resembling instead corporate lending practices. Finally, banks do not have organizational structures and monitoring tools conducive to achieving high efficiency. SME demand-side factors further constrain the market, including limited SME accounting, budgeting, and planning capacity and poor entrepreneurial skills.

Continued promotion of an enabling environment for SME lending and a large-scale downscaling effort involving both the public and private sectors can forge rapid growth in SME lending. Increasing access to finance for SMEs also requires creating a secured transactions law that allows all SMEs to use movable collateral, attracting an institutional investor with a track record in SME lending, and assisting other banks to go down market. While progress has also been substantial on credit bureaus, more could be done to facilitate the creation of credit histories by SMEs.

Remittances

Remittances to Pakistan are estimated at around $16 billion and growing fast, but formal flows do not reach the poor, women, and rural areas, where service is mostly informal. International flows (through both formal and informal channels) total $9 billion, with domestic flows at approximately $6.95 billion. These remittance flows can play a valuable role in providing foreign exchange, but more importantly also offer significant potential to support incomes of poor and vulnerable groups. In Pakistan, however, formal remittances have not been a major part of income for poorer households, mainly because of limited access. Transmission networks work well in urban areas, though outreach to rural and remote locations are difficult, and services are not sufficiently customized to client needs (such as women who might need doorstep delivery, and the poor who rarely have the requisite documentation and accounts). Pakistan Post has a large rural network and is the most common channel for domestic remittances, but services remain relatively inefficient. Home consumption constitutes the largest use of remittances.

SBP has taken various measures that have significantly increased remittances through formal channels, though a large share of domestic remittances remains informally transferred. SBP has been encouraging the private sector toward providing mobile banking solutions. The mobile coverage (at about 90 percent of the population of Pakistan), and the success of mobile money transfer solutions in other countries, suggests that mobile phone banking offers significant potential to scale up access to financial services in Pakistan. To stimulate outreach to remote locations, SBP has been encouraging the private sector to provide mobile banking solutions. Other solutions from international experience include Indian innovations such as the nongovernmental organization (NGO) Adhikar, which developed an efficient domestic customized transfer service, and ICICI Bank, which extended its outreach to remote village centers via computer kiosks. New partnerships among remittance market players and other financial entities both within Pakistan and abroad hold much promise. Further advances in formalizing money transfer flows will bring new clientele and motivation for efficiency gains and customization of services to client needs.

Recommendations Summary

The Way Ahead: Policy Options

A major drive to enhance financial inclusion would involve a joint effort of SBP, the national government, private sector, the community, and donor efforts. The best formula for a rapid scaling-up of access is to rely on technology, literacy gains, financial re-engineering of processes and products, and an enabling legal and institutional framework.*

The Role of the Private Sector

Access to all Financial Services

Diversifying the product range and segmenting clients to increase outreach, simplify procedures, lower costs, and manage risks, to better cater to client needs. Specific suggestions include:

- Use of alternative forms of collateral, such as social collateral, compulsory savings, personal guarantees, crops or machinery purchased, household assets;
- Use of traditional saving arrangements and Rotating Savings and Credit Associations;
- Smaller size of products, and bulk service, to better attract lower-income groups;
- Lower loan size and deposit size to better match women's needs, given their lower incomes;
- Frequent repayments so that installments are smaller and correspond to women's income cycles;
- Literacy should not be a requirement to access financial service;
- Innovative ways to reach customers such as decentralized operations, use of mobile units, operating units located near women clients, transactions at clients' doorsteps, use of female staff. Focus on the promising market niche of financial access for heads of households, especially of interest in rural areas).

Reaching out to the female client: Women's abilities to better manage debt, their stronger savings patterns and client loyalty present an untapped profitable client base for the financial and microfinance sectors in Pakistan. Understanding women's needs more precisely, and reflecting those in the financial products and the provider's policies and procedures, would ensure an increase in women's access to finance in spite of cultural norms, gender segregation, low literacy, and incomes. Global experience suggests offering women credit that is untied to specific use, instead allowing the borrower to suggest the activity.

Learning from the informal financial sector's minimum requirements, flexibility, and cost/time efficiency: Developing linkages with the informal sector would help formalize the sector, increasing the formal sector's client base.

Reaching out to the rural client by leveraging technology: Technology can lower costs, enlarge geographical outreach, increase product quality, help enhance credit

The Role of the Public Sector

Creating awareness of the benefits of access to financial services: Further gains in financial literacy are critical, though more critical is increasing awareness of financial services to promote trust in the sector, as well as information about services and products available. A national awareness campaign can support financial inclusion, especially for women, as well as encourage people to open bank and savings accounts. Awareness-creation and trust-building could be forged through social mobilization and mass media.

Strengthening institutions: Growth in access to finance will be accelerated by an integrated financial system and a strong regulatory framework.

- Stronger institutions (including Securities and Exchange Commission of Pakistan and CIB) are a major part of a rapid increase in financial inclusion.
- Upgrading the existing credit bureau managed by SBP and consolidating the achievements in increasing its coverage to the whole finance service sector including NGO MFIs can place many more potential borrowers within reach of some access to finance. SBP could also facilitate the creation of a credit history for SMEs by mandating the credit bureau to collect information from utility and telecom companies.
- To facilitate SME lending monitoring, SBP should amend SME portfolio reporting requirements to include volumes / number of loans in four sub-brackets (Rs <2M, Rs 2-6M, Rs 6-25M and Rs 25-75M).
- A more efficient Pakistan Post is a must (following the successful examples of Brazil and China), to capitalize on its large network and outreach in rural areas. Government should explore ways to improve remittance and other services and speed up the automation of postal branches. Given the significant developmental potential of Pakistan Post to enhance financial access, it needs modernization in

information, and provide innovative applications for service delivery. Despite some regulatory and operating challenges, technology solutions have enabled poor people to access financial services, for example:

- Innovative bank devices can enhance outreach/correspondent banking (such as India's ICICI Bank computer kiosks in remote village centers).
- Branchless banking via mobile phones and other devices has the potential to decrease operating costs by as much as 12 percent and can help shift some of the financial flows from informal to formal channels, in particular if combined with other correspondent banking channels. Challenges include regulatory, security, and supervision difficulties, and limits on the range of services (as in the Philippines G-Cash and Kenya M-Pesa models).
- The Grameen and Brac low-tech, low-cost, high-volume models present successful experience for microfinance.
- Partnerships among financial institutions (commercial banks and MFBs, linkages with Pakistan Post and NGOs) can unleash remittances and other financial services for the rural poor. A useful example is that of the Indian NGO Adhikar developed an efficient domestic customized transfer service.
- Basic banking has had some success (India, Mexico, South Africa), in particular when banks have voluntarily offered commercial basic banking.
- Home-grown solutions include United Bank Limited's services for bill payments, money transfers; Bank Al-Falah's mobile banking with Warid Telecom; and the remittance service of Etisalat's (UAE)-Smart (Philippines).

operations and regulations. Following most success cases in East Asia, as well as many other continents, PPSB should be placed under the supervision of SBP.

Creating an enabling environment for expanding access to the underserved: Regulations should keep up with the needs of the sector and technological developments, to enable expansion. Simultaneously, an enabling environment should go hand-in-hand with a carefully chosen government presence. Indiscriminate subsidies, especially focused on interest-rates, can be detrimental to the expansion of the sector, as they not only distort prices but crowd out efficient institutions and products. The government should resist populist perceptions that low interest rate funding can serve a developmental purpose. Even more detrimental are state-owned institutions created to promote financial access. Evidence in the case of Pakistan that such institutions (for example, SME Bank) actually improve access is weak; rather, these efforts waste valuable public resources that could more usefully be deployed elsewhere, and eliminate the level playing field for market participants.

Access to Microfinance

Improving MFI sustainability and ability to muster commercial funding/savings deposits, and their further integration into the financial system: MFIs need to improve efficiency, risk management, and profitability to increase reliance on commercial funding.

Encouraging positive public perceptions on accessibility and safety would help.

A further strategy is r**efocusing on microsavings and deposits collection**, given the large untapped demand for such products and is supported by international experience: savings methods that have worked for microfinance include doorstep collection schemes and periodic contribution or "commitment" programs.

Refocusing on microsavings: International experience points to regulatory methods of promoting savings, such as matching schemes and tax advantaged schemes.

Access to SME Lending

Creating a complete and well-functioning secured transactions regime: Security interests over movable assets should be easy and allowed on most assets and by every entity (both physical and juridical persons). Priority rankings should also be clearly defined among those who might have claims on property offered as collateral. The new secured transactions regime should also include a place (such as a

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<td>Carrying out a thorough bank downscaling program and modernizing SME banking. Key features of the downscaling programs that have worked include:
➢ Long-term technical assistance to implement the necessary substantial changes;
➢ Careful selection of bank advisors and content of the technical assistance;
➢ Participation of a mix of committed banks to create competition;
➢ Adequate performance agreements for participating banks.</td>
<td>registry) for making priority interests publicly known, and enforcement of security interests for all assets should be fast and low-cost.
Promoting initiatives proving a demonstration effect of bank downscaling.
➢ Introducing an institutional investor with a track record in SME lending, ideally via selling the SME bank or giving controlling rights on its board to an institutional investor.
➢ Supporting long-term technical assistance programs for selected banks (a good example is the China SME lending program).</td>
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<tr>
<td colspan="2">Access to Remittances</td>
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<td>Reducing informality. Informality will decrease upon the introduction of efficient, low-cost, easy-access remittance services without prohibitive identification requirements. Increasing bank accounts can also help increase remittances through formal channels.

New technologies can reduce costs and make it possible to service areas where traditional bank branch models are not viable.</td>
<td>Formalizing informal remittances, particularly domestic: Public policies aimed at supporting technical and financial literacy, combined with education on the benefits of formal systems would also help.

Supporting remittance services of Pakistani banks abroad, to boost international remittances and forge alliances with international banks. One strategy would be to set the reimbursement rate through partner banks higher than remittances through Pakistani bank networks. Pakistani missions abroad could disseminate information to immigrants on lowest cost and best sources of money transfer (as is done by the Mexican mission to the United States).</td>
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<td>Expanding Pakistani bank presence and remittance service provision abroad, particularly in the major remittance source countries. These include partnerships, or innovative ways to reach customers (for example, Habib Bank Limited’s model for cultivating clients and fostering regular remittance habits in the Middle East). Paperwork should be kept to a minimum, recognizing low literacy levels, and technology interfaces should not be excessively complex. Doorstep delivery models would help remittance recipients, who are generally women or elder groups.</td>
<td>Promoting the structuring of international flows into investments: International good practices include (1) packaging remittances with payment services (such as Bansefi in Mexico); and (2) organizing and targeting Diaspora networks rather than actual remittances flows. At the macro level, Diaspora bonds issues (for example, in Israel, India, Ghana) or securitization of future remittances flows (in Brazil, Salvador) have been used, although securitization is costly. At the micro level, governments have facilitated targeted Diaspora funds.</td>
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<td colspan="2">The Role of Public-Private Partnerships</td>
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<td colspan="2">A concrete way to make progress in expanding access to the underserved is to form public-private working groups on microfinance, small enterprise finance, and remittances, to start a dialogue to tackle key challenges in the sector. Priority themes should include legal and regulatory issues, market transparency, competition and cost, and research and data issues. Public-private discussions on branchless banking could focus on barriers to industry response to recent SBP regulatory incentives, as well as review the Payment and Electronic Fund Transfer Act, data privacy or security regulation that could facilitate e- or m-payments, and the branchless banking regulations providing for bank-nonbank partnerships and use of agents in money transfer services (building on the U.K. Public-Private Working Group on Remittances and the Remittances Task Force, and the World Bank remittance initiative).</td>
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