Towards Achieving

Social and Financial Sustainability:

A Study on the Performance of Microfinance in Pakistan

International Labour Organization

State Bank of Pakistan

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Foreword

Over the years microfinance has emerged as an effective tool for employment generation, women empowerment, and consumption smoothening, all leading towards poverty alleviation. According to Microfinance Information exchange (MIX), more than 1200 microfinance institutions around the world have loaned $7 billion to about 30 million low income people. The success and growth of microfinance has attracted traditional financial service providers. Now the mainstream financial institutions are offering microfinance products.

Multilateral agencies have come to realize the potential of microfinance and its role in improving the socioeconomic condition of poor. At the same time regulatory bodies are increasingly becoming aware of the key role microfinance can play in financial deepening. Extreme poverty has drastic consequences one of them being child labour that negatively affects both the social fabric and future economic aspects of a country. Poor economic conditions compel families to take children out of education into manual labour affecting the quality of future workforce. Realizing the impact of microfinance on poverty alleviation, ILO in Pakistan has been using this as one of the interventions to financially empower families to stop their reliance on child labour income. The State Bank of Pakistan has been the first central bank in the world to introduce a policy framework for microfinance banks. The central bank has been working closely with all stakeholders to facilitate the growth in microfinance sector.

Though having a promising future, microfinance sector is confronted with major challenges; sustainability and efficiency being at the forefront. An organization cannot sustain its operations if it is unable to meet its costs. For microfinance institutions (MFIs) fulfilling social objectives while ensuring financial sustainability is of utmost importance. A better understanding of the issues faced by microfinance sector will help in improving the efficiency and sustainability of microfinance programs. There seems to be a need for a greater role for microfinance sector especially in a developing country like Pakistan. Appreciating the role and significance of microfinance in poverty reduction by providing access to credit and subsequently reducing the incidence of child labour, the International Labour Organization office in Pakistan in collaboration with the State Bank of Pakistan has carried out this study.

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List of Abbreviations and Acronyms

MBB	Micro Banking Bulletin
ADB	Asian Development Bank
AKRSP	Agha Khan Rural Support Program
GB	Grameen Bank
BN	Banco do Nordeste
BRI	Bank Rakyat Indonesia
BRAC	Bangladesh Rural Advancement Committee
SLA	Saving and Loan Association
BAAC	Bank for Agriculture and Agricultural Cooperatives
CIB	Credit Information Bureau
NIC	National Identity Card
CAs	Credit Associations
CBO	Community Based Organizations
CIB	Credit Information Bureau
CWE	Credit with Education
GTZ	Gesellschaft fur Zusammenarbeit
HH	Household
ILO	International Labour Organisation
MF	Microfinance
MFBs	Microfinance Banks

MFIs	Microfinance Institutions
MIX	Microfinance Information Exchange
MSDP	Microfinance Sector Development Program
NGOs	Non-Government Organisations
NRSP	National Rural Support Program
PKSF	Palli Karma Sahayak Foundation
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
PRSP	Poverty Reduction Strategy Paper
PRSP	Punjab Rural Support Program
ROSCAs	Rotating Savings and Credit Associations
RSPs	Rural Support Programs
SBP	State Bank of Pakistan
SECP	Security Exchange Commission of Pakistan
SLA	Savings and Loan Associations
SRSP	Sarhad Rural Support Program
EMI	Equal Monthly Installment

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Executive Summary

While economies around the world have experienced high growth and financial systems have undergone major transformation, a significant number of people especially in the developing countries do not have access to finance. Policy makers have increasingly promoted the use of microfinance as a tool to eradicate poverty and implement financial inclusion strategies. Pakistan being a developing country is no exception to this, having a large number of people that are poor with limited recourse to livelihood. Though limited in its scope, microfinance in Pakistan, has been able to bring some of the large number of unbanked people into the banking network and has also helped in improving their socioeconomic condition. As stakeholders strive to promote and make microfinance sustainable this report has analyzed the supply and demand side issues confronting the microfinance industry in Pakistan.

Faced with constraints like inadequate infrastructure and limited resources microfinance is generally restricted to the provision of microcredit in Pakistan. Other instruments such as saving products, emergency loans, skill development and micro insurance are not very popular with both the regulated and unregulated sectors. One of the key reasons for limited microfinance products range in the country is the high underlying transaction cost and absence of well structured risk mitigation tools. Government and donor provided funding forms the major part of capital of microfinance institutions.

Majority of microfinance clients reside in rural areas of the country and 65 percent of these borrowers are being served by the unregulated sector[a]. It is only recently that the regulated sector i.e. microfinance banks have started offering services to the clientele in urban areas. Despite achieving an impressive average growth of 57 percent (900 thousand borrowers) since 2003 a large number of estimated potential clients 25-30 million remain underserved.

Though microfinance industry has grown significantly, the asset quality indicators for the sector portray an unsatisfactory scenario as reflected by a rising risk coverage ratio. Profitability indicators are important for the sustainability of an industry and microfinance institutions appear to be struggling on this front. This is depicted by a negative return on equity and return on asset ratios for the industry in comparison to an above 10 percent return on asset ratio for microfinance sector of regional countries like India, Sri-Lanka and Bangladesh. However a declining trend in losses and improvement in indicators like operational self-sufficiency of 90 percent which is close to the regional average of 89 percent and a financial self sufficiency 74.5 percent which is less than the regional average of 95 percent project a promising future for the industry.

This report is based on the findings of a survey of microfinance providers in Pakistan. The findings highlight key institutional and operational issues facing this sector. Adverse selection is one of the key issues facing microfinance providers. To expand their client base microfinance institutions have extended loans to individuals who fall outside the defined criteria of eligible microfinance clients but are affluent. According to the survey findings there is a practice of securing loan on behalf of others by using their national identity card.

Despite popular criticism directed at microfinance institutions for charging high interest rate, the survey results show that clients in general did not have reservations regarding the interest charged and were primarily concerned with the availability of credit.

Lack of skilled staff is one of the factors affecting the efficiency of microfinance providers. According to the survey findings one field officer is dealing with

[a] This percentage will be changed in the near future due to transformation of major MFIs including Kashf and NRSP into microfinance banks.

approximately 200 clients. Limited female workforce has restricted the access to female clientele affecting the outreach of MFIs.

In general microfinance providers prefer female clients based on the assumption that women are less likely to default and in certain instances to promote women empowerment. However it has been observed that, in most of the sample observations, once loans were obtained by women they were later used by men. This practice appeared to be voluntarily. Despite this, since women are provided the loan this has led to some empowerment which cannot be quantified.

In Pakistan microfinance lending is mainly conducted through group based model especially by the unregulated sector. While social collateral has proved to be an effective tool leading to lower default rate, it deprives people without collateral to benefit from microfinance. Microfinance institutions prefer to finance running businesses to ensure repayment. This practice excludes new entrepreneurs and limits the outreach of the sector.

The unregulated sector covered in the survey were child labour projects where ILO with its partner NGOs was preventing and rehabilitating child labour primarily through non formal education services. The partner NGOs of ILO also offered their Pakistan Poverty Alleviation Fund's supported microfinance interventions to the interested child labour families to strengthen their income generation capacity and off-set the loss of income due to withdrawal of children from labour. However evidence of a decline in child labour only due to the provision of microfinance facility has not been significant.

Survey findings support the earlier observations of various studies that poor indeed save and channelize them through Rotating Savings and Credit Associations (ROSCAs). However microfinance institutions do not capitalize on these small deposits due to high transaction costs.

According to the survey results majority of microfinance clients expressed the view that rising cost of production and higher startup business cost require a minimum loan of 25000 rupees.

Some clients were alleged of unethical practices on part of the microfinance institutions, and in certain cases of defaults, it was also indicated that loans have been recovered through 'illegal' means. However, these claims could not be substantiated.

> Despite popular criticism directed at microfinance institutions for charging high interest rate, the survey results show that clients in general did not have reservations regarding the interest charged.

There is a huge untapped market of microfinance clients in the country. With the presence of government commitment and facilitation by the central bank there is an opportunity for microfinance institutions to expand their outreach while fulfilling the dual mandate of achieving financial sustainability and socioeconomic uplift of the society.

1 Introduction

The success of Grameen bank increased international focus on microfinance and its ability as an effective tool to fight poverty. Acknowledging this, the government of Pakistan has taken major steps to promote microfinance in the country by introducing the Microfinance Ordinance. in 2001. Since then a number of initiatives have been undertaken by the government and State Bank of Pakistan to ensure steady growth of the microfinance industry. The multipronged based approach to use microfinance for social uplift leading to women empowerment, employment generation, and lowering poverty, though successful, has been confronted with numerous challenges. Sustainability and efficiency issues lie at the heart of the sector's growth.

According to Micro Banking Bulletin data[1], two third of the microfinance institutions (MFIs) of the world are sustainable catering to the needs of the poor. Though institutions cannot be compared to each other objectively, since they might differ in size, geographical location and focus, however there appears to be enough literature based on evidence that microfinance institutions can help poor while ensuring self sustainability.

This report analyses the performance of microfinance sector of Pakistan in fulfilling its dual objective of social uplift and achieving financial sustainability. The main focus of this report has been the performance of microfinance industry in Pakistan with specific focus on both supply and demand side issues. Moreover, it has also reviewed the impact of microfinance on child labour among poor families.

Though a late starter, microfinance industry in Pakistan has expanded its outreach facilitated by the regulatory environment backed by government and central bank's commitment. Multilateral organizations have also played a key role in the expansion of microfinance sector in the country. This report is a result of collaboration between ILO Pakistan and the State Bank of Pakistan and is based on a survey of microfinance sector in three provinces Punjab, Sindh and Baluchistan where ILO's child labour project partner NGOs also introduced their Pakistan Poverty Alleviation Fund (PPAF) supported microfinance interventions. This research has covered key issues by obtaining first hand information from both microfinance providers and their clients.

The report consists of six chapters, introduction is followed by a section on 'Microfinance: An Overview' which reviews recent literature and highlights global and local developments in the industry. This is followed by Chapter three 'Scope of the Study and Methodology' that discusses the objectives of this study and research tools that were used for the analysis. Chapter four reviews the financial performance of microfinance institutions in the country by analyzing a number of sustainability and efficiency indicators based on published data. Chapter five analyzes the survey results, which is followed by chapter six the conclusion providing an insight into the key findings of the survey.

[1] "Microfinance and Public Policy; Outreach, Performance and Efficiency", ILO(2007), Palgrave Macmillan.

2 Microfinance: An Overview

2.1 Microfinance a Global Prospective

According to CGAP[2], "Access to financial services puts power into the hands of poor people. Evidence shows that when poor people have financial services, they use their savings or loans to improve their families' lives in a variety of ways: sending their children to school, buying better medicines and more nutritious food, fixing a leaky roof, meeting social and cultural obligations like paying weddings and funerals, and building income generating potential by investing in business."[3]

Traditionally commercial banks used to abstain from providing financial services to the poor and lower income groups considering them un-bankable due to unavailability of collateral. Under these circumstances credit to poor and lower income groups was only accessible through local money lenders, often at usurious rates. The introduction of microfinance has provided lower income groups an opportunity to benefit from access to financial services.

Microfinance models can be traced back to the early 17th century, but formal microfinance movement started in the mid-1970s with introduction of many innovative methodologies in poor villages throughout Asia and Latin America. Presently microfinance services are being provided by various institutions through a number of formal and informal models[4] (see Table 2.1). Along with specialized microfinance institutions, microfinance services are also being provided by conventional banks, non-governmental organizations (NGO), non-bank financial institutions (such as finance companies and insurance companies). It is difficult to have an exact estimate of microfinance providers; however, the Microfinance Information Exchange (MIX)[5] is presently providing information about 1224 microfinance institutions around the world.

Initially microfinance institutions services were limited to microcredit, however with the expansion of industry, microfinance institutions today offer a wide range of products such as micro-savings, flexible loan repayment and insurance. Some of the microfinance institutions also provide social services that include health care and education.

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[2]CGAP is the abbreviation of Consultative Group to Assist the Poor, an independent resource for objective information, expert opinion, and innovative solutions for microfinance. It works with the financial industry, governments and investors to effectively expand access to financial services for poor people around the world.

[3]Source: CGAP 2007 Annual Report, "Building financial Systems that work for the Poor".

[4]Microfinance institution is an organization that offers small size financial services to low income population.

[5]The Micro finance Information Exchange, Inc. (MIX) provides detailed financial and social performance information from leading microfinance institutions and market facilitators as well as from leading donor organizations and investors in micro finance (Source: http://www.themix.org).

Table 2.1: Microfinance Credit Lending Models

	Informal Lending Model
Individual Lending	This credit lending model involves simply lending to individuals without forming a group or ensuring community guarantee.
Rotating Savings and Credit Associations (ROSCAs)	ROSCAs consist of individuals forming a group regularly contributing to a joint fund, which is offered to one member after each cycle.
Cooperatives	A co-operative is a sovereign body of individuals joined together to achieve common social, economic or cultural objectives through a jointly owned enterprise.
	Formal Lending Model
Grameen Model	Microfinance institution sends its officers to locality to introduce the purpose, functions and operations of the institution. In the next stage, groups of 5 members (mostly women) are formed. However, loan is provided to only 2 members on the guarantee of other three members. The other members become eligible for loan only when first two borrowers have returned the principal plus interest in the specified time (usually 50 weeks).
Associations	In this form of model, the community composed of women or youth form association through which microfinance (and other) activities like savings take place. These groups could be formed around political, religious or cultural matters, which may also have legal status.
Bank Guarantees	In this model a bank guarantee is arranged to obtain credit from a commercial bank. The loan obtained is then used by an individual or by a group.
Community Banking	The whole community as a single unit establishes formal or semi-formal institution through which microfinance is provided.
Credit Unions	Credit unions are groups of people who agree to save their money together and to make loans to each other at reasonable rates of interest.
Intermediatories	Intermediatories play the role of linking borrowers and lenders by enhancing the creditworthiness of borrowers through education, training or funding to make them attractive for lenders.
Small Business	Microcredit is provided to Small and Medium Enterprises (SMEs) along with other inputs for generating employment and incomes.

Capital structure of microfinance institutions has always been a centre of attention. To fund their growth microfinance institutions have tapped a variety of sources with local generated funds being the primary source. However over the last few years microfinance institutions have also accessed international financial markets. Concerns are often raised about the ability of microfinance institutions to generate deposits and their heavy reliance on subsidized credit available through governments and multilateral institutions.

The use of subsidized credit to support their operations in the long run marks a question on the efficiency and financial sustainability of microfinance institutions.

Since financial sustainability is critical for microfinance institutions to carry out their operations successfully, financial problems are likely to limit their wider objectives such as promoting skill development and women empowerment.

A remarkable feature of many microfinance institutions around the world is their high recovery rate. Despite this, many microfinance institutions are neither sustainable nor are able to generate profit. Most of the microfinance institutions rely on subsidies requiring assistance from donors. Lack of profit generation does not imply that a particular microfinance institution is a failure as long as its mission and objectives are being fulfilled. There can be institutions that might be generating profit but do not significantly contribute on the social side, however there can be other institutions that do not generate profit but are financially sustainable and contribute in the socioeconomic uplift of the poor. Microfinance institutions that have been able to positively contribute towards the living standards of their clients through sustainable[6] financial services are seen as successful models.

Microfinance institutions generally focus more on females than males. This is so because research has proved that lending to women has greater impact on the welfare of a family[7]. Moreover it is generally believed that lending to women is also beneficial for microfinance institutions as it improves the repayment rate because women are more risk averse in their choice of investment projects, more fearful of social sanctions, and less mobile (and therefore easier to monitor) than men. Critics, however, argue that microfinance has done little to alter the status of women in terms of empowering women in any meaningful sense. Despite this criticism it is hard to deny the fact that microfinance has provided working opportunities for women (see Sengupta and Aubuchon, 2008).

A major criticism faced by microfinance institutions is that their target population is generally the marginally poor (just below poverty line) and not the very poor (well below the poverty line). Studies have also shown that microfinance is viable only for those (close to poverty line) who have already identified economic opportunities and need small amount of funds to capitalize the opportunity.[8] Such clients can afford loan on very high interest rates because of their ability to generate extra income within the period through efficient utilization of funds. The critics thus believe that as the very poor are not targeted hence microfinance might not be able to significantly help eradicate poverty. Further, critics also believe that microfinance cannot reduce poverty driven by social or economic disasters like floods, migrations or food shortages.

The growth of microfinance industry relies on an environment that encourages competitiveness and innovation. Internationally, various steps have been taken by a number of organizations for the

A major criticism faced by microfinance institutions is that their target population is generally the marginally poor and not the very poor .

standardization of microfinance. In this regard, the publication of the book titled "Building Inclusive Financial Sector for Development"[9], generally referred by microfinance institutions as "Blue Book" is important. Moreover institutions like MIX and CGAP are providing independent information regarding various microfinance institutions around the world.

On the policy front, governments can facilitate microfinance by ensuring macroeconomic stability and devising banking regulations and supervisory frameworks. In this regard, central bank's role in issuing licenses to microfinance institutions and supervising these through implementation of

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[6]Financial sustainability means that the microfinance institution is able to cover all its operating costs, financial costs adjusted for inflation, and costs incurred in growth.
[7]See Khandker (1998), Khandker (2005) and Smith (2002).
[8]For evidence, see Navajas et al. (2000), and Servon (1997).
[9]"Building Inclusive Financial Sector for Development", United Nations (2006).

prudential regulations[10] is crucial to ensure existence of a sustainable and efficient microfinance sector fulfilling the financial requirements of poor. Furthermore, for efficient and sustainable microfinance sector it is important to build credit bureaus. Credit bureaus, whether private or run by government, serve as a platform for sharing information among financial institutions through a data base about client's social behaviour and loan history. The existence of credit bureaus help in lowering the transaction cost of lending by minimizing the probability of adverse selection.

The design and delivery of financial services to the poor and low income population depends on innovation, efficiency, improved technology and appropriate regulation and supervision. Through total commitment and progressing on these frontiers various players in the industry have been able to improve the socioeconomic conditions of the poor (See Box 2.1).

Box 2.1: Case Studies (Success Stories)

Bank Rakyat Indonesia (BRI): Bank Rakyat Indonesia (BRI) is the largest microfinance bank in the world. The BRI Units use locally mobilized savings for provision of credit and has been able to successfully provide microfinance facilities on a large scale throughout Indonesia. Amongst various factors, this success is mainly attributable to effective leadership, strong commitment, and political support. The BRI Unit system was even able to survive the Indonesian banking system collapse in 1998, and remained profitable. This was mainly because it benefited from its status as a state-owned bank thus depositors felt that depositing money with BRI was safe compared to its competitors.

The Credi Amigo Program of the Banco do Nordeste (BN), Brazil: This program was jointly introduced by the World Bank and BN to provide microfinance services to the working poor community of Brazil's northeast region. The CrediAmigo program has been successful in two ways: firstly it has been able to provide microcredit to over 300,000 of Brazil's working poor, secondly the program is financially sustainable.

Equity Building Society (EBS), Kenya has been providing financial services to the underserved, low-income population of Kenya since over two decades. After a disappointing first decade, the EBS brought in outside experts to turn around the institution in 1993. This resulted in improved financial performance and increased outreach. This turnaround was mainly due to dedicated staff committed leadership, high-quality customer service, successful marketing, appropriate product design, and external support from donors.

[10]Central banks impose prudential regulations on microfinance institutions including minimum capital requirements, capital-adequacy ratio, limits on unsecured lending, registration of collateral, loan documentation requirement, etc.

Microfinance in Bangladesh: The microfinance industry in Bangladesh is providing access to credit to around 13 million poor households. Majority of these households are associated with four institutions including Grameen Bank (GB), Bangladesh Rural Advancement Committee (BRAC), ASA, and Proshika. Of these GB is considered as a major breakthrough in the history of microfinance. Since its inception, GB has made tremendous progress in alleviating poverty by providing financial services to the poorest population in Bangladesh. The success of microfinance in Bangladesh can be attributed to the following factors:

- Visionary leadership of microfinance organizations.
- Provision of a favourable macro-environment by the government of Bangladesh.
- Provision of resources at the appropriate time by multilateral organizations.
- Favourable characteristics of Bangladeshi society like high population density and relative ethnic, social, and cultural homogeneity made implementation of the microcredit model relatively easy.
- The public-private microcredit body Palli Karma Sahayak Foundation (PKSF), which channelizes funds to microfinance institutions, has contributed towards growth and improved professionalism of microcredit industry in Bangladesh.

Credit with Education Program (CWE), Madagascar: The network of Savings and Loan Associations (SLA), known as the TIAVO network, serves the poor by integrating the SLA and CWE programs. The CWE program encourages poor women to form groups, or credit associations (CAs), and join the SLA for obtaining credit from the TIAVO network. The members of CA are provided loans on the guarantee of other CA members. Moreover CA members must have savings to obtain credit. The program has been successfully providing services to the poor community of Fianarantsoa, the poorest province of Madagascar.

"Save and Get a Chance", Thailand: The Bank for Agriculture and Agricultural Cooperatives (BAAC) launched this product specifically for the low income clients of Thailand. After initial failure, the program became a success as it received technical support from Deutsche Gesellschaft fur Zusammenarbeit (GTZ). The program has a unique combination of savings, prize drawings and parties that attract clients. Rewards are given to savers who open and maintain saving accounts with prize drawings and parties that celebrate savings.

Banco Solidario (BoncoSol), Bolivia: BoncoSol lends to groups and offers savings and a variety of industrial products at relatively high interest rates (48 percent plus a 2.5 percent commission) as compared to other microfinance institutions. BoncoSol charges high interest rate because its primary focus is profit earning with poverty alleviation being a secondary objective. Because of such high interest rates BoncoSol does not have to rely on subsidies.

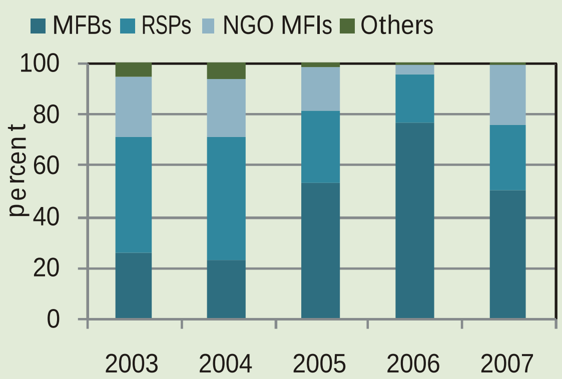
Above cited institutions have performed well in the field of microfinance in different countries. However, comparison cannot be made among these institutions because they operate in different cultural environments.

Source: Scaling up Poverty Reduction Case Studies in Microfinance, World Bank (2004)

2.2 Microfinance in Pakistan

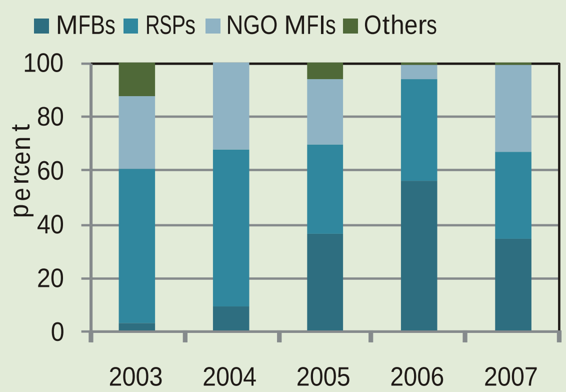
Introduction of microfinance in the country over the last few years provided the financially marginalized segment of the society with an opportunity to access financial services; helping them improve their socioeconomic conditions. The situation was quite different in the last few decades where the focus was limited to agricultural credit during the 60s. In the 70s, there was a move to nationalize banks in the country and most of the credit provided to the small farmers was by public sector banks. During the 80s Agha Khan Rural Support Programme (AKRSP) began its operations in northern region of the country through Community Based Organizations (CBOs). The success of AKRSP led to the gestation of several other RSPs in Pakistan that include the Sarhad Rural Support Programme (SRSP), the National Rural Support Programme (NRSP) and the Punjab Rural Support Programme (PRSP). The decade of 90s witnessed the establishment of NGO-MFIs such as Kashf Foundation, Taraqee Foundation, Bunyad (BLCC) and Damen. New millennium paved the way for development of policy infrastructure for microfinance industry. The government of Pakistan introduced the Microfinance Ordinance in 2001, while the 'Poverty Reduction Strategy Paper' recognized microfinance as an effective tool for poverty alleviation.

Figure 2.1: Total Assets (Share in Total)



Source: PMN

Figure 2.2: Gross Loan Portfolio (Share in Total)



Several major steps have been taken towards supporting the growth of microfinance sector in Pakistan. These steps include establishment of a separate legal and regulatory framework for microfinance institutions, Pakistan Poverty Alleviation Fund (PPAF) a wholesale window for NGO-MFIs/RSPs, Micro finance Sector Development Program (MSDP) focusing on strengthening of institutions by furnishing grants, and establishment of Pakistan Microfinance Network (PMN) a representative body and focal point for microfinance institutions to promote microfinance in the country.

The existence of diverse microfinance institutions operating in the country reflects the significant growth of this sector over the past decade. Up to 2005, microfinance sector operations were highly concentrated with NGO-MFIs and RSPs. However, with the increasing number of formally regulated microfinance institutions i.e. banks, the share of assets and gross loan portfolio for the regulated MFIs increased considerably during 2003 to 2007 (see Figures 2.1 and 2.2). Outreach of the sector has also shown change in its structure as the number of active borrowers of microfinance banks has surpassed the unregulated microfinance sector i.e. NGO-MFIs and RSPs in 2006 onward (see Figure 2.3).

Currently, the microfinance sector players can be classified into three broad categories based on the criteria of their regulatory status (see Box 2.2)

Microfinance Banks and Commercial Banks involved in microfinance, falling under the regulatory ambit of the Central Bank (State Bank of Pakistan);

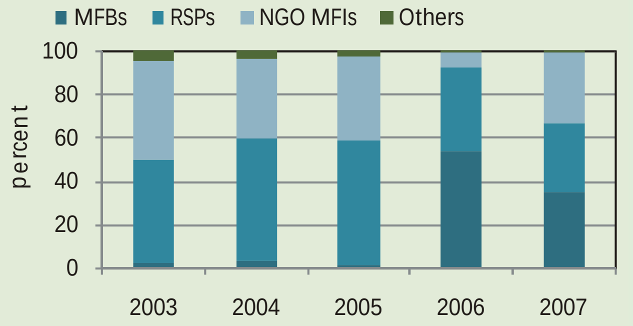
SBP on the outset aptly recognized the need for separately defining a set of parameters for establishing a microfinance bank. The policy framework allows establishment of three categories of formal microfinance banks in the country:

- Nationwide microfinance banks minimum paid-up capital of Rs.500 million
- Province wide microfinance banks minimum paid-up capital of Rs.250 million and
- District wide microfinance banks minimum paid-up capital of Rs.100 million

The prudential regulations have been designed cautiously to allow flexibility and innovation while ensuring effective regulatory and supervisory oversight. The State Bank of Pakistan has also issued mobile banking guidelines to facilitate microfinance banks in their mobile banking operations and has ensured that microfinance banks put in place necessary systems to mitigate the risks inherent in mobile banking operations. Moreover, SBP has not only allowed the transformation of NGO-MFIs into microfinance banks, but has also allowed separate windows of commercial banks to extend microfinance along with whole sale financing of commercial banks for microfinance institutions. Currently there exists a network of seven specialized[11] microfinance banks in the country.

SBP in collaboration with international experts has started working on Credit Information Bureau (CIB) for the microfinance banks. CIB is being developed in partnership with all microfinance institutions including banks, NGOs, RSPs having a central pool of information regarding borrowers' credibility. This should help in achieving more transparency in

Figure 2.3: Number of Active Borrowers (Share in Total)



Source: PMN

particular on the clients' side, whereas prudential regulations can enable transparency on the part of microfinance institutions.

SBP has developed a national strategy to target 3 million microfinance clients by 2010 and 10 million by 2015. SBP has established Financial Inclusion Program worth £50 million in partnership with DFID to facilitate the growth of microfinance sector. SBP has also constituted a microfinance consultative group having representation from central bank, relevant government ministries, regulated microfinance institutions, NGOs-MFIs and donor agencies to work as an advisory body for SBP in microfinance policy formulation process. The group meets on quarterly basis to discuss microfinance policy issues and has been instrumental in developing trust between policy makers/regulators and practitioners enabling the central bank to develop sector friendly policies and regulations.

Leasing companies involved in micro-leasing business regulated by the Securities Exchange Commission of Pakistan (SECP);

[11] (i)Khushali Bank Limited (ii) Rozgar Micro finance Bank Limited(iii)Tameer Micro finance Bank Limited (iv) Pak Oman Microfinance Bank Limited (v)First Microfinance Bank Limited (vi)Network Microfinance Bank Limited and (vii) KASHF Microfinance Bank Limited has started its operations recently from November 27, 2008 while the transformation of NRSP is in process.

Leasing companies are providing access to a number of clients through micro-leasing. However, most of the leasing companies do not provide segregated data on microfinance.

Rural Support Programs, NGO-MFIs, Cooperatives;

NGO-MFIs have been the pioneers of microfinance operations in Pakistan and the combined outreach level of unregulated sector is still larger than the regulated sector MFBs operating in the country. Presently, there are more than 50 NGO-MFIs providing microcredit to the poor. Recognizing the leading role played by the unregulated sector, SBP has issued guidelines for NGOs interested in transforming into regulated microfinance institutions. The aim is to encourage NGO to transform their microcredit operations, if operationally sustainable, into regulated microfinance banks and build sustainable funding base through raising public deposits. This move has led to the transformation of one of the largest NGO-MFI i.e. Kashf, into microfinance bank.

Given that microfinance has established itself as a niche the focus has now turned to the sustainability of the sector. MFIs need to ensure financial sustainability by shifting their reliance from subsidized credit to offering credit based on realistic market rates. In this regard, the government of Pakistan has signed an agreement with ADB (US $ 320 million) to provide funds for sector reforms and product development.

The review of developments related to the microfinance industry in this section highlights the serious commitment on part of the government to promote microfinance within the country. However, a considerable proportion of the economically active poor still lack access to microfinance[12] due to the limited resource base and inadequate retail capacity of microfinance institutions. This demand-supply gap not only leaves room for more commercial microfinance institutions to enter the market but also for the commercialization of microfinance activities. Lack of capacity and innovative products are major hurdles towards the commercialization of microfinance activities. Resolving these issues will help microfinance better address the needs of the poor in the country.

[12]Potential clientele base for microfinance services is more than 6.5 million poor households and the combined outreach of all MFIs around half a million loan.

Box 2.2: Supply Side Microfinance Players

The evolution of microfinance has led to different types of microfinance providers. These are divided into formal and informal players[13]. The formal players are further disaggregated into institutions that are regulated (MFBs) and ones that are unregulated (NGOs and RSPs, etc). The informal players in the microfinance sector include the ROSCAs, moneylenders, and family and friends' savings.

Another classification was proposed by Joanna Ledgerwood (1999) and adopted by the Asian Development Bank (ADB) in (Charitonenko, Campion and Fernando, 2004). This classification recognizes three categories: a) formal institutions those fall under the preview of the general laws, and banking regulation and supervision; b) semi-formal institutions, which are registered and follow relevant general laws, including commercial laws, but not banking regulation and supervision and; c) informal providers: neither special banking laws nor general commercial laws apply.

A variety of institution types make up the landscape of the microfinance sector: Microfinance banks, which are regulated by the central bank; specialized microfinance institutions (MFIs), which are NGOs providing microfinance services only; and multi-dimensional NGOs and rural support programmes (RSPs), which provide microfinance as a part of integrated programmes. Of these, only MFBs can intermediate deposits, although many non-bank microfinance providers mobilize deposits from their credit clients. Some also offer insurance services bundled with credit.

Microfinance banks are operating in the country under the Microfinance Institutions Ordinance 2001. Other than the difference in capital requirements, all types of banks face the same prudential regulations and can offer the same range of services to their clients. However, most of MFBs operations are confined to microcredit and the other products such as insurance and other investment products remained underdeveloped.

The non-bank microfinance institutions are also active in providing financial services to the poor and are registered with the SECP under the Companies Ordinance 1984 or Societies registration Act 1860 or Trusts Act 1882. They cannot serve as intermediaries for deposits. Currently five non-bank microfinance institutions are operating in Pakistan[14].

The other kind of microfinance providers operating in Pakistan are NGOs and RSPs. These organizations not only provide microfinance services but also provide other types of services such as education, health and infrastructure for the poor.

Sources:

1. Charitonenko, S., Campion, A., and Fernando, N. (2004) Commercialization of Microfinance: Perspectives from South and Southeast Asia, ADB, Manila, April.
2. Ledgerwood, J. (1999) Microfinance Handbook: An Institutional and Financial Perspective, Sustainable Banking with the Poor, World Bank.
3. World Bank (2005a) Measuring Financial Access: Outlining the Scope of Current Data Collection Evidence, Financial Sector OPD, September.
4. Microfinance Industry Assessment: A report on Pakistan. PMN, September 2008.

[13] According to the World Bank (2005): In formal microfinance the provider has a legal status; and the rest is included in informal microfinance.

[14] These non-bank MFIs are Asasah, KASHF, SAFWCO, Akhuwat and OPP.

3 Scope and Methodology of the Study

The study 'Towards Achieving Social and Financial Sustainability: A Study on the Performance of Microfinance in Pakistan' addresses the following objectives:

1. To assess the demand and supply issues of Microfinance.
2. To map the diversity of Micro Finance Providers (Banks & Non-Banking Financial Institutions/RSP/NGO) and ascertain their sustainability and efficiency.
3. To determine the effectiveness of Micro Finance in terms of achieving social objectives within the poor communities/child labour families.

A number of studies have highlighted issues in estimating the social impact of microfinance initiatives. A pluralist approach involving multiple case studies and data collection techniques was adopted due to the relatively small size and age of microfinance industry in Pakistan.

The sample size includes 500 clients of microfinance institutions based in Sialkot and its suburbs, Hyderabad, Karachi and Gawadar. ILO arranged access to three of their child labour project partners NGOs, Bunyad foundation in Sialkot and its suburbs, NRSP based in Hyderabad and Taraqee Foundation in Gawadar. These three ILO partners introduced the PPAF support microfinance interventions among the willing families of child labourers in these target areas. The State Bank of Pakistan facilitated access to six microfinance banks. Clients and field teams of these organizations were interviewed for this study. However the sample is not restricted to the above organizations as during field visits the team also interviewed clients and field teams of other organizations present in these selected areas.

The Survey is based on a set of questionnaires. Four groups (a) Borrowers, (b) Non-borrowers, (c) Field officers of microfinance institutions, and (d) Management of microfinance institutions, were targeted and four different types of questionnaires were prepared for each one of them. A pilot survey was conducted in the light of which questionnaires were finalized to ensure better quality of information.

Before visiting the field team members were provided training about conducting interviews. Participant observation technique was borrowed from ethnography and interviewers were trained to observe their surrounding carefully. Team members interviewed the field managers, credit officers, and clients of microfinance institutions.

Clients were visited at their residents or workplace. Once clients and field officers were interviewed, the survey team visited the head offices of scheduled microfinance banks[15]. The team interviewed senior and middle level management of these banks.

Analysis was fine tuned by borrowing research methods from various methodologies. Both qualitative and quantitative techniques have been used in this report. In order to have a holistic view of the developments and issues faced by microfinance industry data triangulation was achieved by complementing primary information obtained from the survey and interviews with financial analysis. Ratio analysis was preferred over econometric analysis due to the relatively limited sample size and short time series characteristic of the data. Since the focus of this research goes beyond the efficiency and

[15]Another microfinance bank i.e. KASHF microfinance bank started its operations from November 27, 2008 and therefore has not been visited.

sustainability of MF, to assessing the impact of microfinance on poverty alleviation, qualitative information from the interviews and observation became an important part of the analysis.

Like other studies conducted to assess the social impact of microfinance, this study too has limitations inherited from the research tools. Ratio analysis on its own fails to provide an insight, while the interpretive approach used to analyze qualitative information can be criticized for researcher's bias. We have minimized the effect of these limitations through data triangulation i.e. by combining the results from ratio analysis with information obtained from interviews, field observation and other published material. Use of pluralist approach has helped us in better analyzing issues faced by the microfinance industry and enrich the analysis of this report.

4 Financial Review of Microfinance Sector

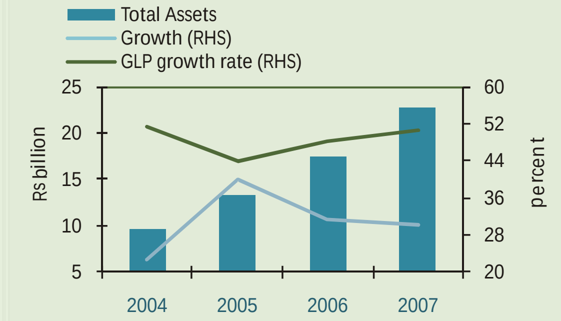
Over the last five years MF sector in the country has shown significant growth in terms of its expansion and outreach[16]. The asset base of the industry has increased to Rs. 22.9 billion in 2007 from Rs. 7.8 billion in 2003[17] (see Figure 4.1). Gross loan portfolio (GLP) has shown an increase of 388 percent for the same period. The growth in assets reflects the expansion of activities related to microfinance in the country. Presently a network of more than 1100 branches across the country, having staff of over 9500, is catering to the needs of around 1.3 million active borrowers (see Table 4.1).

Though an upsurge of more than 900 thousand borrowers since 2003 can be observed but this coverage seems quite low when compared to the huge 25-30 million[18] potential borrowers of microfinance in the country.

The coverage of microfinance institutions still remains lower (little above 4 percent) than the potential market but if the current rate of expansion continues, microfinance institutions are likely to achieve the government target of 3 million active borrowers by 2010.

It is pertinent to mention that more than 65 percent of rural borrowers are still clients of unregulated sector including NGOs and RSPs, etc[19] . This implies that outreach is pre-dominantly rural because of the focus of unregulated sector on rural region since NGOs and, RSPs both mainly target rural areas. Therefore urban areas remained neglected in the past. By realizing the potential market of microfinance clients both regulated and unregulated

Figure 4.1: Assets



Source : PMN

Table 4.1: Outreach

	2003	2004	2005	2006	2007
Total Assets (billion Rs.)	7.8	9.6	13.4	17.5	22.9
Offices	329	386	570	1,073	1,165
Number of Active Borrowers(000)	333	451	613	835	1,267
Number of Active Women Borrowers(000)	165	199	273	434	640
Gross Loan Portfolio (billion Rs.)	2.6	4.0	5.7	8.4	12.7
Total Number of Staff	2,367	2,948	4,296	7,342	9,529

Source: PMN

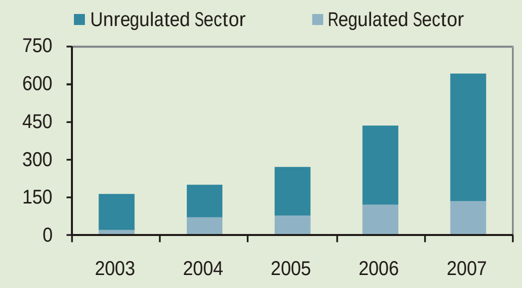
[16]The data for this section was obtained from PMN published reports (Pakistan Microfinance Review)Before 2003, the size

[17]of the formal sector was too small to anlyse in comparison with the overall sector.

[18] 20 percent of total population

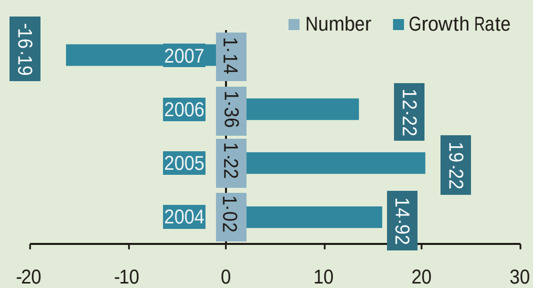
[19]However in November 2008, with the transformation of KASHF and NRSP into microfinance banks, the clientele of the formal sector has surpassed the informal sector clientele.

Figure 4.2: Number of Women Borrowers (000)



Source: PMN

Figure 4.3: Savers (in million) & Growth Rate (%)



Source: PMN

MFIs have started targeting urban areas. Tameer Micro Finance Bank Limited (TMFBL) is a significant example in this regard.

Gender wise distribution of outreach indicates that share of female borrowers in total borrowers has almost remained unchanged over the last five years (2003-2007). However, absolute number of women borrowers has increased significantly (see Figure 4.2). More than 80 percent of the women borrowers are being served by the unregulated sector. This may be attributed to a number of factors such as; a) age of the unregulated sector is more than the regulated sector, b) difference in lending models as unregulated sector mainly follows group based lending model where women group formation is considered relatively easy, and c) ratio of female employees is higher for unregulated microfinance sector. Having female employees for female clients is an effective strategy in a conservative society like Pakistan. First Microfinance Bank Limited (FMFBL) is a successful example in this regard; one female officer is obligatory in each field team and the portfolio of the bank contains 90 percent of female clients.

Though the industry has picked up pace in its expansion, microcredit remains the key service and the deposit base of microfinance institutions has not shown much improvement (see Figure 4.3). The reluctance of microfinance institutions to enhance deposit taking activities is mainly due to the reasons that; a) most of the unregulated sector institutions are not allowed to take deposits, and b) regulated sector institutions have though shifted their focus to deposit taking but continue to show hesitation because of high cost incurred in managing small value deposits. Despite the above concerns microfinance banks cannot ignore the significance of deposits, realizing that microfinance banks are now not only accepting deposits but are also taking institutional deposits and are working on customized saving products.[20]

Enhancing outreach while maintaining sustainability and efficiency of institutions is one of the key challenges faced by the microfinance sector. Outreach has expanded significantly as discussed but asset quality indicators are not satisfactory when compared to the rest of the financial sector. Portfolio at Risk[21] is rising reflected by a declining Risk Coverage Ratio (RCR)[22] (see Figure 4.4).

This situation is mainly due to the formally regulated sector despite that the sector is considered more stringent about the eligibility criterion and monitoring as compared to the unregulated sector. An explanation for this can be that the regulated sector is more transparent in its reporting and follow international accounting standards. In case of unregulated sector, there are chances of

[20]Tameer Microfinance Bank Limited has introduced customized saving products with special focus on female clients in the country..

[21]Portfolio at risk measures the quality of portfolio.

[22]RCR is the ratio of adjusted loan loss reserves to portfolio at risk > 30 days and tells how much of the PAR covered by an MFI's loan-loss allowance

misreporting due to lack of uniform reporting system and standardized accounting procedures. This scenario of low quality assets becomes of greater concern considering that the industry has not been able to earn profit to date. Indicators like ROA and ROE have not only been negative but have deteriorated during 2003-07(see Table 4.2). Microfinance institutions in peer group countries like Bangladesh, Sri-Lanka and India have been able to achieve above 10 percent[23] ROA. However silver lining to this scenario is that the overall losses have declined whereas yield on Gross Loan Portfolio (GLP) has turned positive after 2005 (see Figure 4.5). Operational efficiency indicators for the sector show

Figure 4.4: Asset Quality Indicators

Source: PMN

ratio is higher for unregulated sector compared to the formal regulated sector. This ratio indicates that institutions with a higher ratio have more clientele on

Table 4.2: Profitability Indicators (Percent)

	2003	2004	2005	2006	2007
Profit Margin (adjusted)	-51.6	-53.7	-63.9	-50.4	-35.2
Adjusted Return on Assets(RoA)	-5.0	-5.0	-7.2	-6.1	-6.4
Adjusted Return-on-Equity(ROE)	-8.7	-10.0	-18.7	-19.0	-20.9
Total Expense (Rs. Millions)	129	287	528	552	781

Source: PMN

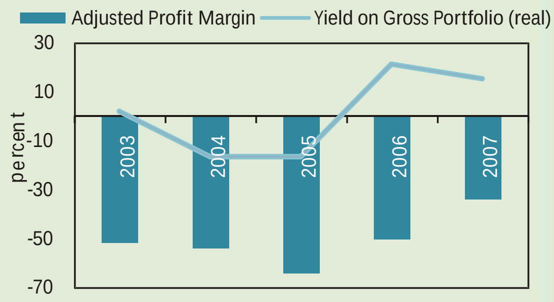
mixed trends during 2003-2007. Even after adopting the popular group based operating model by most of MFIs in Pakistan, the microfinance industry has not been successful in improving the cost per borrower (see Table 4.3), the most commonly used indicator of efficiency. However it is important to mention that the cost per borrowers of microfinance banks is higher than the cost of informal sector institutions. Higher cost of formal sector can be linked to the initial start-up cost, which can be reduced over the time. This indicator needs to be checked in the long term as higher costs can potentially impede the sector's growth.

In comparison to the South Asian trend[24] ratio of borrowers per loan officer for microfinance institutions in Pakistan is towards higher side. This one hand but on the other hand it depicts the possibility of adverse selection and moral hazard problems and ineffective loan monitoring. This aspect was observed during the survey as some of the field officers pointed towards the rising defaults that could be the result of adverse selection problem as a result of officers extending loans just to show improved and better performance while ignoring selection criteria.

However review of Operational self-sufficiency (OSS)[25] and financial self-sufficiency (FSS)[26] indicators present an encouraging scenario. OSS stands at 90 percent which is compatible with the regional average of 89 percent and FSS (74.5 percent) is less than the regional average of 95 percent. OSS has shown an improvement (see Figure 4.6) of 10 percentage points over the last four years. Though

[23] Stephens, B., Tazi, H., et al.(2005)"Performance & Transparency; A survey of microfinance in South Asia", Microfinance Information Exchange, Inc.(MIX)
[24] Ibid
[25] Operational self sufficiency (OSS) measures how well an MFI covers its costs through operating revenues.
[26] Financial self sufficiency (FSS) measures how well an MFI can cover its costs and tells how well the MFI could cover its costs if its operations were unsubsidized.

Figure 4.5: Profitability



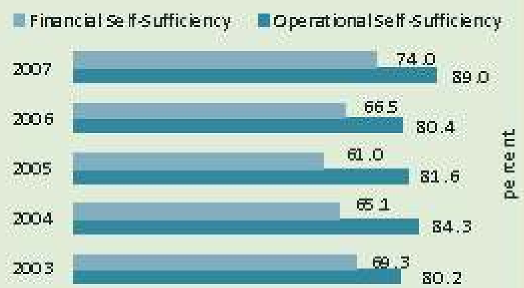
Source: PMN

the improvement in FSS does not appear to be significant but is encouraging as this has occurred in the presence of massive increase in expenditures (500 percent) of the sector due to increasing operations.

A declining trend in important indicators such as equity to asset ratio and commercial liabilities to GLP indicates that the industry is evolving and has started focusing more on sources of income other than equity and is borrowing more from financial institutions. On the other hand, rising trend of GLP to total assets indicates that microfinance institutions have started utilizing their resources relatively more effectively by directing more resources towards credit extension (See Table 4.4).

The financial review of microfinance industry in this section showed that the industry is growing substantially and is performing well in terms of its outreach. However microfinance institutions need to turn profitable, ensuring their sustainability while enhancing outreach.

Figure 4.6: Operational & Financial Self Sufficiency



Source: PMN

Table 4.3: Operational Efficiency Indicators (percent)

	2003	2004	2005	2006	2007
Adjusted Total Expense-to-Average Total Assets	14.8	14.5	18.1	20.4	23.0
Adjusted Operating Expense-to-Average Total Assets	8.6	8.6	9.3	12.0	13.0
Adjusted Operating Expense-to-Average Gross Loan Portfolio	25.6	22.5	22.4	26.7	24.7
Cost per Borrower (Rs. In 000)	2,075	1,939	1938	2486	2262
Borrowers per loan officer	217	259	239	185	307

Source: PMN

Table 4.4: Funding Structure of Micro Finance Institutions (Percent)

	2003	2004	2005	2006	2007
Equity-to-Asset ratio	50.8	46.7	32.1	34.7	28.1
Commercial Liabilities-to-GLP	71.9	18.6	34.8	17.5	21.4
Debt-to-Equity ratio	1.0	1.1	2.1	1.9	2.6
GLP-to-Total Assets	33.5	41.4	42.5	48.2	55.8

Source: PMN

5 Survey Findings

Microfinance is defined as 'the supply of loans, savings, and other basic financial services to the poor'[27]. Microfinance industry continues to grow and microfinance institutions serve more and more clients. The commercial viability of microfinance institutions is imperative for its success. Both microfinance providers and its clients are responsible for sustainability of this sector. Lack of trained and devoted staff and poor governance at the supply side of the microfinance industry coupled with demand side issues including malpractices of the clients like availing loans by using NICs of others, misuse of credit and providing misinformation about their income levels to secure higher loan amount, wilful default, etc. affect the sustainability of the sector. This section of the report highlights the findings of the survey. The survey results indicate that the emphasis of microfinance sector in the country is mainly concentrated on microcredit having following characteristics (see Table 5.1):

According to the survey most of the lending done by microfinance institutions is group based. The loan size varies across regulated and unregulated sector and ranges widely from 3000 to 100,000 within each sector[28]. Loans are generally extended for a year and the repayment structure is based on equal monthly instalments (EMI).

Table 5.1: Loan Activity

(Values in the parentheses are percent shares in total responses)

Average loan size	Below 8000 (4.3)	Rs. 8001 to 10,000 (51.7)	Rs. above 10,000 (44.0)
Duration of loan	Between 6 and 12 month (65.8)	12 to 18 months (21.2)	above 18 months (12.6)
Installment Structure	Fortnightly (0.4)	Monthly (99.6)	
Loan Size Sufficient	Yes (43.0)	No (57.0)	
Ideal amount of loan mentioned by MF clients*	Rs. 25000 (61.4)	Rs. 50000 (34.3)	Rs. 100000 (1.4)
Expenditures on obtaining loan	Less than 100 (29.3)	Rs. 100 to 300 (33.6)	Rs. 300 to 500 (33.6)
Installment Size	Too high (25.0)	Just right (65.4)	Other (9.6)

* Total percent does not equate to 100 due to insufficient information.

Observations made during the survey along with the survey data indicate that elements like loan size, loan duration, and conditions for loans acquisition like group formation and NIC requirement are the main concerns for microfinance clients. According to 61 percent of the respondents ideal loan amount would be Rs. 25,000 because of: (a) high start-up costs, and b) higher cost of doing business due to rising inflation.

Occurrence of default cases is associated with the adverse selection problem. When a loan is extended by a field officer without assessing the repayment capacity of the client there is a greater probability of

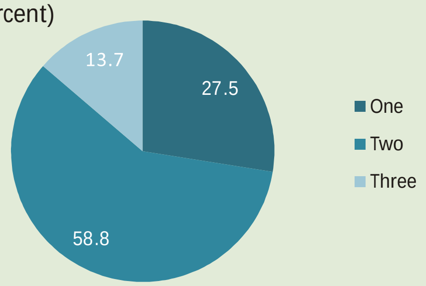
[27] CGAP

[28] The data was obtained from the interviews/survey with the microfinance institutions' staff/clients.

a default. One of the interviewed microfinance banks' officials expressed that one of the reasons for high rate of defaults was that “Most of the loans were given to those people who did not need them”.

Survey data provides strong evidence of increase in loan amount with the second loan cycle. It implies that for every next loan cycle from the same microfinance institution, clients get higher loan amount. Survey findings confirm that most of the clients were in their second loan cycle (see Figure 5.1). This can help in lowering of operational costs and reducing credit risk. A long relationship with client lowers the probability of default and does not require initial ground checks leading to lower costs. This would also provide microfinance institutions an opportunity to target new clients while maintain business with the existing ones.

Figure 5.1: No.of times loan availed by a single client (in percent)



The recommendation of loan amount on the basis of clients' repayment capacity is important in ensuring smooth and sustainable operations of microfinance institutions. The repayment capacity of clients depends upon their source of income, nature and condition of their business. More than 91 percent of the survey respondents indicated that the loan is extended for expansion of already established businesses (see Figure 5.2). This might be because assessment and appraisal of a running business is easier than that of a new business. According to a senior manager of a microfinance institution “We extend loans to only those individuals who have a running business for at least two years”. Another reason behind discouraging loans facility for new ventures can be the high level of risk underlying a newly established business.

Following the global trend microfinance institutions genereally use the group based lending model. According to the survey findings group formation for acquiring a loan is one of the major hurdles in securing a loan. A large number of respondents believed that individual lending can be more beneficial for them, however microfinance institutions are of the view that group lending is critical to overcome the problem of voluntary default since it works as social collateral. According to the field managers of microfinance institution, people generally provide two reasons for not availing loans (i) problems related to group formation and (ii) insufficient loan amount.

According to a field officer “We should not convince (pressurize) anyone to get loan beyond his/her capacity”,

One of the respondents mentioned “Loan amount should be enhanced as drill machine is of Rs. 25000 and small machine is of Rs. 8000-10,000”.

According to another client “loan size should be at least 50000 in first step with a maximum instalment should be between 2000-2500. Daily workers should be given smaller loans like Rs 10000 but businessmen should be given higher loans of at least Rs.50000”.

One respondent mentioned, “A small loan amount is used for fraudulent activities by clients. Small loan amount compels clients to take loans from various institutions and at times people get loans using others NICs. If amount of loan is increased then there won't be any such practices”.

Though groups act as social collateral, the supervision and monitoring of loan by field officer remains important. Field officers and clients were of the view that a bad loan in group based lending model could be more disastrous than individual bad loan. If the supervision by the field officers is not effective, group based lending may lead to a default by the whole group or area. In case of Pakistan though rare incidents at that scale have happened in cities due to urban clients' exploitation of the fact that microfinance institutions are unlikely to go for litigation due to high costs. At times this factor has been used by microfinance providers themselves. In order to increase clientele, field officers have persuaded their competitors' clients to join them convincing them that no action would be taken by the other organization due to high cost of litigation. This factor has been used by micro finance providers themselves. In order to increase client base, field officers' frequent visits to clients not only assist in developing of a good working relationship between the microfinance institution and the client but also

One respondent told, "He availed 20,000 rupee loan for the expansion of his business (surgical equipments) but later used for other purpose (tube well for irrigation). However he was able to pay the loan from other sources".

help in mitigating the risk of default through continuous monitoring of loan.

Misuse of loan amount is another common problem faced by microfinance institutions as it causes high risk of default thus adversely affecting the sustainability of a microfinance institution.

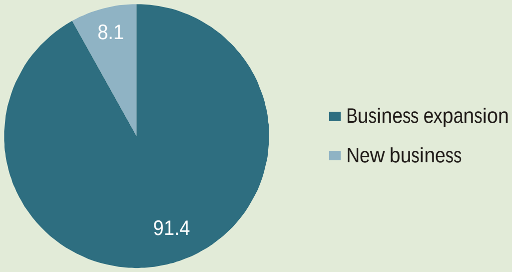
According to the management of a microfinance institution "For the purpose of sustainability, microfinance institutions should keep balance

According to a borrower, "Individual lending is better than group lending because in group lending one person can restrict others".

Another microfinance client expressed, "I have obtained 3 loans from an NGO. The loan is better than committee but people sometimes face problems in forming groups".

According to a non-borrower respondent, "It is difficult for people without a house to obtain a loan".

Figure 5.2: Purpose of loan (in percent)



Note: Sum does not equate to 100 as 0.5 percent of the borrowers utilized it for personal consumption

between its social and financial objectives". This is important because serving the poor will not be possible in the long-term unless the institution is financially sustainable.

5.1 High Rate of Interest and Sustainability

One of the most cited criticism regarding microfinance industry is the high rate of interest charged on loans. During the survey most of the interviewed microfinance institutions' officials justified charging high interest rate by linking it to the high operational cost and it still being lower than the interest rate charged by money lenders. From clients side perspective one of the reasons for poor people willing to pay high interest rate is that the poor are more concerned with the access to credit than the cost of it. Comparing interest rates requires borrowers to have some understanding of financial literacy, which does not exist widely even in some developed countries. Similar situation exists in Pakistan as survey findings revealed that due to low literacy level microfinance clients were unable to fully understand the procedure underlying interest calculations. It is worth highlighting that most of the MFIs do not make satisfactory efforts to communicate the mechanism behind interest rate calculations. As a result borrowers can only compare instalment size on loans of similar amount and duration leaving them with insufficient information to make a decision.

Poor people are generally willing to pay interest rates that a larger business would not. Economic theory of 'diminishing marginal returns to capital' resolves this paradox that suggests, at low levels of capital, production and output increases significantly. At higher levels of capital the increase in output will decline. However, above 70 percent of the respondents expressed that if an alternative loan is offered on a lower interest rate, they would accept it (see Figure 5.3).

Contrary to the views of microfinance clients, most of the interviewed field managers indicated that interest rate differentials neither provided enough reason to cause existing clients shift towards new providers nor persuade new clients to enter the market. This highlights the need for promoting financial literacy and product innovation to cater to the needs of microfinance clients. By facilitating the entrance of new players and encouraging competition microfinance clients can be provided better service at lower price.

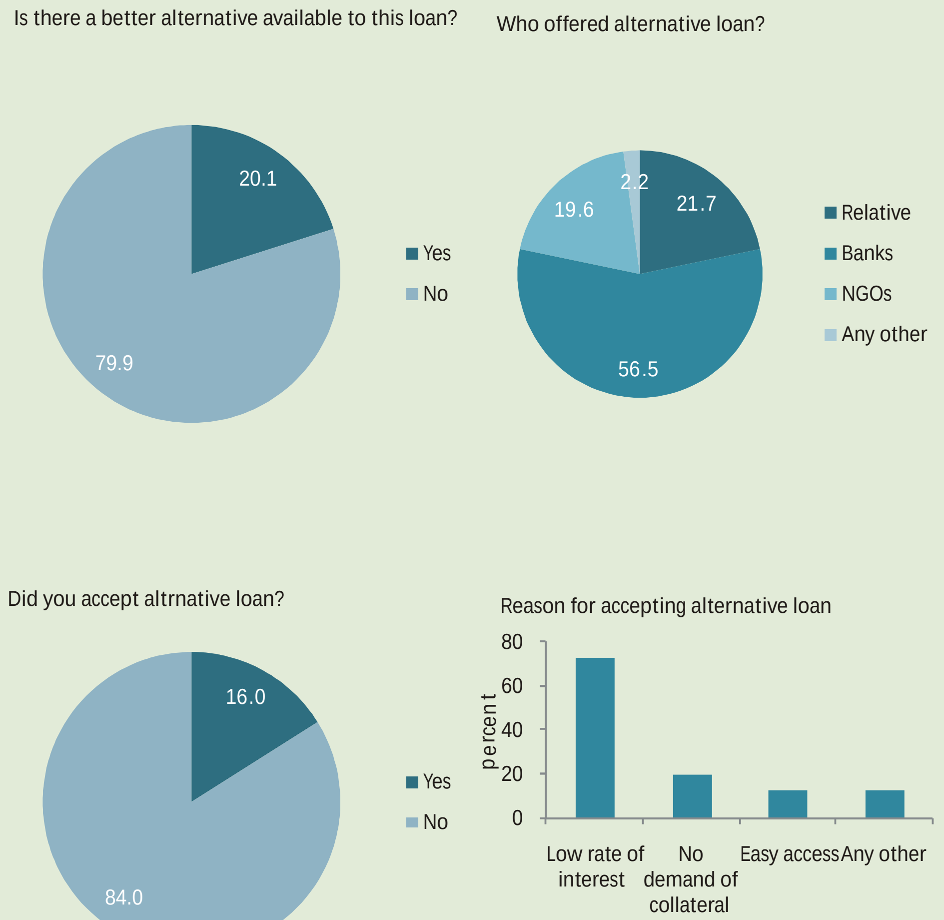
Survey results verified the general perception that the interest rate of microfinance institutions though higher is still lower than the interest rate charged by the informal moneylenders. Microfinance institutions charge lower interest rates as compared to the local money lenders because of the use of joint liability lending and economies of scale. However, the interest rate pattern varies upon their structure and area (urban or rural) of operation.

High loan recovery rate of microfinance institutions is regarded as one of the greatest achievements of microfinance sector. Survey findings supported this claim as results indicate that the recovery rate of all surveyed microfinance institutions was above 90 percent. This is remarkable as there is no strict requirement of formal collateral. The use of joint liability contracts, aggressive monitoring and continuous repayments were cited as the reasons for high repayment rate. However, according to Mordruch (1999) there is an issue of validity as many repayments are self reported and it is important to understand the methodology of calculating these repayments. This observation was also confirmed by our discussion with an MFBs' official during the survey as he was of the view that “the recovery rate of microfinance sector as a whole is not good. Microfinance institutions show excellent recovery because of window dressing. If a loan is overdue for a significant time period, it is reissued and thus cannot be classified as default”.

> “If the objective is to earn profit, the interest rate is low. If the objective is to reduce poverty then the existing interest rate is enough”. (Field manager)

> According to a credit officer, “The ideal interest rate should be between 7 to 10 percent and this can be achieved by making clusters of clients in one area so that cost per borrower will be optimized. The obtaining of middle level loan (between 50,000 and 200,000) is difficult in Pakistan because smaller loans are provided by microfinance institutions and larger loans are provided by conventional banks”.

Figure 5.3: Alternative loan



Note: The percent sum is not equal to100 because there may be more than one reasons for accepting altrnative loan

5.2 Concerns Regarding Microfinance Loan

"Those who have taken loans are also worried about the payment of loan. They cannot pay loan". Non-borrower

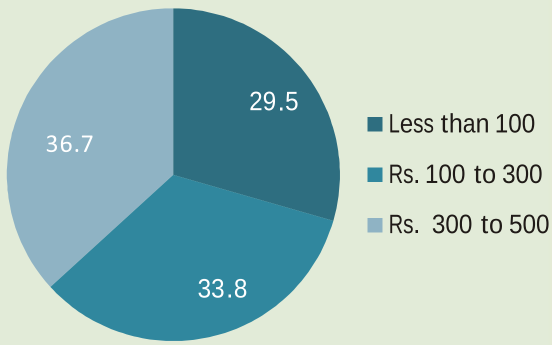
"People say that amount given back is higher than actual amount of loan what's the use of such a loan then". Non-borrower

One of the commonly cited reasons for not availing microfinance loan is high interest rate and small loan amount. It is interesting to observe that a very small percentage of respondents mentioned Islamic factor as a reason for not availing a loan. According to a microfinance bank official the compliance of Islamic principles might be an influencing factor in areas of NWFP, that have unfortunately not been covered in this study due to limited time and resources.

According to credit officers interviewed in the field, clients were not comfortable with high processing fee for acquiring a loan. Survey results show that 34 percent of the respondents paid Rs. 300 Rs. 500 as loan processing fee which appears to be high for a loan amount of Rs. 10,000. On average the processing fee for regulated institutions is even higher i.e. Rs. 500 (see Figure 5.4). However no respondent mentioned processing fee as a reason for not availing a loan. A small number of clients expressed their concerns about the penalty charged in case of late payments and preferred those institutions that accommodated such incidents. A single bad experience of one client in a small area builds up bad reputation of the institution within the locality. A respondent from Hyderabad told, "People from banks come and quarrel with clients who fail in paying their instalments in time". In one of the visited areas clients mentioned instances where microfinance banks' field teams resorted to illegal practices by confiscating private possessions of clients such as television sets. Sometimes clients shied away from regulated institutions due to their aggressive behaviour in case of late payment even if it was involuntary.

According to a female borrower, "Banks take away assets of people and call male members to bank if instalments are delayed".

Figure 5.4: Expenditure on obtaining loan



Moreover clients expressed their concern regarding lengthy and complicated procedures, terms and conditions and about forms being in English[29]. Frequent meetings of field officers with their clients, high amount of instalment and smaller increase in loan amount were few key factors quoted as reasons for not availing loans.

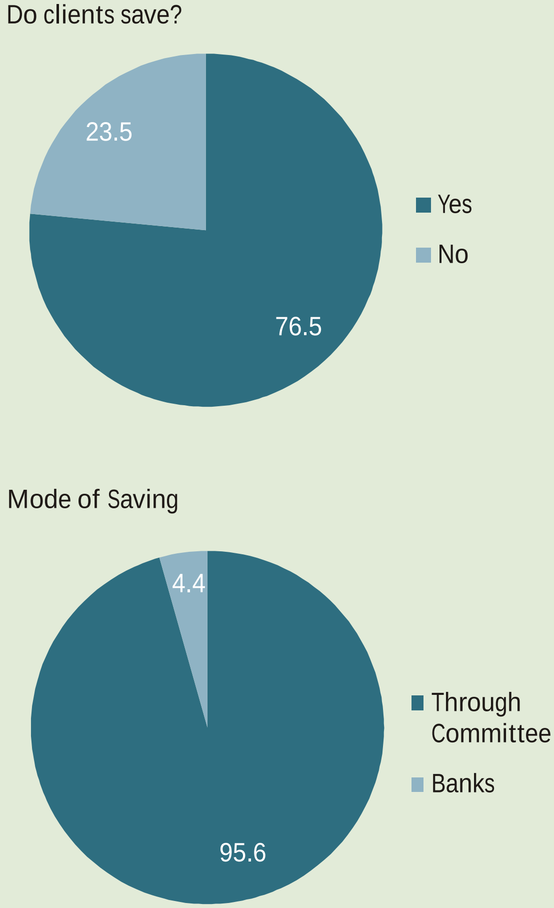
Survey results point towards an interesting insight that sometimes people expect "Qarz-e-Hasna"/ donations instead of loan especially from players of unregulated sector; NGOs. This expectation is based

[29]Now microfinance banks in Pakistan have started using forms in both languages (Urdu and English).

on the fact that NGOs are generally considered to provide donations. This perception needs to be addressed by industry, as in the case of microfinance loans, recovery is important even for NGOs to make the program sustainable.

5.3 Microfinance Need for Diversification

Figure 5.5: Saving pattern (in percent)



In many developing countries including Pakistan, most microfinance institutions offer microcredit while ignoring other services like micro savings, micro insurance and skill development, etc. Savings are considered life line for financial institutions. Microfinance sector is no exception to this. More deposits imply that there are more funds to lend and help the institution become sustainable. Most of the survey respondents mentioned that they were not using formal deposit services. Around 90 percent of the respondents did not have a bank account. The demand for deposit services can be observed by the level of informal savings among microfinance clients. They save for various purposes like insurance against bad health, disability and other emergencies, investments, social and religious obligations, etc. Survey results indicate that above 95 percent respondents were saving through unregulated channel of committee-a local term for ROSCAs (see Figure 5.5). Informal and formal unregulated sector in the country cannot offer deposit service due to regulatory requirement thus leaving a huge potential market for regulated sector (banks) to intervene.

However, the survey data showed that banks' saving products are not popular among the low income people and the quoted reasons include, disrespectful attitude of bank staff, minimum balance requirements, hidden costs charged to depositors, taxation on accounts, deduction of 'Zakat' and complicated procedure to open an account.

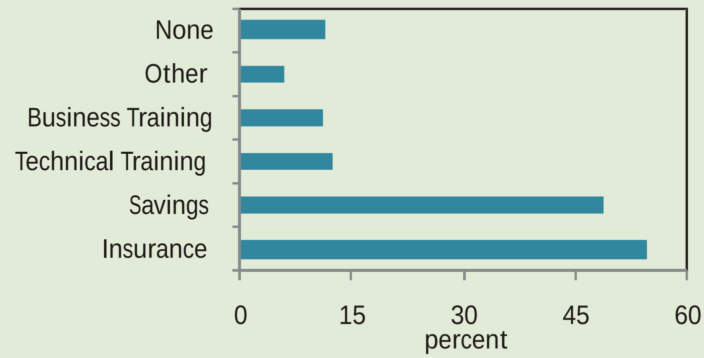
It is worth mentioning that the supply side players do not appear to be interested in deposits taking. This is mainly because of the high overhead cost incurred by the banks on such deposits due to their smaller size. In contrast to past experience microfinance banks have recently picked up pace in accepting deposits and currently four out of six microfinance banks are offering saving products. However, it is imperative to mention that still the major portion of deposit base of these microfinance banks is institutional funds.

Microfinance bank is expected to offer both financial and non-financial services. Non-financial services include social intermediation like training in basic entrepreneurial skills, literacy or basic financial skills, group capacity building efforts, etc. Survey respondents mentioned that they were being offered other services like insurance, saving and technical training, etc. by microfinance institutions (see Figure 5.6) but all these services are very limited and the regulated sector is relatively dominant in this respect. For example, banks while extending credit give a cheque to its clients instead of cash. In this way the microfinance borrower has to go through the whole process of opening a bank account that is considered as financial training.

5.4 "Microfinance Loan: An Eligibility Criterion"

It is obligatory for banks to mention social objective in their mission statements while unregulated microfinance sector is mainly concerned with social performance. It implies that all microfinance institutions in the country have social uplift of the poor as a fundamental component of their mission statements.

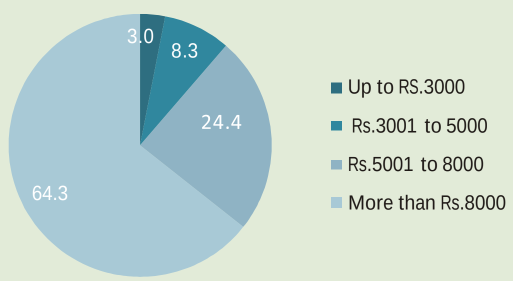
Figure 5.6: Other Facilities offered by MFIs (in percent)



Note: The percent sum is not equal to 100 because more than one facility may be provided by MFIs to clients

Like many other developing countries microfinance operations in Pakistan has been seen as a tool for poverty alleviation. Microfinance is generally expected to enhance access to economic opportunities and other social services. Despite limited outreach of microfinance services its impact on the poor by creating income generating activities cannot be challenged. As far as the contribution of micro finance interventions is concerned, the scope of its impact might be debatable but its positive impact is an accepted fact.

Figure 5.7: Monthly income of whole family (in percent)



"MF literature clearly mentions that MF targets the richest of the poor and poorest of the rich[30]".

Survey data regarding respondents' living standard clearly identified that microfinance clients do not belong to the poorest segment of the society. More than 65 percent of the respondents have monthly income of more than Rs. 8000 which is also supported by their living standards. Not only did a majority of respondents, (more than 87 percent) possessed their own houses but they also have facilities of electricity (98.4 percent), gas (89.8 percent), television (96 percent), washing machine (86.6 percent) and mobile phone (65 percent) (see Annex A, Table A1).

Box 5.1: Who is poor in Micro finance?

An interesting observation regarding the definition of poverty is its uniformity across various MFIs. Micro finance ordinance has provided the definition of poverty for MFBs i.e. a person would be considered poor if his income is below taxable income or monthly household income is below Rs. 12,500. Keeping this maximum range, banks have identified their own eligibility criteria. However it should be noted that official poverty line is Rs. 878/adult/month (household income is Rs. 5268) implying huge variation between these two definitions. Few NGOs claim that they are covering the population near extreme poverty (50 percent of Poverty line) while others use the official Poverty line as the eligibility criterion.

Microfinance institutions do not provide loans to the very poor. The survey data indicates that the income of more than 80 percent of non-borrowers was below 8000 and 50 percent below 5000 (see Figure

5.7). The difference between living conditions of borrowers and non-borrowers[31] of survey respondents also explains the income difference of both the groups (see Annex A, Table A2). There exists significant demand of microcredit among non-borrowers as 53 percent of the surveyed non-borrowers obtained loans from money lenders or their relatives and most of them were not contacted by any microfinance institution. Non-borrowers also expressed their concern regarding high interest rate of MFIs and high instalment amount.

> An old lady revealed, “One of my relatives (male) paid Rs. 1000 to two group members to use their ID cards. He obtained loan from an MFI. After paying couple of instalments, he escaped. Now I am paying instalments of these two group members as well. No one gives me receipt. Sometimes MFI's official come to my house and misbehave and one time they took away my goat with them”.

The eligibility criterion for securing a loan varies and is related to particular institution's definition of a potential microfinance client. Regulations for the formal sector require microfinance banks to follow standardized eligibility criteria for obtaining a loan however this restriction does not apply to the unregulated sector (See Box: 5.1). Variation in poverty levels of microfinance clients calls for product innovation and customized services aligned with target group's expectations.

5.5 Role of Regulations and Transparency in the Microfinance Sector

The quality of the loan portfolio is considered to be one of the main factors in achieving financial sustainability of the banking sector. Increased transparency on part of service provider and the borrower is essential for ensuring successful banking operations. Compliance of prudent regulations by banks helps in achieving the desired level of transparency in the sector. An instance where microfinance provider cannot ensure productive use of a loan creates problems of adverse selection. High levels of adverse selection and moral hazard problems affect the viability of microfinance sector by increasing number of bad loans making the industry unsustainable. All surveyed microfinance institutions mentioned need of an effective central data base to share client information to minimize the problem of adverse selection.

Strict adherence to regulations and increased transparency levels help in keeping the issue of moral hazard in check. Realizing the significance of transparency, especially microfinance banks have started focusing on the development of systematic procedures.

According to one of the senior manager of a microfinance banks, “Our field officers collect information about a prospective client and submit it to the verification section. The verification team sends the case to the Risk Management Department (RMD). RMD works independently and provides its feedback on; (a) social risk assessment and (b) financial risk assessment. This minimizes if not eliminate the problems of adverse selection”.

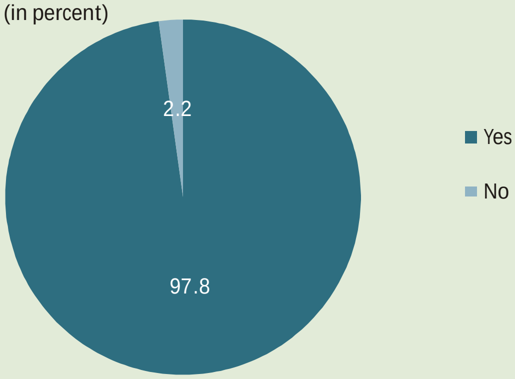
“A leading microfinance bank in Pakistan suffered heavy losses due to lack of transparency in the past. Now the bank has a central hub and all its branches throughout the country are connected. Every case is verified at each step and monitored carefully in the head office through real time connectivity of all branches”.

Transparency levels within the microfinance sector

[30]Terms adopted from “Microfinance and Public Policy, Outreach, Performance and Efficiency”, ILO (2007), Palgrave Macmillan.
[31]control variable

can be enhanced by forming solidarity groups and promoting strong social binding in the group. On regulation side there should be a platform such as banking courts to deal with the problem cases. It is almost impossible to go for litigation against a bad loan in microfinance sector due to high cost linked to a small loan size. This is important as currently there are no effective legal means available to microfinance institutions to deal with voluntary defaults. However while there is need to increase transparency on the client side, microfinance institutions need to be forthcoming by simplifying their procedures and increasing communication with the client so that they are aware of all the details before entering into a transaction.

Figure 5.8: Has loan helped to increase household income? (in percent)



5.6 Impact of Microfinance Interventions (Success Stories)

While analyzing the impact of microfinance it should be considered that the social impact cannot be quantified especially if the initiatives being reviewed have a short history of five years[32]. Similar to earlier studies impact of microfinance initiatives could not be quantified however majority of the respondents seem to have experienced a qualitative improvement in their living standards. Clients of formal (both regulated and unregulated) microfinance sector had experienced a positive change in their socioeconomic condition (see Figure 5.8) as expressed in their interviews of which some are quoted in this section (see Box 5.2). Majority of interviewed credit officers were of the opinion that microfinance interventions certainly had positive outcomes but the magnitude of these improvements was undermined by factors like inflation and natural calamities.

Another important positive impact of microfinance is female empowerment (see Annex B). Women especially in conservative cultures have unequal access to education and training opportunities. Increased access to finance has demonstrated an improvement in the socioeconomic condition of women around the globe. By obtaining microfinance loans, women attain financial independence a step that is likely to lead to their empowerment.

Like other social impacts of microfinance, women empowerment cannot be quantified; however an increase in number of female clients (as discussed in the section on financial review) can be an indicator of rising awareness among female clients. It is worth mentioning that according to the field officers especially of unregulated sector women are better

According to microfinance bank field manager “Earlier women especially in rural areas did not have CNICs. Previously they were not allowed to come out of their house and CNIC was not considered important for them. Now they have their CNICs and running their own businesses.

[32] 1. Montgomery, H. (2005), Meeting the Double Bottom Line The Impact of Khushhali Bank's Micro finance Program in Pakistan.
2. Zaidi, S. Akbar, Sarah Javeed and Sarah Zaka; (April 2007), Social Impact Assessment of Microfinance Programmes, Study commissioned by and submitted to the EU-Pakistan Financial Sector Reform Programme, Islamabad.
3. Poverty and Social Assessment: Pakistan Microfinance Policy, Oxford policy management, May 2006.

> According to a field officer, “Women borrowers become stronger in house affairs because even if male is using the loan she will be the focal contact making her important which is expected to raise her status at home”.

clients as compared to their male counter parts. This observation is consistent with the anecdotal argument of women being better clients with reference to recovery of loans.

According to the survey in cases where loans were provided to women, they were generally utilized by male members of the family. However this practice is not being discouraged because majority of the interviewed field officers are of the view that this practice does not neutralise the objectives of microfinance i.e. socioeconomic uplift of the poor.

Box 5.2: Social Impact: Success Stories

A lady stated, “I started a very small business of pottery after the death of my husband. Faced with constraint of limited resources, my children stopped going to schools rather I got them involved in work. I was advised by one of my relatives to avail microfinance loan . I have been able to manage the business so well that I can now afford sending my children back to school”.

B. Another female client from Hyderabad shared, “My husband was an employee in a floor mill but had to leave the job because he suffered a cardiac arrest. To meet daily expenses, I availed microfinance loan and my husband started a cabin. The work was going fine and couple of instalments were left when an angry mob destroyed cabin while protesting against the assassination of Mohtarma Benzair Bhutto (former prime minister). My cabin was looted. Thanks to the microfinance institution they again helped us by issuing another loan to establish the business once again”.

C. A male client shared his experience “I am in the third cycle of loan. I had a small shop when I obtained the first microfinance loan. Now have hired seven helpers and my business has expanded significantly”.

Since majority of the unregulated sector (surgical instrument manufacturing, glass bangle, and deep sea fishing) covered in the survey were related to child labour, respondents were specifically questioned about the impact of microfinance to stop child labour.

> A respondent mentioned "I obtained loan on behalf of my 11 year old son, who worked in surgical factory. Now he goes to school and does not work.

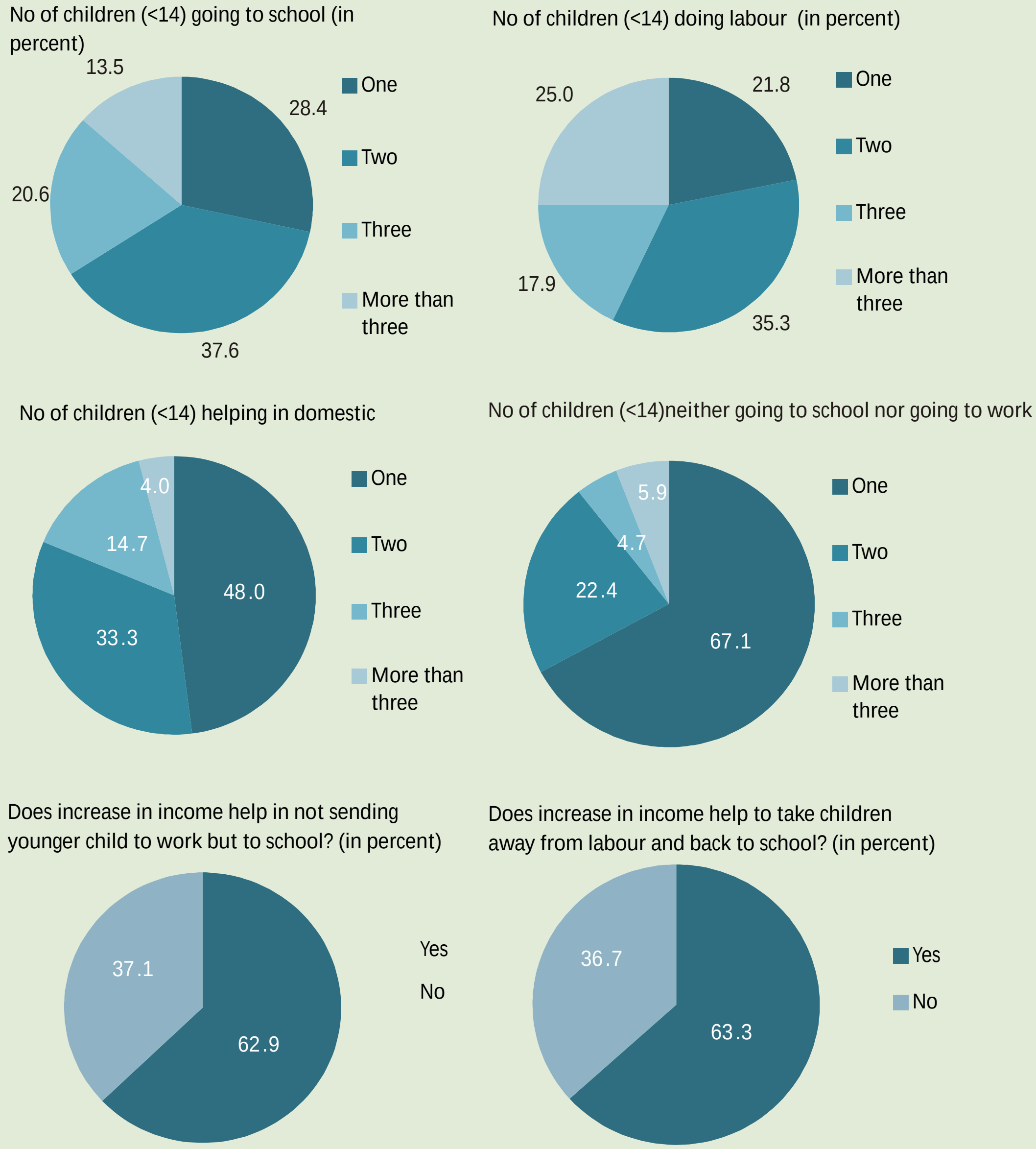
Survey results revealed that the availability of loan had a partial impact to reduce the incidence of child labour. Though respondents expressed rise in their income levels as a result of availing the loan but it alone did not serve as a universal remedy to fully convince parents to take their children out of work. Despite a limited impact the data also indicates that in certain cases microfinance interventions did lead to improvement in the clients' socioeconomic condition by enabling them to take their children out of work and put them into school (see Figure 5.9).

> Another participant told, "One of my children goes to work at 8 o'clock in the morning and comes back late in the night. He works in the hotel. He gets Rs.80-100 daily".

A majority of parents indicated that an increase in family income helped them send their children to school (62.9%) instead of work; and also helped them withdraw children from work and send them to school (62.3%). Most of the respondents reported a positive relation between income generated through micro-credit interventions and child's school education. However this is not always the case unless financial measures are supported by additional services like free non-formal/formal education for children, provision of free health services and extensive social mobilization of the families against child labour. Thus it is difficult to infer that micro finance interventions alone can enable families to reject child labour and send their children to school.

> A client related to glass bangle industry mentioned about the health facilities and said, "No one provides medical service to the children working in bangle industry who get ill. Moreover they do not get wages for those days if they don't go for work".

Figure 5.9: Incidence of Child Labour Among Borrower Families



Note:Sum may not add up exactly to 100 due to rounding off

6 Conclusion

Responding to the positive initiatives of government and the central bank, microfinance industry has grown at a significant pace; however it is able to cater to only 4 percent of the potential market. Both at the government and private level there is a need to increase participation to reach out to the 25-30 million potential clients of microfinance. The survey findings highlight lack of product diversification as one of the major impediments in increasing outreach and attaining sustainability. Micro credit is the major service being provided in the country under the umbrella of microfinance[33]. This calls for research and innovation on the product development side.

Field survey has revealed that the main concern of microfinance clients is access to credit rather than interest rate. A common condition of all microfinance institutions for loan acquisition is client having the National Identity Cards (NIC), which restricts enrolling more clients since a significant number of people, particularly women, do not possess these. This issue can be resolved by the use of latest Information communication technologies as has been done in other developing countries or by facilitating the potential clients acquiring the NIC. It can also be concluded through survey results that a major apprehension of microfinance clients is the lower loan amount and the condition of group formation. However microfinance institutions have now started offering individual loans as a response to clients demand.

It is critically important for all microfinance institutions in the country to improve on the efficiency frontiers and utilize better management information systems. Competition in the market can be an effective impetus for attaining efficiency and sustainability. For a meaningful linkage between the major players of the market and to mitigate the increasing credit risk in microfinance, SBP in collaboration with international experts has started working on Credit Information Bureau (CIB).

Consumer protection requires microfinance products to completely disclose the interest rate mechanism, and all terms and conditions of the contract. SBP has been working on consumer protection since 2006 and has made it mandatory for MFBs to follow the "Trust in Lending" principle. For settlement of problem cases of microfinance sector, there is a need of platform like banking court. This will improve recovery rate and will also minimise the complaints of clients against the unethical means practiced by the field officers of microfinance institutions.

Success in microfinance means providing sustainable financial services that help raise the standard of living of poor. Though at times putting social agendas such as skill development, providing education and eradicating child labour puts strain on the resources, it should not deter microfinance institutions from their dual objective of attaining financial sustainability while contributing towards the social uplift of the poor. The limited data collected through this survey reconfirms the argument that though impact of microfinance is hard to be quantified, it does have a positive impact on the clients as in this case by reducing child labour.

Policies need to be designed carefully as in this case a loosely designed policy/product can push the already vulnerable people into further poverty. However success of microfinance institutions around the globe has established that microfinance can make an important contribution in improving the socioeconomic conditions of the poor. All stakeholders of microfinance industry in the country need to realize that microfinance is but one element of a comprehensive strategy to combat poverty. Interventions based on this can indeed lead to poverty alleviation.

[33]Pakistan Microfinance Network (PMN)

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Annexure A

A1: Respondents' Living Standards

As percent share of positive responses in total responses

	Borrowers	Non-Borrowers
Own House	85.4	76.8
Water Connection	97.9	96.4
Telephone	17.3	7.1
Gas	65.2	76.8
Mobile Phone	69.1	48.2
Electricity	97.4	94.6
Jewellery	26.6	23.2
Refrigerator	41.8	33.9
Fan	100.0	96.4
Washing Machine	78.9	76.8
Computer	7.3	10.7
Iron	96.1	87.5
Bath Room	100.0	98.2
Bicycle	24.8	14.3
Motor Cycle	15.1	14.3
Donkey Cart	7.8	8.9
Television	93.1	91.1
TV Cable	77.6	83.9
Domestic Animal	7.9	3.6

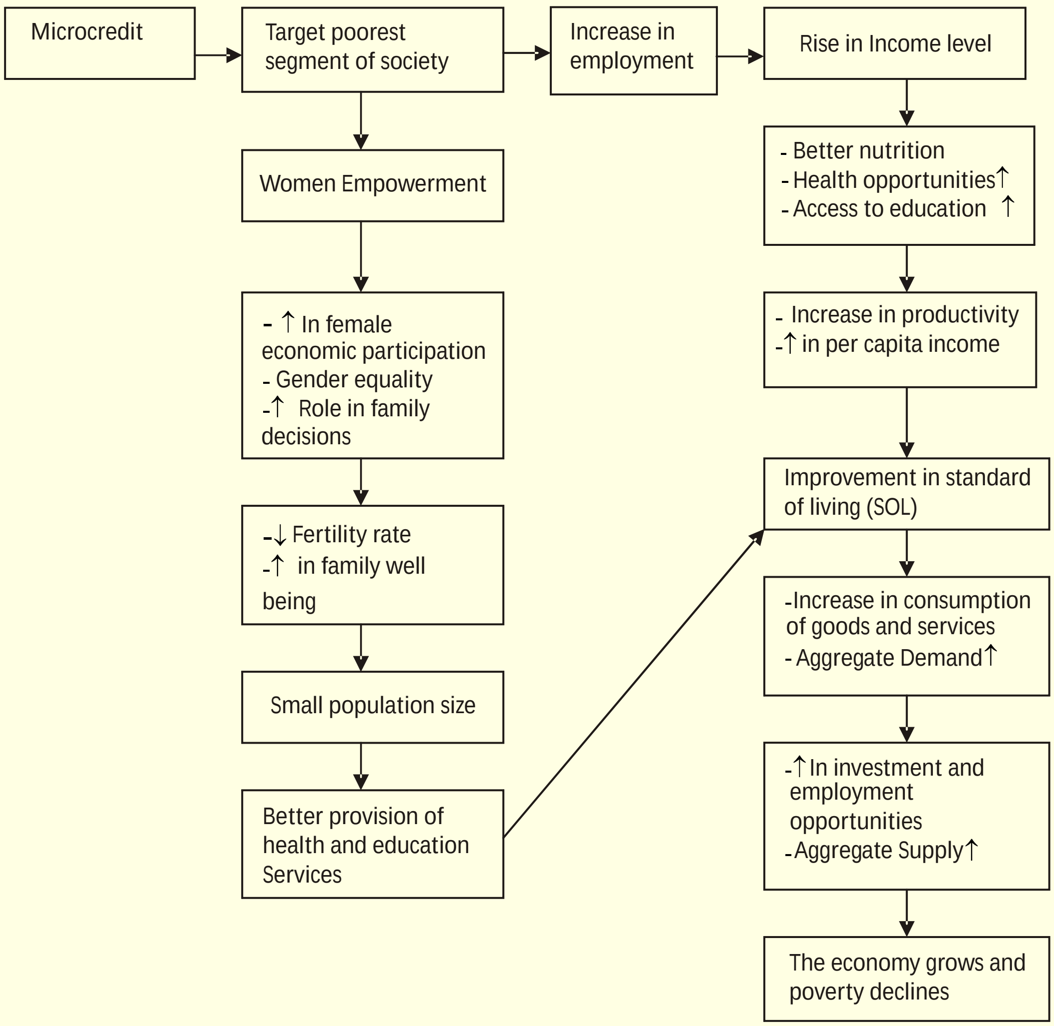
A2: Respondents Characteristics

As percent share in total responses

			Borrowers			
Gender	Male	Female				
	27.0	73.0				
Education levels	Below Metric	Metric	Intermediate	Above Inter	Technical	Other
	29.8	19.2	5.8	4.3	2.4	38.5
Marital status	Married	Unmarried	Widow			
	86.7	4.7	8.2			
No. of children	Less than 4	4 to 9	More than 9			
	33.2	60.3	6.6			
No. of earners	Less than 3	3 to 5	More than 5			
	42.4	46.9	10.3			
Monthly income (whole family)	Up to 3000	3001 to 5000	5001 to 8000	More than 8000		
	3.0	8.3	24.3	64.3		
			Non-Borrowers			
Gender	Male	Female				
	0.0	100.0				
Education levels	Below Metric	Metric	Intermediate	Above Inter	Technical	Other
	36.4	18.2	2.3	2.3	2.3	38.6
Marital status	Married	Unmarried	Widow			
	76.4	3.6	20.0			
No. of children	Less than 4	4 to 9	More than 9			
	19.2	71.2	9.6			
No. of earners	Less than 3	3 to 5	More than 5			
	75.5	18.9	5.7			
Monthly income (whole family)	Up to 3000	3001 to 5000	5001 to 8000	More than 8000		
	3.0	8.3	24.3	64.3		

Annexure B

Flow Chart: Transmission Mechanism of Microcredit to Poverty Alleviation



Source: 1st Quarterly Report (2004-05), State Bank of Pakistan