Improving Microfinance Governance:
A Role for the Asia Foundation

Prepared for:
The Asia Foundation

By:

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List of Acronyms

ADR: Alternative Dispute Resolution
CFI: Commercial Financial Institution
CGAP: The Consultative Group to Assist the Poor
CPD: Balochistan Policing Project
ERD: Economic Reform and Development
GNI: Gross National Income
GoP: Government of Pakistan
IMF: International Monetary Fund
MFA: Microfinance Association
MFB: Microfinance Bank
MFI: Microfinance Institution
MIX: Microfinance Information Exchange
NBFC: Non-Bank Finance Company
NGO: Non-Governmental Organization
NPL: Non-Performing Loans
PMN: Pakistan Microfinance Network
PPAF: Pakistan Poverty Alleviation Fund
RSP: Rural Support Programme
SECP: Securities and Exchange Commission Pakistan
SEEP: Small Enterprise Education and Promotion Network
SME: Small- and Medium-Scale Enterprise
SMFI: Specialized Microfinance Institution
SMN: Sindh Microfinance Network
SPB: State Bank of Pakistan
TA: Technical Assistance
TAF: The Asia Foundation
USAID: United States Agency for International Development
WEEP: Women's Economic Equality Project

Currency Exchange Rate

1 US $= Pakistan Rupees (Rs.) 79.5
Executive Summary

The Asia Foundation (TAF) is a non-profit organization committed to the development of a peaceful, prosperous, just, and open Asia-Pacific region. Its mission is to promote and implement programs in the Asian continent regarding law, civil society improvement, and economic assistance and development. This report was requested by the Director of one of TAF’s core programs, Economic Reform and Development, which seek to accelerate economic growth and improve economic policy frameworks throughout Asia.

The recent exponential growth of the microfinance sector has come to the attention of many organizations seeking to alleviate poverty in the developing world. Asia lies at the centre of the microfinance industry, and oversees 83% of global microfinance accounts. For these reasons, TAF recently began to explore the possibility of a program in microfinance, focusing on regulatory and governance issues. In this report, we seek to identify an appropriate role for TAF in improving microfinance regulation and governance in Asia, and select an ideal Asian country in which to launch such a program.

Our analysis covers four broad themes: 1) exploration of TAF’s core competencies relevant to microfinance, 2) country-specific research to choose a country in which to launch TAF’s microfinance program, 3) examination of challenges faced by the microfinance sector in the country ultimately selected (Pakistan), and 4) analysis of potential TAF roles or programs to improve microfinance governance that align with the foundation’s core competencies and address the challenges of Pakistan’s microfinance sector.

Selection of Pakistan for an Asia Foundation Program in Microfinance Governance

We initially considered four countries as potential candidates for an Asia Foundation program in microfinance governance: Afghanistan, Nepal, Pakistan, and Timor Leste. The optimality of each country is assessed along five key criteria, developed through research and interviews.

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with the client and microfinance experts. These criteria are designed to capture internal and external feasibility constraints that are essential in assessing the suitability of each country for the proposed program. The selection criteria are as follows:

1. High degree of regulatory development
2. Openness to microfinance reform
3. Strong US foreign policy interest
4. Data availability
5. Alignment with TAF capabilities

We chose Pakistan as the most optimal country, because it ranks high on all five criteria. Each of the three other countries ranked high on only one of the five criteria.

**General Role for the Asia Foundation in Improving Pakistan’s Microfinance Sector**

Pakistan’s microfinance system can be divided into three distinct but interrelated levels: micro, meso and macro. The *micro* level involves both microfinance clients and “financial service providers” (i.e., microfinance institutes or MFIs). The *meso* level encompasses organizations delivering “support services and infrastructure,” such as microfinance associations, credit bureaus and ratings agencies. The *macro* level is comprised of central banks, ministries of finance and other national government entities that determine the regulatory landscape within which the other levels operate.³

Although TAF’s core competencies in Pakistan could be adapted to address microfinance governance challenges at any level of the microfinance system, we find that TAF is best positioned to work with and alongside existing organizations at the *meso* level to improve the ability of these actors to help resolve the most fundamental challenges facing the microfinance industry, which are those found at the micro and macro levels. TAF has a proven track record working with organized groups to affect systemic change. Although TAF has significant experience with issues relating to governance, it lacks a comparative advantage in building up a rudimentary financial regulation framework at the macro level. In addition, TAF would

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³ Brigit Helms, 2006 (p. 15).
likely be less effective working at the micro-level than the meso-level.

**Specific Program Options for Improving Pakistan’s Microfinance Sector**

To determine what issues a TAF program should address, we identified key challenges facing the microfinance sector in Pakistan at the micro and macro levels. For this research, we first conducted an in-depth literature review, and then supplemented it by interviewing key microfinance stakeholders in Pakistan.

After determining the most critical challenges in Pakistan’s microfinance sector, we created five distinct program options for TAF that could, together, address all these challenges. These programs include:

1) *A program to refine microfinance regulations* in order to meet the changing needs of the industry and enable the sustainable growth of microfinance providers.

2) *A program to promote equity-based microfinance services* to address Pakistan’s significant unmet demand for equity based microfinance services (i.e., services compliant with Islamic Sharia laws that discourage taking fixed interest loans).

3) *A consumer financial and business literacy program* to address the limited financial and business literacy common to many current and prospective consumers of microfinance services. Improved financial and business literacy would enable consumers to more effectively utilize microfinance services.

4) *A program facilitating transformation of non-licensed microfinance providers into licensed microfinance banks* to improve sustainability and transparency. Non-Licensed MFIs often view microfinance as a social rather than financial service, and thus engage in less sustainable activities (e.g., reliance upon donor funds).

5) *An MFI management capacity-building program* to improve the financial expertise and business management skills often lacking at the MFI management and board levels. Because many managers come from the NGO sector, their strengths often lie in running social programs, rather than in business or finance.

**Recommendations for an Asia Foundation Microfinance Program**
We assess the attractiveness of our five program options along two key dimensions: Impact and Feasibility. In assessing Impact, we focus primarily on the size of the population the program will affect and the urgency of the need. In assessing Feasibility, we focus both on internal TAF competencies and on potential external barriers to success (e.g., local resistance to the program). An assessment of the five program alternatives yields two that appear most attractive for a TAF microfinance governance program in Pakistan: a program promoting equity based microfinance services and a program to refine various microfinance regulations.

1) Promotion of equity-based microfinance services which comply with Sharia law was selected for a number of reasons. Through this program, TAF has the potential to expand the reach of microfinance services to a potentially large un-served market. This program is well-aligned with TAF’s competencies in research, issue analysis and coalition-building. TAF can potentially leverage in-house expertise of its country officers in Pakistan and Indonesia to launch this program. Currently, the supply of these types of services is minimal, which creates room for TAF to create substantial impacts.

2) Refinement of microfinance regulations was selected for several reasons. This program is strongly aligned with TAF’s traditional focus on governance, tailored to a specific country. It also addresses systemic issues which affect the entire microfinance sector as well as all the stakeholders in the system, rather than acute problems which might only pertain to certain individuals or institutions. Furthermore, TAF possesses strong ties to a well-organized network of microfinance institutions, Pakistan Microfinance Network, which would make a great partnership for rolling out this program. TAF ties to other players within State Bank Pakistan (SBP) and other leading microfinance institutions would also prove beneficial. Finally, this program can also address some of the disincentives which exist for the transformation of unlicensed MFIs to regulated microfinance banks (e.g., subsidized loans and tax exemption status).
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Introduction

The Asia Foundation (TAF) is a non-profit organization committed to the development of a peaceful, prosperous, just, and open Asia-Pacific region. Its mission is to promote and implement programs in the Asian continent regarding law, civil society improvement and economic assistance and development. This report is commissioned by one of TAF’s core programs, Economic Reform and Development (ERD), which seeks to accelerate economic growth and improve economic policy frameworks throughout Asia.

Within the economic development landscape, the recent exponential growth of the microfinance sector has come to the attention of many organizations seeking to alleviate poverty in the developing world. Asia lies at the centre of the microfinance industry, and oversees 83% of global microfinance accounts. The recent growth of microfinance presents policymakers, regulators, microfinance practitioners in Asia and around the world with many regulatory and governance challenges, as they try to keep pace with a rapidly evolving industry. For these reasons, TAF recently began to explore the possibility of an Asia Foundation role in microfinance, focusing on regulatory and governance issues. This report thus seeks to identify answers to the following question:

\[ \text{What role should The Asia Foundation play in improving microfinance regulation and governance, and where should such a program be launched?} \]

To answer this question, the team pursued several overlapping areas of research covering four broad themes: 1) exploration of Asia Foundation core competencies relevant to microfinance, 2) country-specific research to inform launch-country selection, 3) examination of the microfinance landscape in the selected country (Pakistan), and 4) exploration of potential programs to improve microfinance governance which align with TAF core competencies and address the current challenges of this country.

This research yielded four main findings. First, country-specific research and assessment of

\[ ^4 \text{The Asia Foundation Website. About The Asia Foundation. } \text{http://asiafoundation.org/about/} \text{ (accessed 19 October 2008).} \]

\[ ^5 \text{The Asia Foundation Website. Asia Foundation Program Areas. } \text{http://asiafoundation.org/program/} \text{ (accessed 19 October 2008).} \]
TAF core competencies revealed Pakistan as the most suitable country for TAF to launch a microfinance governance program. Second, we conclude that an Asia Foundation microfinance program that operates in partnership with organized groups (e.g., microfinance associations) would be most appropriate for The Asia Foundation given the organization’s competencies and history of working toward systemic rather than acute changes. Third, research and interviews exploring Pakistan’s microfinance system revealed a number of important challenges facing the industry, which The Asia Foundation might be in a position to help address. Finally, to address these inter-related challenges, five potential TAF programs were considered: 1) promotion of equity-based microfinance products 2) improvement of consumer financial and business literacy 3) improvement of MFI management capacity 4) facilitation of the transition of non-licensed providers into licensed MFIs, and 5) refinement of microfinance regulations. Assessment of the impact and feasibility of each program revealed two as potentially most attractive: refinement of current microfinance regulation and promotion of equity based microfinance products.

Each component of the above process is discussed further in the following sections. Section 1 provides further details on the policy issue, outlining the evolution of the microfinance industry and the challenges it currently faces. Section 2 details the rationale underlying the selection of Pakistan as the most suitable launch country, and examines Asia Foundation competencies both globally and in Pakistan, outlining the types of roles TAF might be best suited to play. Section 3 examines Pakistan’s microfinance landscape at each of three key levels, and identifies key challenges facing different market participants. Section 4 outlines five programs developed to address the challenges identified in Section 3. Finally, Section 5 concludes with a brief summary, as well as some next steps recommended for driving this project forward.

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6 Microfinance Associations are one of many organizations operating at the “meso” level of the microfinance sector. MFIs serve as their membership base, with MFAs providing training, policy advocacy and other services to their members.
1. Policy Issue

1.1 The Evolution of Microfinance

In the last two decades microfinance has evolved rapidly into a global movement dedicated to providing access to a range of financial services to poor and near-poor households. The organizations that provide these services, known as microfinance institutions (MFIs) may operate as formal micro banks, non-bank financial institutions, non-governmental organizations, or community-based financial institutions. These providers offer a range of financial services from small business loans to savings accounts, money transfers, insurance, and consumer loans. The Consultative Group to Assist the Poor (CGAP) estimates that there are currently 500 million active clients in the microfinance industry, with an average micro-loan size worldwide of $1,026, and an average savings account balance of $1,126. Asia lies at the center of the microfinance industry, and currently holds 83% of global microfinance accounts.

These MFIs generally pursue both economic and social goals including poverty alleviation, women’s empowerment, and financing of small and medium-scale enterprises. Given the rapid growth of the microfinance industry, however, the sustainability of MFIs is becoming increasingly important as a minimum condition for achieving these social missions. Thus, for the purpose of this analysis we consider sustainability to be a primary goal for MFIs, as sustainable institutions are better able to pursue their broader social mission. We also continue to take into account the importance of achieving other social goals (see Appendix 1.1 and 1.2 for additional details on the goals of microfinance).

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7 CGAP is a World Bank associated organization which provides advisory services, training, research and development, and information dissemination. Its on-line data base houses research and publications, articles, as well as microfinance-related fact updates.
8 Helms, 2006 (p. 6).
10 However, there are MFIs that pursue purely social goals since microfinance cannot always be made profitable. In high cost settings, where potential clients are extremely poor and risk-averse or live in remote areas with very low population density, continuing operations may mean relying on subsidies. Whether microfinance is the best use of these subsidies, or whether targeted grants and subsidies are a better way to support poverty alleviation, will depend on evidence about its impact on the clients. For the purposes of this report, we consider MFIs to be “sustainable” if they can collect loans and cover costs well enough that their operations can continue serving existing clients as well as expand, without the need for from grants or soft loans from donors or governments.
1.2 Challenges Facing Microfinance

The microfinance system can be separated into three distinct but integrated levels of activity: micro, meso and macro. To understand prevailing conditions and challenges in the microfinance sector in Pakistan, research was conducted at each of these three levels. The results of this research are used to help explore key challenges facing the sector, which are identified at each level of the system.

Source: Adapted from Helms, Access for All

The micro level involves both microfinance clients and microfinance service providers. From the borrowers’ perspective, challenges often relate to their limited financial sophistication, which can increase their vulnerability to predatory lending practices. From the lenders’ perspective, a lack of sustainable funds and limited managerial experience present operational challenges. The meso level includes “support services and infrastructure” (e.g., microfinance associations, credit bureaus, auditors, etc.). Limited capacity, including an inadequate supply of technical service and education providers, can be an important challenge on the meso level. The macro level is comprised of central banks, ministries of finance and other national government entities. At this level, systemic failure or a contagious collapse of MFIs, exposed to the same underlying risks is a key concern for policy makers.

11 Predatory lending is “the practice of a lender deceptively convincing borrowers to agree to unfair and abusive loan terms, or systematically violating those terms in ways that make it difficult for the borrower to defend against.” Source: The Investor Dictionary: http://www.investordictionary.com/definition/predatory+lending.aspx (accessed 10 January, 2009).
12 Brigit Helms, 2006 (p. 15). For simplicity, clients are included at the micro-level.
On an aggregate level, extreme challenges involving each of these levels can threaten the failure of individual MFIs and the entire industry. These failures can place the financial viability of microfinance clients and the entire financial system at risk (see Appendix 1.3 for examples of these failures). Improved governance and regulation is one tool for addressing many of these challenges on various levels. Good governance and regulation practices provide an oversight mechanism against excessive risk taking by lenders, thus helping to ensure institutional solvency, protection of depositor funds, and systemic stability. They help ensure financial sustainability of individual institutions, thus enabling them to increase their growth and deliver access to finance over the long term.

The remainder of this report thus aims to identify an appropriate role for TAF in improving microfinance regulation and governance in Asia, to select the most suitable Asian country where such a program should be launched, and to explore possible Asia Foundation microfinance programs in this country context.
2. Country Selection for an Asia Foundation Program

The Asia Foundation was initially considering four countries as potential candidates for a program in microfinance governance: Afghanistan, Nepal, Pakistan and Timor Leste. In the first stage of the project, we assessed the candidate countries along five key criteria, developed through research, including interviews with the client and microfinance experts. We used quantitative data sources such as the CGAP’s access to finance database and the MIX Market data depository for MFIs; and qualitative sources such as literature review and interviews to assess these countries based on our criteria.

2.1 Country Selection Criteria and Comparative Assessment

Our assessment criteria were designed to capture internal feasibility and external feasibility constraints that will be essential in determining the suitability of each country for the proposed program. Internal feasibility constraints arise from TAF organizational competencies, mission and structure, while external feasibility constraints are a function of the existing policy and regulatory environment. The attractiveness of each country for a TAF program depended on well it ranked on the following selection criteria:

1. High Degree of Regulatory Development: Presence of a sufficiently well-developed regulatory framework that does not require substantive reform. Such an environment would allow TAF to easily build upon an existing framework.
2. Openness to Microfinance Reform: Demonstrated openness of the current regulatory environment and policy makers to reform. A more open environment would enable TAF to play an effective role more easily.
3. Strong US Foreign Policy Interests: Demonstrated importance of the country to US foreign policy objectives, as well as past and projected foreign aid spending in the country. TAF is better able to garner donor support for programs in countries with greater US foreign policy interest.
4. Data Availability: Access to publicly available data and information on the microfinance sector, current regulations, and key players to enable TAF to conduct comprehensive research and policy analysis.
5. **Alignment with TAF Capabilities:** Alignment with TAF competencies and organizational and operational strengths would enable it to launch a new program that leverages existing comparative advantages.

The four candidate countries were ranked along these selection criteria, and Pakistan was selected as the most suitable country for a TAF program to improve microfinance governance. Table 1 exhibits the detailed results of the country selection process.

Pakistan was selected because it ranks high in meeting all five criteria. It aligns well with TAF core competencies and areas of expertise; it is strategic from a US policy perspective; it has a well-developed regulatory system that does not require substantial reformulation; the policy environment in Pakistan is amenable to reform; and it has good quality data coverage in the microfinance sector. Each of the other three countries ranks high in only one of the five criteria, which singles out Pakistan as a clear choice.
Table 1: Country Selection Matrix

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Afghanistan</th>
<th>Nepal</th>
<th>Pakistan</th>
<th>Timor Leste</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory</td>
<td>√ - Needs to develop appropriate regulatory</td>
<td>√ Needs to simplify current regulatory</td>
<td>√ + Needs to refine existing framework to</td>
<td>√ - Needs to develop appropriate regulatory</td>
</tr>
<tr>
<td>Development</td>
<td>framework</td>
<td>framework</td>
<td>adjust to industry needs</td>
<td>framework</td>
</tr>
<tr>
<td>Regulatory</td>
<td>√ Regulatory capacity constraints</td>
<td>√ - Institutional transition complicates</td>
<td>√ + Regulators attuned to reform, use</td>
<td>√ - Regulatory capacity constraints</td>
</tr>
<tr>
<td>openness</td>
<td>prospect of reform</td>
<td>prospect of reform</td>
<td>consultative approach</td>
<td></td>
</tr>
<tr>
<td>US Policy Interest</td>
<td>√ + Strategic ally, interest in promoting socio-</td>
<td>√ - Long term interest in promoting political</td>
<td>√ + Strategic ally, interest in promoting socio-</td>
<td>√ US interest in preventing return to conflict</td>
</tr>
<tr>
<td></td>
<td>economic development</td>
<td>stability and economic development</td>
<td>economic development</td>
<td>and supporting economic development</td>
</tr>
<tr>
<td>Data Availability</td>
<td>√ - Inadequate data</td>
<td>√ + Substantive data</td>
<td>√ + Substantive Data</td>
<td>√ - Inadequate data</td>
</tr>
<tr>
<td>TAF Capabilities</td>
<td>√ - Does not align with areas of expertise</td>
<td>√ Does not align well with areas of expertise</td>
<td>√ + Aligns well with areas of expertise and</td>
<td>√ - Does not align with areas of expertise</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>core competencies</td>
<td></td>
</tr>
</tbody>
</table>

**Key**
- √++ = High suitability
- √ = Moderate suitability
- √– = Low suitability
2.2 Rationale for Pakistan

Background: Pakistan has undergone a spell of political instability since 2007 culminating in the election of a democratic government in February 2008. With a Gross National Income (GNI) per capita of $870, it is classified as a low income country (see Appendix 2 for a detailed “Pakistan Country Profile,” including an overview of key socio-economic indicators). In Pakistan, an estimated 22.3 percent of the total population lives below the national poverty line, and another 20.5 percent lies between 100-125 percent of the poverty line.\(^{13}\) Although the microfinance and formal banking sector has shown good growth, broad based access to finance remains a challenge with only 12 percent of the population having access to deposit services.\(^ {14}\)

High Degree of Regulatory Development: At present Pakistan has a well-established regulatory system formulated and enforced by the central bank, the State Bank of Pakistan. However, a number of challenges persist at the micro, meso, and macro levels that hamper sustainability and growth of the microfinance sector. As the industry continues to evolve, refining and improving the implementation of the regulatory system to enable sustainable expansion and growth of the microfinance industry creates need for a facilitation role to spur reform.

Openness to Change: The policy and regulatory environment in Pakistan would enable The Asia Foundation to improve microfinance governance. The State Bank of Pakistan, the primary regulator of microfinance, has adopted a consultative approach in developing an enabling regulatory framework to allow microfinance institutions to conduct their operations in a sustainable manner. Policy makers at the SBP are attuned to the needs of the industry, and invite input from international experts such as CGAP as well as industry representatives to refine the existing framework. Keeping in view the changing needs of the industry, the SBP also issued new guidelines in areas such as Islamic banking, transformation of non-profit entities into licensed microfinance institutions, and branchless banking. Recently the SBP

\(^{14}\)CGAP Microfinance Gateway, *Country Profile,*
articulated its National Microfinance Strategy aimed at increasing outreach of microfinance services to 3 million borrowers by 2010. It has also set up a special microfinance focal group with an independent head and qualified staff to develop strategies for increasing access to finance.

**US Foreign Policy Interest:** Pakistan is a strategic ally of the US, and one of the primary objectives of American foreign policy assistance to Pakistan has been to support socio-economic development as a part of the multi-pronged strategy in combating the threat of extremism and terrorism.\(^{15}\)

**Data Availability:** Pakistan is also an excellent candidate in terms of data availability. The regulatory framework and laws are well documented and easily accessible. Operational and financial information for the major microfinance institutions, microfinance associations, and other key players is also available in the public domain.

**Alignment with TAF Capabilities:** Given Pakistan’s high ranking on the above criteria, TAF expressed a clear interest in exploring possible programs to improve microfinance governance in Pakistan.\(^{16}\) While all abovementioned criteria were important considerations, Pakistan’s strong existing microfinance regulatory framework yields an ideal environment for TAF, as Pakistan’s regulations do not require substantial reform. Working in a country with a well-developed regulatory framework will enable TAF to leverage its existing strengths, rather than requiring expertise in financial regulation (not a TAF core competency) to first improve the regulatory framework. The following section illustrates the capabilities TAF can bring to bear in its effort to improve microfinance governance in Pakistan.

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\(^{16}\) Interview with Zahid Elahi, Program Officer of the Asia Foundation, Pakistan, February 2009.
3. Asia Foundation Competencies

After selecting Pakistan as the most suitable country in which to launch a TAF microfinance program, we conducted an in-depth exploration of The Asia Foundation’s general competencies, focusing on TAF competencies in Pakistan.

Our findings indicate that a microfinance governance program in Pakistan aligns well with TAF organizational and operational strengths. The Asia Foundation has demonstrated global competencies in four key areas: 1) Technical Assistance and Capacity Building, 2) Research to Inform Programs and Policy, 3) Country and Issue Analysis and Assessments, 4) Facilitation of Dialogue and Exchanges (see Appendix 3 for an assessment of the strength of these competencies in the Pakistan office, as well as an overview of relevant TAF programs in Pakistan). While these competencies span many topical areas, TAF’s work in governance, law, economic reform, and development align most closely with microfinance.

Many similar competencies are found at The Foundation’s Pakistan offices, where it has maintained a continuous program since 1953. The Foundation’s work in Pakistan focuses on four key areas relevant to microfinance: 1) Supporting electoral and governance reforms, 2) Improving service delivery through effective and responsive governance, 3) Budget literacy (supporting greater transparency of, and increased community participation in, local government), 4) Women’s empowerment through education, legal literacy and protection. These broad capabilities in Pakistan illustrate that TAF could play many different roles in microfinance governance, working to improve conditions at the micro, meso or macro levels. As discussed below, we find that TAF is best positioned to work with and alongside existing organized groups at the meso level to improve the ability of meso-level actors to help resolve the most fundamental challenges facing the microfinance industry at the micro and macro levels.

17 Interview with Zahid Elahi, Program Officer of the Asia Foundation, Pakistan, February 2009.
19 The Asia Foundation Website: Pakistan (accessed 27 January 2009).
**Meso Level:** Projects at the meso level can involve research and analysis, coalition building, fostering of public-private dialogue, and other programs aimed at solving problems at the intersection between MFIs and the government. Such programs could ideally leverage TAF competencies, both globally and in Pakistan specifically.

**Micro Level:** Projects at the micro level often involve working with individual MFIs, lenders, and borrowers. However, TAF’s core strengths appear to lie more in working with organized groups, thereby typically increasing the breadth of TAF impact. Rather than improving conditions for individuals or organizations, TAF’s focus is on improving the broader economic and governance environment. Although MFIs can be organized into larger groups, these organizations are usually aided by actors at the meso or macro levels.

**Macro Level:** Projects at the macro level often involve playing a direct role in policy advocacy. CGAP, the World Bank, the IMF, and other similar organizations, often perform these functions, and are effective in this role largely due to unique and hard-to-develop comparative advantages which enable them to work more directly and influentially with governments. TAF does not seek to play such a role, given its lack of comparative advantage in developing financial-sector regulation. However, TAF could play a critical role in helping meso-level organizations facilitate a dialogue between the government/State Bank of Pakistan and microfinance institutions. Although operational capacity will need to be added to execute a new program in Pakistan, TAF has the advantage of established relationships with key microfinance players. This includes the national microfinance association (which acts as the industry representative in regulatory and policy matters), key contacts at the Ministry of Finance, and TAF country representatives with experience working directly in microfinance.

Based on these competencies, The Asia Foundation is clearly best equipped to work with organized groups at the meso-level. As subsequently discussed, there are a number of ways TAF can help these organized groups do more to address the most critical challenges facing the microfinance sector.

With respect to operational capacity, TAF may need to bring in additional personnel with expertise relevant to these new programs including, for example, one or more new employees.
familiar with the microfinance sector (if current employees lack this expertise). In addition, they may need to increase their administrative staff to handle any new workflow associated with a program expansion, and may also require other additional equipment (e.g., computers, etc.) to support this expansion.
4. Challenges Facing Pakistan’s Microfinance Sector

As aforementioned, the most critical challenges facing the microfinance industry exist at the micro level (e.g., limited access to microfinance services among certain segments of the population) and macro level (e.g., some central bank regulations unnecessarily hinder the growth of microfinance institutions). These challenges are often resolved most efficiently and effectively through the aid of organized actors at the meso level who are able to act as information sources for and intermediaries between micro and macro-level actors, such as microfinance institutions and the Central Bank. Among other things, these actors work to facilitate dialogue and actions within and between these two groups that help improve the microfinance sector (e.g., better designed regulations).

Based on TAF’s competencies, The Asia Foundation is best positioned to help resolve micro and macro level challenges by working with existing organized groups at the meso level, rather than directly with microfinance institutions or government agencies at the other two levels. For example, TAF can provide meso-level organizations and actors at other levels with relevant empirical research and training on topics related to improved microfinance governance.

Because of the strong inter-relationships between these levels, research was conducted at each level to understand prevailing conditions and challenges in the microfinance sector in Pakistan. This research began with an in-depth literature review, and was later supplemented with interviews of key stakeholders on the ground in Pakistan. The results of this research were used to help identify key challenges facing the sector, which are identified at each level of the system. These challenges form the foundation of our program options and recommendations.

Since TAF is best-suited to work with groups at the meso-level, we first discuss the challenges faced by this level and explain how a TAF program can help address some of them. Next we discuss primary challenges at the micro and macro levels. These challenges are the most fundamental ones facing the microfinance sector and the ones meso-level organizations work to address. With a few noted exceptions, each challenge we identify will
be addressed by at least one of the TAF program options proposed in the next section.

4.1 The Meso Level: Microfinance Associations (MFAs)

Microfinance Associations (MFAs) are among the organizations operating at the meso level of the microfinance sector, alongside credit bureaus, ratings agencies and other groups providing support services to the microfinance industry. Because of their unique role as intermediaries between the macro and micro levels (as well as with other meso-level actors), MFAs have been identified as the most appropriate partners for TAF to consider in its attempt to improve microfinance governance. As discussed below, we also find that a TAF role at this level can help meso-level organizations address some of the challenges they face.

MFAs are a relatively new development in microfinance, with most originating in the late 1990s. They are member-based organizations, with membership primarily comprising independent MFIs. They engage in a wide range of activities generally aimed at improving the sustainability and impact of MFIs. The services offered by individual MFAs can differ greatly. In many cases, services are not provided directly by the associations as they primarily “facilitate, connect, coordinate, design or supervise.” Services provided by MFAs may include: 1) networking, 2) information collection and dissemination, 3) technical and organizational assistance, 4) standards, regulation and supervision, and 5) lobbying/advocacy, amongst other things (see Appendix 4.1A for more information on each role and a list of additional roles). Training is perhaps the largest and most important service in terms of financial and personnel efforts, while information intermediation and lobbying/advocacy are also core activities.

Like services provided, membership structures differ widely across MFAs. The core members are MFIs, although in some associations it appears that other organizations and

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21 This section draws heavily on findings from Roland Gross and Dr. Michael Brüntrup, Microfinance Associations (MFA): Their Role in Developing the Microfinance Sector, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), April 2003 (pp. 32-56).
individuals are allowed to join as ordinary (or associated) members. However, MFAs typically do not represent the entire microfinance sector – many sectors remain excluded. According to the German development group GTZ, MFAs often exclude the “cooperative sector, the consumption credit sector, the poverty-oriented programs of commercial banks or other fragments.” Because member characteristics can differ so notably, internal conflicts are not uncommon.

4.1.A. Microfinance Associations in Pakistan

Interviews and a literature review reveal that the Pakistan Microfinance Network is the most prominent MFA in Pakistan. Some smaller associations operate at a provincial level, while other organizations (e.g., NGO coalitions) perform certain functions similar to MFAs without assuming this title.

Launched informally in 1997 and established as a separate legal entity in 2001, the Pakistan Microfinance Network (PMN) is the only national-level network for microfinance practitioners in Pakistan. PMN plays a catalytic role in promoting change, and stays in constant contact with the SBP, Ministry of Finance and the Planning Commission. It acts as a “disseminator of microfinance information with the aim of enhancing the scale, quality, diversity and sustainability of microfinance providers in Pakistan.” PMN pursues three key objectives in support of its mission:

1. **Building the capacity of stakeholders, especially retail microfinance institutions:**

Through training courses, PMN works to build technical expertise and disseminate operational best practices.

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26 Ordinary members have the same voting rights, regardless of their size, contributions or performance. Source: Roland Gross, 2003 (p. ix).
29 BWTP Asia Resource (p. 1).
31 BWTP Asia Resource (p. 1).
33 Syed Mohsin Ahmed, General Manager of the Pakistan Microfinance Network (PMN). Interviewed by Kelly
2. **Acting as an information gateway:** PMN disseminates industry-relevant information, improving transparency, promoting benchmarks and serving as a point of contact for the retrieval of data/information.\(^{34}\)

3. **Promoting an enabling environment that benefits the work of all stakeholders:** Through networking, coalition building, advocacy and establishing a one-to-one relationship with key regulators.\(^{35}\)

PMN membership currently includes 20 MFIs, “including most of the largest and better-established microfinance institutions in the country, representing a regional balance and accounting for approximately 90-95% of the Pakistan’s microfinance sector.”\(^{36,37,38}\) (See Appendix 4.1.B for a detailed membership list). However, many smaller MFIs operating in rural areas are not represented by PMN, and may instead work with a rural microfinance association. NGOs providing microfinance may instead be covered by NGO coalitions in one of the provinces, if they are associated with an MFA at all.\(^{39}\)

At the provincial level, several smaller associations exist. The Sindh Microfinance Network (SMN) is perhaps the most notable MFA (and the only one with an internet presence). SMN was “established to provide opportunities to grass roots level MFIs working in [the region of] Sindh to enhance their skills, build their capacities and maximize outreach with sustainable

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\(^{34}\) In 1999 PMN began to promote transparency among its members, requesting that they self-report performance indicators, which are then aggregated, analyzed and published bi-annually in a nation-wide report, the Performance Indicators Report. Their attempts to improve financial and social disclosure at the industry level have also included a Credit Bureau program, undertaken with the help of private sector. *Source:* BWTP Asia Resource (p. 1).

\(^{35}\) PMN organizes policy seminars and nation-wide conferences on regulatory issues. In addition, PMN publishes position papers on issues of consensus among its members. PMN’s objective is both to try to understand the rationale underlying SBP advocacy of particular policies and, when appropriate, to try to persuade regulators to adopt PMN’s policy recommendations using research and evidence. *Source:* BWTP Asia Resource (p. 2). Ahmed, Syed Mohsin, General Manager of the Pakistan Microfinance Network (PMN). Interviewed by Kelly Spann, February 2009.

\(^{36}\) Aban Haq, 2008 (p. 22).

\(^{37}\) BWTP Asia Resource (p. 2).


\(^{39}\) Interview with Zahid Elahi, Program Officer of the Asia Foundation, Pakistan, February 2009.
approach[es]. SMN appears to represent approximately 20 MFIs in the Sindh province. While other provincial-level networks existed previously, many were reportedly less successful and ultimately closed down. In addition, NGO coalitions (e.g., in Sarhad and Punjab) are reported to perform some functions similar to MFAs.

4.1.B. Challenges

Interviews with TAF and PMN representatives in Pakistan, in addition to a literature review, reveal the following key challenges facing PMN. We focus on PMN because it is by far the best established MFA in Pakistan:

1. **Funding**: Like many organizations, PMN (and MFAs in Pakistan generally) are resource-constrained.

2. **Sophisticated empirical research**: PMN has difficulty developing sophisticated, empirically-based rationales to support policy recommendations to the central bank (SBP), e.g., regarding benchmarking specific microfinance regulations against regulatory “good practice” in other regions.

3. **Central Bank strategy**: PMN lacks a clear, well-defined long-term strategy for managing its relationship with/influencing the SBP regarding to affect regulatory and other changes.

At the provincial MFA or NGO coalition level, one additional challenge appears:

1. **Organization and sophistication**: While many challenges doubtless face these organizations, lack of an Internet presence is perhaps most notable. Dedicated

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42 Aban Haq, 2008 (p. 22).  
43 Challenges are drawn from literature review and interviews with: Syed Mohsin Ahmed, General Manager of the Pakistan Microfinance Network (PMN); Zahid Elahi, Program Officer of the Asia Foundation, Pakistan; Mr. Suleman G. Abro, CEO of the Sindh Microfinance Network (SMN).
websites for these organizations are generally lacking. In addition, outside of the Sindh Microfinance Network, no provincial MFAs or NGO coalitions are mentioned in the general literature covering the microfinance sector in Pakistan.

In our section on program alternatives for The Asia Foundation, we propose a role for TAF that directly addresses two of PMN’s primary challenges. For many of our program options, TAF’s role would involve working with MFAs to provide sophisticated empirical research and to facilitate coalition-building in order to improve governance. For example, one option includes having The Asia Foundation work with PMN and the Central Bank of Pakistan to refine microfinance regulations. Although the proposed program alternatives do not directly address MFA funding, this challenge would be indirectly addressed by TAF’s participation at the meso level, helping to expand the effectiveness of meso-level organizations without additional funding.

4.2 The Micro Level: Microfinance Institutions (MFIs)

The micro level can include borrowers, lenders, or microfinance institutions themselves. Microfinance institutions can be broadly grouped into three types; (1) commercial banks offering microfinance services as a separate product; (2) non-bank institutions that specialize in microfinance and are prudentially regulated; and (3) NGO or government support programs that specialize in microfinance or offer microfinance as a separate service. The latter group tends to rely on government or donor support and is not overseen by a central bank, while the two former groups operate as self-sustaining financial institutions under central bank regulations. Generally, the central bank prudentially regulates microfinance institutions when they perform the role of intermediating deposits. Many of the most critical challenges facing Pakistan’s microfinance industry exist at the micro level. As subsequently discussed, by working with and alongside meso-level organizations, a TAF program could help address many of these challenges.

4.2.A. Microfinance Institutional Landscape in Pakistan

The microfinance industry in Pakistan has grown extensively in the past several years,
increasing by nearly 50% in 2007 alone. Currently, there are 29 microfinance institutions in Pakistan, and as of March 2008, the sector had 1.6 million active borrowers and 1.7 million savers with a gross loan portfolio of 16.5 billion rupees (US $208 million) and 4.2 billion rupees (US$ 53 million), respectively. Microfinance institutions in Pakistan are generally divided into five types as shown in Table 2.

Table 2: Microfinance Institution Types in Pakistan

<table>
<thead>
<tr>
<th>Institution Type</th>
<th>Description</th>
<th>Other Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Microfinance Bank (MFB)</td>
<td>Licensed and prudentially regulated by the State Bank Pakistan (SBP)</td>
<td>Able to intermediate deposits</td>
</tr>
<tr>
<td>Specialized Microfinance Institution (SMFI)</td>
<td>Provides specialized microfinance services</td>
<td>NGO-based, not regulated by SBP, not able to intermediate deposits</td>
</tr>
<tr>
<td>Rural Support Programme (RSP)</td>
<td>Part of program is dedicated to microfinance operations</td>
<td>Not overseen by SBP, not able to intermediate deposits</td>
</tr>
<tr>
<td>Non-government organization (NGO)</td>
<td>Microfinance operations as a component of program</td>
<td>Not overseen by SBP, not able to intermediate deposits</td>
</tr>
<tr>
<td>Commercial Financial Institution (CFI)</td>
<td>Offers microfinance services as a separate function</td>
<td>Averseen by SBP, able to intermediate deposits and</td>
</tr>
</tbody>
</table>

Of the 29 microfinance providers in Pakistan, two are commercially financed institutions, six are microfinance banks, and the remaining 21 are unregulated specialized microfinance institutions, rural support programmes, and non-governmental organizations. Specialized microfinance institutions, rural support programmes, and non-governmental organizations can all be grouped together into the third general category mentioned in section 3.1 since they

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44 Aban Haq, 2008 (p. 7, 8).
46 Aban Haq, 2008 (p.7).
are not licensed or regulated. And as noted in Table 1, only microfinance banks and commercial financial institutions can intermediate loans and thus fall under the supervisory authority of State Bank Pakistan.

Borrowers utilize loans in a variety of ways: 30% are used for trade, 29% agriculture, 16% livestock/poultry, and the remaining quarter is divided up among several other sectors.\(^{49}\) With respect to market share, RSPs have 39% of borrowers, MFBs (33%), SMFIs (22%), NGOs (5%), and CFIs (1%). Savings is dominated by RSPs with 83% of savers, followed by MFBs at 12%.\(^{50}\) Of the 29 institutions offering microfinance services, 20 report to the MIX Market and just 5 reported operational self-sufficiency at or above 100% in 2007.\(^{51}\) The figure of one quarter of microfinance institutions achieving operational self-sufficiency is presumably skewed as institutions reporting to MIX Market are generally regarded as higher performing; therefore the true figure for operational self-sufficiency for the entire microfinance sector is probably significantly lower. (For a complete table see appendix 4.2).

It is estimated that two thirds of the poor in Pakistan live in rural areas, yet microfinance services are disproportionately located in urban environments.\(^{52}\) On the supply side, the cost of operating in remote, sparsely populated areas can preclude microfinance providers from working in these regions. Conversely, one component of the seemingly modest demand for microfinance services in rural areas may be associated with a lack of Sharia based financial services in these regions.\(^{53}\)

The Government of Pakistan has been very supportive in developing microfinance institutions in an effort to alleviate poverty. Subsidized loans are extended to NGOs, as well as Rural Support Programmes (but not MFBs or CFIs) through the Pakistan Poverty Alleviation Fund (PPAF). Often subsidized loans are passed on to borrowers without concern

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\(^{49}\) Maheen Saleem Farooqi, 2008 (p. 6).
\(^{50}\) Maheen Saleem Farooqi, 2008 (p. 1).
\(^{52}\) Aban Haq, 2008, (p.7).
\(^{53}\) Interview with Zahid Elahi, former Pakistani government official and TAF representative, February 2009.
for operating costs, which may contribute to the prevalence of unsustainable institutions.\(^{54}\)

4.2.B. Challenges

Despite the recent success of the microfinance sector and a regulatory structure that is generally supportive, microfinance institutions face the following significant challenges.

1. **Non-licensed MFI desire not to be regulated:** The need for and benefits of regulating microfinance providers are not sufficiently understood by non-licensed providers. The potential benefits to the MFI itself are, first, in breaking the dependence on donor funds. Secondly, growth in regulated MFIs has the potential to increase overall access by increasing services offered. Many microfinance providers hold the perception that microfinance is merely a charitable activity and not the provision of financial services to the poor.\(^{55}\) This is problematic since non-licensed providers are limited in their ability to offer the full range of services to meet client needs including savings, investment and insurance products that would be beneficial in lifting clients out of poverty. Additionally, non-licensed MFI growth is hampered by an inability to access commercial debt markets which could reduce impact and outreach. Additionally, the desire not to be regulated is affected by policy distortions such as loss of tax exemptions and access to subsidized funds discussed below.

Understanding the benefits of regulation could perhaps pave the way for some NGO-based providers to become microfinance banks, which would better integrate microfinance into the financial sector which would allow for scaling up, sustained growth, and greater access. The belief that microfinance is a charitable service rather than a financial service is long-standing and widespread, which makes it a particularly difficult challenge to address. One way to address the challenge is through regulation. By integrating MFIs into the formal financial sector, they will be able to offer a full range of services, and access wider financing options for growth. Finally, regulation can correct policy distortions that will be discussed in Macro level challenges.


\(^{55}\) Eric Duflos, 2007 (p. 10).
2. **Non-licensed MFIs rely on subsidized loans:** NGOs and Rural Support Programmes rely on external support in the form of government subsidized loans. Often government-subsidized loans given to specialized microfinance institutions, NGOs, and Rural Support Programmes are passed on to the end client. The problem is that providers rely on external subsidies to fund operations. Certain programs require government subsidies, such as microfinance activities in rural and remote areas where costs are high and clients are extremely poor. However, it is necessary to reduce MFI reliance on subsidies in cases where costs can be covered by streamlining operations and passing on costs to clients who are able to pay higher interest rates. This issue is problematic because of the adverse impact on MFI sustainability. In effect this policy creates subsidy reliance, inhibits growth independent of donor funds, and curbs impact and outreach. This issue could be addressed through regulation which would encourage sustainability. Licensed microfinance banks are ineligible to receive funds disbursed through the Pakistan Poverty Alleviation Fund. Conversely, licensed microfinance banks are required to adhere to reporting and disclosure practices and are rated according to soundness of financial practices. These kinds of practices provide incentives for efficiency. Certain practices and policies discussed above could be addressed through policy refinement discussed in the Macro level challenges.

3. **Demand for Sharia (Islamic law) compliant microfinance is unmet:**\(^{56}\) Many consumers are wary of undertaking conventional microfinance products that charge fixed interest rates, as these are incompatible with Sharia law. Currently only one MFB offers Islamic microfinance services and the outreach of Islamic products is extremely limited.\(^{57}\) According to industry practitioners, there is a significant demand for Sharia-compatible microfinance products.\(^{58}\) These products are often called equity

\(^{56}\) Islamic financial law prohibits giving or receiving any fixed, predetermined rate of return on financial transactions. Cost plus markup financial contracts and equity based models (profit-and-loss sharing) are permitted according to Sharia principles. See Nimrah Karim, Michael Tarazi, Xavier Reille. *Islamic Microfinance: An Emerging Market Niche.* CGAP Focus Note: 49. 2008, for an overview of Islamic microfinance principles and products.

\(^{57}\) Nimrah Karim, Michael Tarazi, Xavier Reille, (p. 8).

\(^{58}\) Interview with Zahid Elahi, former Pakistani government official and TAF representative, February 2009.
based products and are delivered through a profit/loss sharing model that makes the lender a partner in business enterprises set up by the clients through loans.

4. **MFI management capacity is limited:** The composition of boards and management structures of MFIs lack financial expertise. Often management comes from the NGO sector focused on social programs rather than the financial sector. The management’s lack of expertise is a problem because they may be more focused on charitable functions rather than the sustainable delivery of services.

5. **Consumer financial literacy and business expertise is limited:** Consumers of microfinance services often fail to grasp the complexities of financial services. This information problem reduces the ability of microfinance consumers to locate and obtain the financial services that best fit their needs.

6. **Rural access to finance is limited:** Though two thirds of the poor live in rural areas, only one third of microfinance branches are in rural regions. Many MFIs do not have the infrastructure or ability to expand to underserved rural areas. The cost of serving rural areas often is untenable for microfinance institutions.

With the exception of limited rural access, we will address each of these challenges in a least one of our TAF program options. We chose not to address the challenge of limited rural access because of the difficulty in achieving sustainable access in remote markets. Providing access in these areas will likely require some level of subsidization and external support.

4.3 **The Macro Level: Microfinance Regulation in Pakistan**

Regulatory and policy frameworks constitute the macro-level in the microfinance landscape. The primary actors at this level are the regulating bodies, which includes the central bank and the government. Considering that microfinance institutions are governed by regulations at

59 Interview with Agha Ali Javad, General Manager of the National Rural Support Programme (NRSP), February 2009.
60 Aban Haq, 2008 (p. 7).
61 Interview with Bruce Tolentino, Director of Economic Reform and Development, The Asia Foundation, February 2009.
the macro level, it is unsurprising that we find overlap among the challenges faced at the micro and macro levels (e.g., the desire of some MFIs to remain unregulated). However, in our research we also find a number of challenges concerning stringent regulations that are unique to the macro-level. Each macro-level challenge identified below is addressed in our proposed TAF program options.

4.3.A. Pakistan’s Regulatory Framework for the Microfinance Sector

In Pakistan, the microfinance sector was first brought under direct regulation of the State Bank Pakistan (SBP) through the Microfinance Institutions Ordinance in 2001.\(^\text{62}\) The overarching goal of regulation in Pakistan is to institutionalize microfinance as a part of the formal financial sector, and enable the microfinance sector to deliver financial access to the poor in a sustainable manner. The National Microfinance Strategy of the SBP further maps out the short-term goal of expanding outreach of microfinance services to 3 million borrowers by 2010 through commercialization of sustainable microfinance.\(^\text{63}\) The regulatory framework in Pakistan thus serves as a supervisory and monitoring mechanism that allows the SBP to keep a check on the operational and financial sustainability of the licensed providers. The non-licensed providers are registered under the Securities and Exchange Commission Pakistan and various provincial registration authorities and are merely subject to various disclosure requirements (see Appendix 4.3A for an overview of the regulatory approach by institution type, and Appendix 4.3B for an overview of licensing criteria).

The regulatory framework adopted by the SBP is in conformance with CGAP Guiding Principles on Regulation and Supervision of Microfinance (see Appendix 4.3C for details of these guidelines). Despite the many regional and institutional differences that complicate microfinance governance, Consultative Group to Assist the Poor (CGAP) suggests some

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\(^{62}\) Government of Pakistan. *Microfinance Institutions Ordinance of 2001*. Islamabad, Pakistan, 2001. This Ordinance applies to all institutions licensed by the SBP, but excludes the non-licensed providers.

\(^{63}\) Shamshad Akhtar. *Expanding Microfinance Outreach in Pakistan: Presentation to Prime Minister*. State Bank of Pakistan, 2007. In order to expand access the National Microfinance Strategy outlines a three-pronged strategy of sustainable operations, private domestic capital to finance growth, and building up the human resource base to support expansion of services. The SBP also recognizes the difficulty in delivering commercially viable programs in rural and remote areas, and recommends subsidized lending should be confined to these areas.
guiding principles with respect to microfinance regulation.\textsuperscript{64} These guidelines indicate that that the specific types of regulation will depend on the level of the industry’s development. In most countries with a reasonably developed microfinance sector, the purpose of regulation is to allow the MFIs to provide a range of financial services such as taking deposits from the public in a sustainable manner. Such regulation is perceived as enabling the growth and formalization of microfinance into the traditional financial sector.

The key features of Pakistan’s regulatory system are:

1. \textit{Regulation of deposit-taking providers}: CGAP Guiding Principles stress the importance of tailoring regulations to the specific needs of providers. CGAP recommends that prudential regulations (i.e., regulations that are designed to ensure the financial soundness of the regulated institutions and protect depositors’ funds)\textsuperscript{65}, should be only applied to deposit-taking institutions that hold public money. These regulations are costly to monitor and enforce, and they require a specialized financial authority to oversee their implementation. Examples of prudential regulations include capital adequacy ratios or liquidity requirements that are designed to maintain a check on the amount of risk an institution can undertake. (Also refer to Appendix 4.3D for details regarding prudential regulations applied by the SBP)

In Pakistan, prudential regulations are applied only to providers licensed by the SBP as microfinance banks (MFBs) and commercial financial institutions that offer microfinance services as a separate function.\textsuperscript{66} All other MFIs, such as NGOs and other non-profit providers that the Pakistan’s Microfinance Institutions Ordinance restricts from deposit-taking, are free from prudential regulations.\textsuperscript{67} Therefore, they operate outside the purview of the SBP’s regulatory authority. By adopting this differentiation SBP has been quite

\textsuperscript{64} Robert Christen, 2002 (p. 4).
\textsuperscript{65} There are two broad categories of financial system regulation. The first category encompasses “prudential regulations” that aim to ensure the financial soundness of the regulated institutions. The second category consists of “non-prudential regulations” that pertain to the “conduct of business” of financial institutions. Non-prudential regulations include measures like registration with an appropriate authority for transparency purposes, keeping adequate accounts, prevention of fraud and financial crimes, and various types of consumer protection measures.
\textsuperscript{66} For the purpose of regulation, those institutions offering microfinance services and licensed by the SBP are referred to as Microfinance Banks.
\textsuperscript{67} However, RSPs are permitted to hold small deposits for their members not for the purpose of financial
successful in striking a balance between promoting private entry into the microfinance sector and preserving the soundness of the regulated institutions for protection of their retail depositors. In an effort to promote sustainable microfinance, the SBP has also issued NGO transformation guidelines, designed to assist in the integration of providers with the interest and requisite capacity to transform unregulated MFIs into licensed Microfinance Banks (see Appendix 4.3 E. for details of these guidelines). Despite this effort, SBP still lacks an effective strategy to facilitate the non-licensed providers wanting to make this shift towards becoming deposit-taking institutions.

2. **Financial risk management:** CGAP suggests a number of regulations in the areas of capital requirements, liquidity, unsecured lending, and loan loss provisioning (see Appendix 4.3C for details) in order to manage financial risk-taking by microfinance institutions. The broad principle underlying these recommendations is that good regulation should be narrowly targeted to safeguard the financial system and small depositors, and should entail minimal enforcement costs. The SBP has issued a set of prudential regulations regarding financial risk management (for details, see Appendix 4.3D). A number of independent assessments have deemed this framework suitable for enabling microfinance sector expansion. However, according to industry practitioners, certain regulations such as loan size capping and exclusion from domestic institutional debt markets may slow down the growth of MFBs (see Challenges below).

3. **Pricing:** CGAP cautions against regulatory attempts to cap interest rates since this hinders the development of sustainable microcredit. In conformity with this guideline, the SBP does not impose interest rate ceilings. However, the MFBs are required to implement appropriate

intermediation.

68 Robert Christen, 2002 (p. 20).
73 Robert Christen, 2002 (p. 10).
interest rates and pricing policies, keeping in view development and sustainability objectives. Currently, the interest rates charged by most providers in Pakistan do not cover their operational costs. A number of these providers receive subsidized funding by the Pakistan Poverty Alleviation Fund (PPAF). The PPAF was set up the Government of Pakistan (GoP) in 2001 to encourage private entry in the sector, and is jointly funded by the GoP, the World Bank and other international donors.

4. Reporting and disclosure: CGAP recommends that reporting and disclosure requirements should be simple to minimize regulatory costs. In Pakistan, all licensed institutions are required to maintain and submit financial records to the SBP on a bi-monthly, quarterly, and annual basis. They also must obtain credit ratings and publish audited financial statements annually. The reporting and disclosure requirements do not appear to be burdensome for the licensed providers (MFBs). The non-licensed providers that manage rural and small-loans (RSPs and NGOs) and would be expected to find these requirements burdensome are not obliged to comply.

5. Tax treatment: There is no consensus over tax policies with respect to MFIs, but the CGAP Guidelines suggest that non-profit NGOs should be exempt from taxes on income. In Pakistan, MFBs are liable to income taxes of 39 percent, but have been given a 5 year tax holiday beginning in June 2007. NGOs are exempt from income taxation, and a key concern for many NGOs contemplating transformation to MFB status is the loss of tax-free status. It has been argued that microfinance providers should be given special treatment, given their focus on poverty alleviation.

4.3.B. Challenges

Based on the above review, there appear to be three key challenges at the macro level. The latter two challenges were identified as challenges at the micro-level as well.

74 Eric Duflot, 2007 (p.13)
75 Eric Duflot, 2007 (p. 13).
76 Eric Duflot, 2007 (p. 22).
77 Eric Duflot, 2007 (p. 11).
1. **Refinement of prudential regulations**: Certain prudential regulations must be adjusted to meet the changing needs of the industry and enable continued growth of microfinance banks. Specific regulations that have been identified by PMN as restrictive are: \(^79\)

- Loan Size Caps: There is a sizeable gap between the amount that commercial banks lend without collateral (Rs. 2 million) and the current limit for microfinance loans (Rs. 150,000). This restriction likely creates a “missing middle” in the market.
- Loan Loss Provisioning: Stringent loan loss provisioning rules require MFBs to hold much larger proportions of their capital in form of lower risk assets relative to commercial banks. In addition, the requirement to classify loans overdue by more than 30 days as non-performing loans (NPLs) may result in adversarial interactions between lenders and borrowers.
- Bar on foreign exchange transactions: This limits the ability of MFBs to access foreign capital to finance expansion.
- Exclusion from “Scheduled Bank” status: A “Scheduled Bank”, is one that is rated as having good risk management practices. Most institutional investors require borrowers to have “Scheduled Bank” status as a sign of sound financial practices. Currently, MFBs cannot acquire this status, which prevents them from tapping into domestic institutional debt markets.
- Prohibition on borrowing against receivables: MFBs are currently restricted from using their balance sheet receivables as collateral to raise private debt to finance growth.

2. **Improving dissemination and understanding of benefits of regulation amongst non-licensed providers**: As previously discussed, most microfinance practitioners at the NGO level still view microfinance primarily as a charitable activity, and are not willing to become part of the regulated financial sector.\(^80\) This restricts them from offering the whole range of financial services to their clients, particularly saving and investment products. It also hampers their impact and outreach potential, as these providers may not

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\(^80\)
be able to exist viably in the long term without external subsidization. The SBP can improve understanding of the benefits of regulation amongst the non-licensed providers facilitating the transition of those institutions having the organizational interest and capacity to transform.

3. **Need to correct policy distortions at the macro level:** Some of the policies at the macro level, such as loss of tax-free status and access to subsidized funds (see below), also discourage the transformation of the non-licensed providers in addition to reducing sustainability. Firstly, the loss of tax free status can be a serious disincentive for many NGOs contemplating transformation to MFB. A differentiated tax structure whereby the new licensees are subject to lower rates may provide one way of addressing this problem. Secondly, there is a need to address the issue of subsidized credit delivery by macro level institutions operated by the government. Reliance on donor funds creates challenges for long term viability and impact of the providers. SBP perceives the challenges surrounding provision of subsidized credit, including poor incentives for sustainability and is working on these issues as a part of its National Microfinance Strategy. Specific proposals in this area are:

- Privatization and reform of the Khushali Bank to limit the role of Government of Pakistan (GoP) in direct retail credit delivery, and bring it under the same regulation procedures as the other MFBs. This will level the playing field and allow other MFBs to compete effectively with Khushali Bank.

- Defining criteria for access to subsidized funds through the Pakistan Poverty Alleviation Fund (PPAF), which would limit subsidization to those providers having the highest costs of provision (remote rural areas). Under the current mechanism, there could be crowding out effects whereby providers serving poorer and remote areas are crowded out by providers less reliant on subsidies, given fixed amount of donor funds available. Thus, defining criteria for access of funds would encourage

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80 Eric Duflos, 2007 (pp. 13-14).
those non-licensed providers serving lower cost areas to streamline their operations, and cut back on any wasteful overheads.

Therefore regulatory changes related to these issues need to be considered to remove the policy distortions that hurt sustainability and also discourage transformation of non-licensed providers into licensed providers.

In the next section, we will address all three of these challenges in a least one of our TAF program options.
5. Microfinance Governance Challenges and Program Alternatives

In this section, we discuss five distinct microfinance governance programs for The Asia Foundation to consider undertaking in Pakistan which, together, address most of the challenges addressed in the previous section, and affect all three levels of Pakistan’s microfinance sector. For each program, TAF would be working with or alongside meso-level organizations to help resolve the most critical challenges facing the microfinance sector: the challenges at the micro and macro levels. By providing these services, TAF would also help resolve challenges faced by meso-level actors (e.g., limited sophisticated empirical research on microfinance governance issues).

The five TAF program alternatives include: 1) a program aimed at refining various microfinance regulations, 2) promotion of equity based microfinance services, 3) a program facilitating transformation of non-licensed microfinance providers into licensed microfinance banks, 4) a consumer financial and business literacy program, and 5) a program to improve MFI management capacity. The first and third programs primarily address challenges at the macro-level, while the other three address challenges at both the micro and macro-levels of the microfinance sector.

The design of these programs is informed by a Logical Framework approach. This process begins by defining the Goal/Purpose, Outputs, and Activities corresponding to each of the five programs. We then assess each program’s attractiveness along two key dimensions: Impact and Feasibility. In assessing Impact, we focus primarily on the size of the population it will effect and the urgency of the need. In assessing Feasibility, we focus both on internal TAF competencies and on potential external barriers to success (e.g., likely local acceptance or resistance to the program).

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82 The challenge of rural access at the MFI level is not addressed in these alternatives. Urban MFIs possess certain economies of scale that render them inherently more profitable than their rural counterparts (e.g., population concentration in urban areas lowers the cost structure, enables different repayment schedules, etc.). The operating strategy for rural MFIs is unique, and it may not be possible to improve upon this. The Asia Foundation confirmed the client’s preference not to explore this challenge further.

83 Logical Frameworks are a management tool used in the design, monitoring and evaluation of development projects. Development organizations including USAID, GTZ, UNDP and DFID commonly employ these tools, which require articulation four key items: Goal, Project, Output and Activities. For each of these items, measurable indicators, means of verification and key assumptions are considered.
Based on this assessment of Feasibility and Impact, we have prioritized two programs for further consideration: a program aimed at refining various microfinance regulations, and a program aimed at the promotion of equity-based (Sharia-compliant) microfinance services. In the discussion below we outline each alternative, beginning with what we have determined to be the most optimal program and proceeding to the least optimal program for the Asia Foundation. The rationale for each program’s prioritization in this ranking appears at the end of each program section.

It should be noted that the specific outputs and activities we outline for each program could certainly vary; our outline represents just one example of how each program could be developed. However, we choose to describe the potential details of each program in order to provide a more concrete sense of the type of program that could be designed. These detailed descriptions also enable us to draw more specific conclusions regarding the impact and feasibility of each program. However, there are many program variations that could accomplish the same goal/purpose.

Finally, Table 3 provides a summary of our analysis of the various program alternatives, ranked from most to least desirable. The program rankings are (1) refinement of MF regulations, (2) promotion of equity-based MF products, (3) transition of non-licensed providers, (4) consumer financial and business literacy and (5) management financial literacy. The table includes the goal as well as key points related to the program’s potential impact and feasibility. As evident from the table, the two programs we prioritize are the ones that are likely to have the largest impact, and are the most feasible. Appendix 5 includes a version of the same table, with additional detail explaining the rationale behind each scoring.
Table 3: Program Alternatives

<table>
<thead>
<tr>
<th>Program</th>
<th>Goal</th>
<th>Impact</th>
<th>Feasibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rank 1: Refinement of MF Regulations</td>
<td>Create a more enabling financial system</td>
<td>√+</td>
<td>√+</td>
</tr>
<tr>
<td>Rank 2: Promotion of Equity-Based MF Products</td>
<td>Improve utilization of microfinance services and increase access to finance</td>
<td>√+</td>
<td>√</td>
</tr>
<tr>
<td>Rank 3: Transition of Non-Licensed Providers</td>
<td>Increase awareness of the importance and need for financial regulation of microfinance institutions</td>
<td>√+</td>
<td>√-</td>
</tr>
<tr>
<td>Rank 4: Consumer Financial and Business Literacy</td>
<td>Increase financial and business literacy amongst microfinance customers in Pakistan through educational programs</td>
<td>√</td>
<td>√-</td>
</tr>
<tr>
<td>Rank 5: Management Capacity</td>
<td>Build MFI management and board capacity by improving corporate governance and financial literacy</td>
<td>√-</td>
<td>√+</td>
</tr>
</tbody>
</table>

Key

√+ = Highly attractive
√ = Moderately attractive
√- = Less attractive

5.1 Refinement of Microfinance Regulations

Some of the current regulations require refinement in order to meet the changing needs of the industry and enable the sustainable growth of microfinance providers. Such regulations include loan size caps, loan loss provisioning, and bar on foreign exchange transaction. MFIs and MFAs have had difficulty achieving changes to poorly designed regulations in large part because they have not been able to develop a clear, well-defined long-term strategy for advocacy with the SBP regarding regulatory changes. Therefore, TAF could play an important role in helping to develop and execute an advocacy strategy leading to a more favorable regulatory environment for microfinance institutions.

5.1.A. Program Description

Goal/Purpose: The goal is to create a more enabling financial system, to improve access to
finance, and to bring greater financial sustainability of MFIs in Pakistan. The purpose is to improve upon current regulations in order to ensure a favorable regulatory environment for MFIs. The current regulatory structure in Pakistan is relatively well-established, and conforms to broadly agreed-upon regulatory principles. However, some regulations have been identified as restrictive, and others aimed at promoting MFIs such as subsidized credit delivery, have allegedly negative impacts on the sustainability of MFIs. Fixing flawed regulations would help to improve the general regulatory environment for MFIs.

**Outputs:** Four primary outputs could help achieve this goal: research findings on well-regarded regulatory practices, development of specific alternative regulations (e.g., adjustment of loan size limits), development of a strategy for advocating regulatory changes with SBP, and strengthening dialogue with relevant stakeholders including financial regulators.

**Activities:** The first step would be to identify and prioritize the limitations of regulations in Pakistan. Our research results regarding regulatory challenges could inform this process. Research on good regulatory practices and their applicability to Pakistan will also prove useful. The next step would be to engage or partner with financial consultants, experts, or research institutions to conduct research on alternatives to the specific regulatory limitations. TAF also could conduct research on an advocacy strategy. Based on research findings, TAF could create a forum to engage various stakeholders and governmental authorities in partnership with MFAs to explore alternatives to the inadequate regulations.

5.1.B. Program Assessment

**Impact:** The main benefit of the program would be creating a more enabling financial system that facilitates the sustainable growth of the microfinance industry. A regulatory change at the macro level will bring about system-wide impacts, affecting all stakeholders. It will influence each of the eight currently licensed MFIs (covering ~34% of the market) and their

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84 Eric Duflos, 2007 (p. 20).
85 Eric Duflos, 2007 (pp. 21-22).
clients, as well as potential new entrants to the market. Furthermore, this program will help the microfinance industry and the SBP to meet the goal of expanding outreach of microfinance services to 3 million by 2010, which has been set out in a National Microfinance Strategy. Although regulatory challenges in Pakistan have been assessed as minor in comparison to those of other countries, resolving these challenges at the margins could enable Pakistan to emerge as a model for microfinance governance good practice in the developing world.

**Feasibility:** This program would tap into TAF’s competency of mobilizing experts to conduct research and rallying stakeholders for coalition-building. Given the complexity of financial regulation, the feasibility of this program would be enhanced by adding TAF operational capacity or forging partnerships with microfinance associations at the meso level. TAF’s experience and skill in working with organized groups and building coalitions for advocacy would prove useful. Furthermore, the relative openness and flexibility of the financial authorities in Pakistan raises the feasibility of this program. Finally, the existence of a strong microfinance association (PMN) with an excellent relationship with SBP suggests that a strong and successful coalition among relevant stakeholders could be easily formed.

5.1.C. Conclusion

Refining regulation was selected as the most attractive candidate program for TAF for several reasons. First, this program is strongly aligned with traditional TAF programs focused on governance tailored to a specific country. Second, it addresses systemic issues affecting the microfinance sector as well as all relevant players, rather than acute problems which might only pertain to certain individuals or institutions. Furthermore, TAF possesses strong ties to PMN, a well-organized network of microfinance institutions, which will make a great partner for rolling out this program. TAF ties with other players within State Bank Pakistan (SBP) and other leading microfinance institutions will also prove beneficial. Finally, this program can also address some of the disincentives which exist for the transformation of unlicensed

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86 Aban Haq, 2008 (p.1).
88 Eric Duflos, 2007 (p. 20).
MFI to prudentially regulated MFBs (e.g., subsidized loans, tax exemption status).

5.2 Equity Based (Sharia compliant) Microfinance Products

There is significant unmet demand for equity based (Sharia compliant) microfinance services in Pakistan. Currently, a number of providers -- particularly in rural areas -- are unable to achieve full take up of their services, because people are wary of fixed interest contracts that violate Islamic laws. A program to research the potential for, and promote the provision of, such services would likely help improve access to finance.

5.2.A. Program Description

**Goal/Purpose:** To improve utilization of microfinance services and thereby make access to finance more inclusive in Pakistan. This program will ensure the widespread availability of microfinance products that meet the needs of clients who do not want to undertake conventional microfinance contracts. Currently the availability of Islamic microfinance products is very poor and limited to urban areas. This hinders the expansion of access to people that do not want to commit to fixed-interest type contracts. Promotion of equity based (profit-and-loss sharing) models is one way of ensuring more inclusive financial access.

**Outputs:** The outputs for this program will include research findings regarding Islamic microfinance practices at an international level, research findings regarding demand for such products in Pakistan, location of partner microfinance providers (or commercial banks) interested in launching equity based lending programs, and creation of dialogue forums amongst lenders to promote interest in provision of such services.

**Activities:** In order to implement this program, the first step will be to identify the needs of the clients in Pakistan, the specific target groups and the size of the market that would be the beneficiaries of equity-based microfinance services. The next step will be to identify international good practices and lessons in the use of Islamic microfinance that may be applicable to Pakistan. Based on these findings, TAF can engage key stakeholders through awareness programs to explore potential for provision of such products. It can also partner
with microfinance providers or microfinance associations to conduct a pilot project to study the impact of offering equity-based products.

5.2.B. Program Assessment

Impact: The main benefits of this program will be promoting inclusive financial access and encouraging innovation in microfinance services to cater to the needs of existing and potential clients. The quantitative impact of this program in improving access is hard to assess at this stage given the scarcity of data on demand. Based on SBP’s estimates, as many as 25-30 million borrowers are not being catered to by the microfinance market. A recent CGAP study suggests that up to 40 percent of respondents in Muslim countries like Jordan, Algeria and Syria cited religious reasons for not using fixed interest micro loans, and a large proportion of the existing client base also reported that they would prefer to use Sharia compliant products if they became available. According to TAF country representative, potential demand for these products in Pakistan is significant as well. While the impact of such an effort is quantitatively uncertain at this stage, an early success in promoting a feasible equity based model would help establish TAF as a pioneer in innovation of microfinance services. This space is also relatively unexplored: currently, one pilot program exists, run by HSBC Amanah in partnership with an international charity, Islamic Relief.

Feasibility: This program will leverage TAF’s competency of identifying gaps at the local level and improving the responsiveness of systems to the needs of the stakeholders. TAF can utilize its capabilities in research and issue analysis, coupled with knowledge of local needs and customs, to address the challenge of promoting demand-driven microfinance services. The current TAF representative in Pakistan has significant experience working with the microfinance industry at the grass-roots level and understands client needs. Furthermore,

89 Interview with Zahid Elahi, former Pakistani government official and TAF representative, February 2009.
90 Shamshad Akhtar, 2007. These comprise different categories of poor populations as identified by the Pakistan Household Income and Expenditure Survey of 2001.
91 Nimrah Karim, Michael Tarazi, Xavier Reille. *Islamic Microfinance: An emerging market niche*. CGAP Focus Note: 49. 2008, for an overview of Islamic microfinance products, (p. 5).
92 Interview with Zahid Elahi, Program Officer of the Asia Foundation, Pakistan, February 2009.
TAF’s experience working with microfinance in Indonesia (one of the pioneers in Islamic microfinance) would also prove useful in launching this program.

However, TAF may encounter a number of challenges in implementing this program. Identifying best practices may prove difficult, as the international Islamic microfinance market is relatively small and findings are not easily transferable across country or even across narrowly defined regional contexts. It may be difficult to find large partners in the industry since undertaking such a program will involve a lot of uncertainty about profitability. Working with smaller partners may not lead to sufficient impact, given that this project will likely involve a substantial commitment of research and operational resources by TAF.

5.2. C. Conclusion

Despite these potential hurdles this program alternative appears to be the second most attractive candidate, since it will help TAF create an impact in an area that is relatively unexplored. Working towards promotion of Sharia compliant microfinance products will help TAF leverage its comparative advantage in identifying gaps at the local level and making systems more responsive to the needs of stakeholders. It will also be able to utilize existing expertise in the Pakistan country office as well as from its experience in Indonesia.

5.3 Facilitate Transition of Non-Licensed Providers

Non-Licensed MFIs often view microfinance as a social rather than financial service. This belief inhibits these MFIs from offering a full range of client services, limits growth independent of donor support, and may decrease access. In addition, certain regulatory structures provide disincentives to non-licensed MFIs to becoming prudentially regulated microfinance banks. The Asia Foundation could play a role in helping to address these obstacles, leading more non-licensed MFIs to become microfinance banks. This program would involve adjusting current regulatory policies which can be addressed through the Refinement of Microfinance Regulation program discussed earlier.

5.3.A. Program Description

Goal/ Purpose: To increase awareness of the importance and need for financial regulation of
microfinance institutions. To demonstrate to non-regulated microfinance institutions a) the ways in which regulation can increase financial sustainability and maintain social missions, 
b) the problems associated with reliance on external funding and unsustainable operations, 
and to facilitate the transition from NGO-based MFIs to regulated MFBs which offer a full range of services and have the potential to significantly increase microfinance reach.

Outputs: First, research on market integration and financial sustainability of regulated versus non-regulated microfinance institutions in other countries would need to be conducted. Second, training sessions on the benefits of and need for regulation with representatives from regulated MFBs, SBP, or other regulatory and financial experts could be provided for the management of non-regulated MFIs.

Activities: Initially, research on the impacts of the relatively recent shift by some organizations from NGO microfinance providers to prudentially regulated Microfinance Banks (MFBs) needs to be conducted. Currently, six MFBs exist, while the majority of MFIs (21) are NGO-based or government supported. Issues such as financial integration of the microfinance sector, operational sustainability, and reliance on external funding must be further explored. Once research has been conducted TAF could partner with organizations such as State Bank Pakistan (SBP) and Pakistan Microfinance Network to conduct seminars and workshops on regulation and financial sustainability with respect to microfinance. These seminars could focus on the benefits of regulation, in reducing reliance on external support, increasing sector growth, and provision of the full range of financial services to the clients.

5.3.B. Program Assessment

Impact: Based on the size and scale of unregulated MFIs, the potential impact is significant. Currently there are 29 microfinance providers comprised of two commercial banks, six licensed and prudentially regulated Microfinance Banks, and the remaining 21 are unregulated NGOs and Rural Support Programmes. The 21 unregulated microfinance providers make up over three quarters (76%) of borrowers, 88% of savers, and 76% of the
market share in terms of gross loan portfolio. This accounts for around 1.2 million active borrowers. The program would cut across micro, meso, and macro levels as the aim would be to increase financial sustainability at the micro level by implementing the program through microfinance associations and the State Bank at the meso and macro levels respectively. A successful program that brought more microfinance institutions under the regulatory fold would likely increase financial sustainability, and positively affect the growth and impact of the sector in achieving its mission of poverty alleviation.

Efforts to facilitate this process and enhance financial viability are underway. The State Bank is promoting the transition of non-licensed MFIs to regulated microfinance banks and has issued a set of guidelines that outlines the transition process. (see Appendix 4.3.E for a summary of these guidelines) Additionally, the Pakistan Poverty Alleviation Fund (PPAF) has developed a program called Program for Increasing Sustainable Microfinance (PRISM) aimed at increasing the financial sustainability of individual microfinance institutions by offering services such as management support and capacity building. One of the ways to increase financial sustainability may be to facilitate the transition of non-licensed MFIs to licensed microfinance banks by increasing market based funding sources (which can be addressed through refinement of certain prudential regulations), and the promotion of robust and frequent financial reporting.

Feasibility: There are several external barriers to having success in carrying out this type of program: Firstly, the widely held belief that microfinance is primarily a charitable as opposed to a financial service; secondly, the unattractive prospect for non-licensed institutions of forfeiting government support and tax-exempt status when they become regulated; and finally the impacts of the current economic crisis.

The belief in Pakistan that microfinance is primarily a social service has long been the case. Often board members and middle management come from NGO backgrounds and lack financial expertise which is representative of the social service belief. Regarding the second

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94 Aban Haq, 2008 (pp. 1-5).
95 Aban Haq, 2008 (pp.24-25).
96 Eric Duflos, 2007 (pp. 15-22).
barrier, NGOs and Rural Support Programmes receive government subsidized loans through the Pakistan Poverty Alleviation Fund (PPAF) but would lose access to these funds were they to become a licensed MFB. Additionally, MFBs are required to pay income tax, after a five year tax holiday, while unregulated microfinance providers are exempt. Therefore there are a number of disincentives for non-licensed MFIs to transition from an NGO or Rural Support Programme into a prudentially regulated MFB. Finally, the current economic crisis contributed to an increase in inflation of more than 20% in Pakistan and this trend could inhibit the transition from non-licensed MFIs to regulated MFBs.

Internally, TAF is well positioned to take this role as it would entail leveraging existing relationships, building coalitions, and advocacy. TAF could work both with PMN and other local partners to emphasize the importance of being regulated and viewing microfinance as a financial service. At the macro level TAF could also work with SBP to advocate regulatory adjustments which would help facilitate the transition of more licensed MFBs.

5.3.C. Conclusion

Facilitating transition of non-licensed providers was ranked third among our five program candidates due to TAF’s strong competencies in advocacy and coalition building. However, because of challenges relating to feasibility, this program was not ranked as highly relative to the others. Changing a widely held belief by unlicensed MFIs that microfinance is a charitable, rather than financial, service is a difficult process and assessing the impact of this kind of program could prove equally arduous. More importantly, some of the obstacles to facilitating the transition to licensed microfinance bank (e.g., reliance on government support, tax-exemption status) can be incorporated into the Refining Microfinance Regulation program discussed earlier, which could in fact help facilitate the transition of non-licensed banks into prudentially regulated MFBs.

97 Eric Dufoulos, 2007 (pp. 22-23).
98 Maliha Hameed Hussein, 2007 (paragraph 36).
99 Interview with Mr. Suleman G. Abro, CEO of the Sindh Microfinance Network (SMN), February 2009.
5.4 Consumer Financial and Business Literacy

Current and prospective consumers of microfinance services often lack the financial and business literacy necessary to effectively utilize microfinance or participate in the financial system. Therefore, another TAF program option could focus on conducting activities to increase consumer financial and business literacy.

5.4.A. Program Description

Goal/Purpose: Increase financial and business literacy amongst microfinance customers in Pakistan to ensure that current and prospective microfinance customers a) have the financial sophistication to understand the conditions and requirements of the loans they are accepting and do so with prudence, and b) have the minimum skills necessary to effectively run a small-to-medium-sized enterprise.

Outputs: Two primary outputs can help to achieve this purpose. Basic information products can be produced and disseminated on each topic, and training programs can be offered.

Activities: Activities to support these outputs can be considered in rough chronological order. First, research must be conducted to assess what approaches to consumer financial and business education have been attempted in the past, and the success of these methods. For example, “low-touch” financial education through distributing information brochures, though more cost effective, is also believed to be potentially less successful in improving financial literacy. Conversely, “high-touch” in-person training programs tend to be more costly but also yield better results. After considering alternative approaches to consumer education, partnership possibilities should be explored. While TAF may be well-positioned to help develop informational products or training programs, other organizations may be better equipped to roll these programs out. For example, consumer protection organizations, such

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as the Consumer Association of Pakistan, may possess the ability to more easily contact consumers and efficiently scale-up training programs. Once an appropriate partner is identified, TAF must develop the requisite materials, working in tandem with the partner and leveraging findings from research into consumer education best-practices in other domains relevant to financial literacy and small business management. Finally, once suitable materials are developed a pilot program can be launched, with TAF refining the approach as necessary before scaling up.

5.4.B. Program Assessment

**Impact:** With 1.8 million active borrowers and savers in Pakistan, the potential impact of such a program is estimated to be very significant.\(^{101}\) By helping to improve the success of small businesses launched by microfinance clients, a financial and business literacy program could also help to expand the base of borrowers seeking microfinance loans, enabling more people to effectively take advantage of the services microfinance has to offer. However, the urgency of the need must be explored further. While there appears to be consensus that financial literacy in Pakistan could be improved, this need has also been recognized by other organizations. For example, in 2007 Pakistan launched a “financial inclusion strategy” which includes a National Microfinance Strategy jointly developed by the SBP and the Pakistan Microfinance Network. The SBP has also entered into a partnership with the UK’s Department for International Development “to coordinate and help implement this financial inclusion package.”\(^{102}\) While financial literacy is addressed, it is unclear whether this program includes a small business management element.

**Feasibility:** The successful launch of such a program hinges on three factors: experience with educational programs, a strong curriculum in financial education or small business management, and the ability to achieve scale. TAF has spearheaded several educational programs in Pakistan, including development of video-based voter education programs, educational booklets on women’s rights, and anti-trafficking radio segments. While TAF

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does not appear to have worked specifically on the issues of financial literacy or small business management in Pakistan, many other organizations around the world have developed successful programs which TAF could build upon. For example, the organization *Global Financial Education Program* has developed a strong financial education curriculum tailored to the needs of the developing world.\(^\text{103}\) Finally, while many of TAF’s prior educational programs have used a modified “low-touch” approach (i.e., booklets, video and radio), partnerships with other organizations, like the Consumer Association of Pakistan, could greatly enhance the feasibility of this project.

**5.4.C. Conclusion**

Our cross-program assessment ranked Consumer Literacy fourth among the five candidate programs, primarily because some work is already being done on this issue, leaving less room for TAF to have a strong and differentiated impact. Additionally, TAF normally does not operate at the consumer level, and prefers interventions with the potential to more directly yield systemic change. Finally, a program focused on consumer training would require significant investment to reach the scale necessary for major impact.

**5.5 MFI Management Capacity**

Financial expertise and strong business management skills are often lacking at the MFI management and board levels. Managers often come from the NGO sector, with strengths in running social programs, rather than in business or finance. However, given the many similarities of microfinance institutions to formal sector banks, more robust financial and management expertise within MFIs would likely lead to improved MFI sustainability. To address the issue of MFI management capacity, a TAF program could be developed that would do improve managers’ financial literacy and knowledge of corporate governance.

**5.5.A. Program Description**

*Goal/Purpose:* To build MFI management and board financial and management

capacity/expertise, in order to improve corporate governance and financial literacy and ultimate enhance the sustainability and social impact of MFIs.

Outputs: Similar to a consumer financial literacy program, two primary outputs can help to achieve this goal: tailored information products on finance and business management best-practice could be produced and disseminated to MFI management and board members, and relevant training programs covering the same topics could be offered to the same audiences.

Activities: Activities to support these outputs parallel those for development of a consumer financial literacy program, and can be considered in rough chronological order.

First, research must be conducted to assess what (general and MFI-specific) management training approaches have been attempted in the past, and the success of these methods.

Second, after considering alternative approaches, partnership possibilities should be explored. Several organizations are already working successfully to address similar problems. For example, The Global Director Development Circle brings together leading global professional membership organizations for directors to “share expertise in corporate governance and professional director development.”104 In Asia, The Association of Development Financing Institutions in Asia and the Pacific provides training to development banks and other financial institutions through conferences and seminars, as well as training packages (informed by the organization’s research) on a variety of relevant managerial issues.105 In the microfinance sector, a joint venture was recently formed between CGAP and the Open Society Institute: the Microfinance Management Institute, with the objective to disseminate knowledge (including learning/teaching materials) on microfinance business models and management development frameworks.106 These or other organizations could prove valuable partners.

2009).

104 The Global Director Development Circle (GDDC). Official Website: http://www.globaldirectors.org/, (10 February 2009).


Third, once an appropriate partner is identified, TAF must develop the requisite materials, working in tandem with the partner and leveraging relevant research findings. Finally, once suitable materials are developed a pilot program can be launched, with TAF and its partners refining the approach as necessary before scaling up.

5.5.B. Program Assessment

Impact: With 29 MFIs currently operating in Pakistan, the potential impact of such a program is significant - success in this area could also encourage further expansion of existing MFIs as their operations become more successful, thereby enhancing overall program impact.\(^{107}\) Although challenges in this area clearly persist, some work is already being done to improve MFI management capacity. For example, in addition to the Microfinance Management Institute, five of its partners are also playing a role in MFI management education. This includes ACE Consultants which “helps SMEs and microfinance banks to rethink their strategic and operational assumptions and identify winning propositions that assist them in exploiting new opportunities.”\(^{108}\) The non-profit Center for Excellence in Microfinance: Institute of Management Sciences which is a “higher education institution” providing training and consulting services to the microfinance sector.\(^{109}\) The Rural Finance Resource Center National Institute on Banking and Finance provides “technical services including course design, curriculum development and recruitment, selection, conducting training need assessments and research” for the microfinance sector.\(^{110}\) Shorebank International, Pakistan is a non-profit training service provider and consulting firm which offers short training courses and consultative services to MFIs.\(^{111}\) Finally, The Pakistan Microfinance Network is also a partner in Microfinance Management Institute’s initiative, though its precise role in


unclear. Given the amount of attention already focused on management education, the ability for TAF to have a significant impact must be explored further.

**Feasibility:** Similar to a consumer financial and business literacy program, the successful launch of a management capacity-building program hinges on three factors: experience with educational programs, a strong curriculum in financial education or small business management, and the ability to achieve scale. However, unlike a program in consumer education, attaining scale in a management training program may be easier. Although the market for MFI training appears to be more crowded, the audience (MFI managers) is more concentrated and easier to access and aggregate than are individual consumers scattered throughout the region. If a good curriculum can be developed and attractive partnerships can be formed, this could present a relatively easy way for TAF to have a notable impact in improving microfinance governance in Pakistan.

5.5.C. Conclusion

Of the five programs considered, the Management Literacy program was deemed least attractive, primarily because multiple actors are already operating similar programs, leaving less room for substantial Asia Foundation impact.
6. Conclusion and Next Steps

We find that Pakistan appears to be the most appropriate country for a TAF program aimed at improving microfinance governance. After exploring the various challenges at each level of Pakistan’s microfinance system, and developing programs capable of addressing these challenges, we find that two specific programs emerge as most attractive for TAF to pursue with respect to impact and feasibility. These programs are designed to help refine microfinance regulations and to promote equity-based (Sharia compliant) microfinance products.

Moving forward, TAF may want to develop complete Logical Frameworks for each of the two prioritized programs. While we have developed drafts of the Goals, Purposes, Outputs and Activities for each program, we have not developed in detail the other components of the Logical Framework: Measurable Indicators, Means of Verification, and Important Assumptions remain to be developed for each prioritized program. We have just taken initial steps towards developing these other components for the two primary program recommendations (see Appendix 6.1).

Once the Logical Frameworks are completed, the attractiveness of these candidate programs can be assessed in greater depth. While a variety of assessment approaches exist, excellent work has been done by the Harvard Business School, and other institutions to develop criteria for assessing program attractiveness. Appendix 6.2 includes a table synthesizing criteria developed by these experts, and supplemented with input from TAF representatives.112

Our exploration of the microfinance landscape in Pakistan has revealed many important but solvable challenges facing the microfinance sector. Addressing these challenges will enable the microfinance system in Pakistan to better tackle the problem of access to finance, which is one of the root causes of poverty in Pakistan and other parts of the developing world. The

Asia Foundation, with its long history of addressing economic and governance issues in the Asia, is very well positioned to play a meaningful role in improving microfinance governance in Pakistan, and thus to help overcome these various challenges.
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Appendix 1: Policy Issue

1.1. Goals of Microfinance

Advocates of microfinance suggest that microfinance services help to achieve a number of both economic and social goals, including:113

- Alleviation of poverty and promotion of economic investment through encouraging savings and investment
- Financing of small and medium-scale enterprises (SMEs) that are largely underserved by the formal sector
- Preparation of clients for participation in the more formal banking system
- Empowerment of women, who have historically been largely excluded from access to financial capital through the formal banking system because of economic, social, and political barriers.

Not all organizations are designed to achieve each of these goals, with each MFI prioritizing objectives according to their location, structure, budget, clientele, ownership preferences, and other relevant factors. Though many possible goals exist, poverty alleviation remains an objective for most providers. The economic and policy literature shows that microfinance services can be an effective mechanism for poverty reduction; however experts agree that microfinance cannot be regarded as a panacea for poverty alleviation.114 Currently there is a growing emphasis for MFIs to achieve financial sustainability in order to increase outreach (measured in terms scale or the number of clients served and depth of poverty level) and impact (measured in terms of change in socio-economic outcomes of the clients attributable to MFI services). Financial sustainability entails that MFIs can collect loans and cover costs well enough that operations can continue serving existing clients as well as expand, without need for from grants or soft loans from donors or governments. Sustainable MFIs provide reliable access to financial services for the poor and by breaking their dependence on donations and subsidies can commit to long-term and widespread service provision independent of donor trends. Although there has been no systematic evaluation of non-sustainable versus sustainable MFIs in terms of impact, the available evidence suggests that it is possible to reach the poor profitably.115

1.2. Poverty versus Sustainability

Nathaniel Goldberg conducts a comprehensive literature review of the impact of

115 However, there are MFIs that pursue purely social goals since microfinance cannot always be made profitable. In high cost settings, where potential clients are extremely poor and risk-averse or live in remote areas with very low population density, continuing operations may mean relying on subsidies. Whether microfinance is the best use of these subsidies, or whether targeted grants and subsidies are a better way to support poverty alleviation, will depend on evidence about its impact on the clients. This has implications for microfinance governance which are addressed in goals for governance section.
microfinance on poverty and socio-economic outcomes, using a broad sample of impact evaluation studies published from 1988 to 2005. In most of the studies reviewed microfinance helps to increase incomes and lift families out of poverty. However, it is difficult to isolate the directly attributable impact of microfinance on socio-economic outcomes, since a number of social, institutional, political, economic, and cultural factors also affect these outcomes. Thus, there is still a need for rigorous evaluation studies using randomization to help understand how microfinance impacts the lives of its clients.

On the other hand, the experience of MFIs such as ASA in Bangladesh, XAC Bank in Mongolia, CARD in Philippines, and FINCA in Uganda amongst others demonstrates that very poor clients can be reached profitably. Industry level data aggregated by Microfinance Information Exchange (MIX) shows that those NGOs that targeted the poorest clients outperformed the total sample of NGOs reporting to MIX in 2003 in terms of profitability.

More recent analysis of MIX datasets indicate that there is no significant correlation between the operational self sustainability and the proportion of the poorest borrowers served, indicating that a higher percentage of poor borrowers does not necessarily hurt profitability. Although there has been no systematic evaluation of non-sustainable versus sustainable MFIs in terms of impact, the available evidence suggests that it is possible to reach the poor profitably.

1.3. Examples of Microfinance failure

Modern examples of MFI failure help to illustrate the complexity of developing sound governance practices capable of avoiding various possible forms of MFI failure.

The Rise and Fall of Finansol: One noteworthy MFI failure which attracted interest among practitioners and experts was the case of Finansol, a Colombian regulated finance company which was very successful in its first three years of operation. The micro lender grew quickly and had a portfolio of more than 55,000 active clients, $34 million in outstanding loans, and numerous lines of credit. Just one year later it was involved in an operational crisis that put the financial viability of its clients at risk and jeopardized the reputation of the micro financial model. Finansol’s critical errors included: a failure to track multiple loans made to a single client; a high delinquency rate and loan losses, which did not show up in financial statements; accounting errors that independent auditing firms failed to detect; and poor self-governance that included shared membership on the Finansol and Corposol (the NGO which founded Finansol) boards and a concentration of power on both boards. Eventually these

117 Helms, 2006 (p. 47). Note that MIX Market datasets only consist of MFIs reporting data to MIX, and findings should not be generalized to the entire universe of financial institutions serving the poor.
120 C. Vasconcellos, 2003 (p. 33).
issues proved detrimental, especially to the microenterprises that made up Finansol’s client base. The Finansol example is a prototypical case of operational failure which a more sound governance structure may have helped to protect against.

Failure in Bolivian microfinance sector: The case of Bolivian MFI failure in the 90s represents another example where improved governance practices may have helped to mitigate failure. During that period, the government established a wide range of financial sector reforms that improved the level of competition in the microfinance marketplace, thus stimulating the creation of several institutions, including banks, finance companies, and cooperatives. However, the government failed to effectively supervise Bolivian microfinance operations following this initial period of encouragement. Many microfinance clients took advantage of offers of quick and easy credit from a variety of institutions, borrowing from multiple lenders, and often in quantities which exceeded what they could feasibly repay. Eventually excessive debt became a serious problem just as Bolivia suffered an economic slowdown. According to Sergio Navajas, a senior economist with the United States Agency for International Development (USAID) in Bolivia, the main problem in Bolivia was “lax supervision and a need for clearer guidelines in the microfinance sector, which should be provided by governmental financial authorities as well as international financial institutions.”

Appendix 2: Pakistan Country Profile

<table>
<thead>
<tr>
<th>At a glance</th>
<th>People *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surface area (sq. km)</td>
<td>770,880</td>
</tr>
<tr>
<td>Capital</td>
<td>Islamabad</td>
</tr>
<tr>
<td>Currency</td>
<td>Pakistan Rupee</td>
</tr>
<tr>
<td>Population growth rate (2001-2007)</td>
<td>2.3</td>
</tr>
<tr>
<td>Poverty headcount ratio at national poverty line (% of population)</td>
<td>23.2</td>
</tr>
<tr>
<td>Urban population (% of total population)</td>
<td>36</td>
</tr>
</tbody>
</table>

121 C. Vasconcellos, 2003 (p.33).
122 C. Vasconcellos, 2003 (p. 34).
Population, total (millions) 162.39  Life expectancy at birth, total (years) 65
GNI (US $) (billions) 141.00  Mortality rate, under-5 (per 1,000) 97
GNI per capita, (US $) 870  Primary completion rate, total (% of relevant age group) 62
Languages: Urdu, English & regional languages  Ratio of girls to boys in primary and secondary education (%) 78
Religion: Muslim 95%, Other (includes Christian and Hindu) 5%

Key Economic Indicators

<table>
<thead>
<tr>
<th>States and markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth (annual %)</td>
</tr>
<tr>
<td>Time required to start a business (days)</td>
</tr>
<tr>
<td>Doing Business Rank (out of 178)</td>
</tr>
<tr>
<td>Inflation, GDP deflator (annual %)</td>
</tr>
<tr>
<td>Fixed line and mobile phone subscribers (per 100 people)</td>
</tr>
<tr>
<td>Inflation, consumer prices (annual %)</td>
</tr>
<tr>
<td>Internet users (per 100 people)</td>
</tr>
<tr>
<td>Agriculture, value added (% of GDP)</td>
</tr>
<tr>
<td>Roads, paved (% of total roads)</td>
</tr>
</tbody>
</table>

Source: World Development Indicators, 2007. All data is for the year 2007, except where noted otherwise

*These are the most recent estimate (latest year available, 2001-07)

Figures in grey are the most recent estimates from CIA World Factbook for the latest year 2003-2008

Political Structure

President is the head of state, elected by members of the Senate and National Assembly and members of the provincial assemblies. The Prime Minister is appointed by the members of the National Assembly through a vote. Pakistan is subdivided into 4 provinces, 1 territory, and 1 capital territory, with provincial and local governments.

USAID Spending

US assistance is intended to support the government in counter-terrorism activities, economic growth, education, health, good governance, and earthquake reconstruction. Total USAID spending is expected to increase from $0.73 billion in 2007 to $0.8 billion in 2009. (Sub areas of Governance: $55,221, Health: 96,061, Education: $163,509, Economic Growth: $118,859, and Humanitarian Assistance: $50,000)

Microfinance Sector at a glance

<table>
<thead>
<tr>
<th>Classification</th>
<th>No of MFI</th>
<th>Gross Loan Portfolio $158,978,220</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>6</td>
<td>Bank 45.8</td>
</tr>
<tr>
<td>NBFI</td>
<td>1</td>
<td>NBFI 2.6</td>
</tr>
<tr>
<td>NGO</td>
<td>13</td>
<td>NGO 48.4</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>Other 0.78</td>
</tr>
</tbody>
</table>

No of clients 1, 283, 317

Source: MIX Market, 2008

Appendix 3: Asia Foundation Competencies

3.A. Strength of TAF Core Competencies in the Pakistan Office

The strength of these competencies in the Pakistan office can be ranked as follows (with 1 being the most important, 5 being the least important):

- **Project Design and Management** – TAF Pakistan manages large scale as well as small projects. e.g., HRF is a multimillion dollar/year project, while TAF also funds small projects such as Alternative Dispute Resolution (ADR). TAF’s staff is well

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123 Paraphrased from email from Zahid Elahi
positioned to identify local partners with strong capacity regarding specifics project and help TAF’s partner organizations to carry out their activities, reporting, monitoring etc.

• **Technical assistance and Capacity Building** – TAF Pakistan also provides technical assistance/support to partner organizations to strengthen their operations (e.g., Balochistan Policing Project (CPD) and Women's Economic Equality Project (WEEP).

• **Facilitation of Dialogue & Exchanges** – TAF recently held a regional conference on Best Practices for Domestic Election Observation. Senior representatives from various countries attended to share their experiences and lessons learned, promoting greater understanding. A Knowledge Development Forum initiated by TAF, as well as other initiatives, also fall in this category.

• **Country and Issue Analysis and Assessment** - Since TAF has been present in Pakistan since 1953, it has a deep understanding of the complex political, economic and social factors that influence the development progress and policy-making in Pakistan.

• **Research to Inform Programs and Policies** – The Foundation has currently published a study on Drivers of [Economic] Change (see below). It also completed the Hudood Ordinance (a criminological and sociological analysis of the use and application of the Zina Ordinance (relating to the offense of Zina, which forbids extra-marital sexual activity). TAF has also conducted research exploring interest rate differentials in the banking sector. The policy implications have however been limited. On the other hand the Free And Fair Election Network facilitated by TAF continues to have an effect on policies

### 3.B. Programs in Pakistan: Competencies Relevant to Microfinance Governance

Several TAF programs in Pakistan illustrate the capabilities TAF possess which are most relevant to MF:

1) TAF’s *ECI Private Limited* program which establishes “Mobile Business Service Units” for women to bring “business advice to peoples’ doorsteps” demonstrate strong capabilities in training and capacity building.

2) TAF’s *Drivers of Change Study* designed to analyze the underlying systems, approaches, and mechanics that are important for pro-poor growth and development demonstrates TAF’s focus on systemic (rather than acute) problems affecting economics and government.

3) Both TAF’s *Emerging Issues Forum* (hosted to consider US / Pakistan foreign policy relations) and TAF’s *Strategic Policy Assessment* (analyzing drivers of conflict within Pakistan) demonstrate TAF’s deep knowledge of important issues in Pakistan, its strong relationships in the region and its ability to bring the right stakeholders together to affect change.

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Appendix 4: Challenges Facing Pakistan’s Microfinance Landscape

4.1 The Meso Level: Microfinance Associations

4.1.A. Services provided by MFAs:

- **Networking:** Providing a forum for informal exchange amongst MFIs (e.g., providing “insights into the working procedures” of other MFIs).{125}

- **Information collection and dissemination:** Including serving as a resource centre, compiling statistics, hosting workshops and conferences, providing internet and email platforms, and providing training. Many of these activities remain focused on disseminating “international best practice”.{126}

- **Public Relations:** Public Relations can make stakeholders more aware of, e.g., the public benefits and needs of the industry, and can create public pressure for government/donor support for MF. It can also increase prospective clients’ awareness of MFIs and inform them about, e.g., legislation, supervision, etc.{127}

- **Lobbying/Advocacy:**{128} MFAs work on behalf of their members to “influence policies and resource allocation in favor of their members.” They serve as an intermediary between MFIs and the government, regulatory authorities and other stakeholders (e.g., donors, other microfinance organizations, commercial banks, service providers, education centers, auditing associations, etc.).{129}

- **Consultancy:** Direct consulting is generally too time-consuming for MFAs with limited resources. It is also more formal than other consulting because it is assumed to reflect the perspectives of all of the MFA members. Given this, MFAs tend not to consult directly, but may help design, coordinate and supervise these services. Also, similar to lobbying, MFAs may serve in an advisory capacity to public bodies.{130}

- **Training:** MFA training works with different groups within the constituent MFIs (senior management level and support staff, midlevel staff, and operational staff) to train them on issues as diverse as business planning and budgeting; monitoring, evaluation and impact assessment; internal audit and control; communication and writing skills; and community mobilization).{131}

- **Technical and organizational assistance:** Unlike training, technical assistance (TA) requires “longer-term, in-depth, on-the-job provision of know-how”.{132} Due to its intensive nature, few MFAs are well-positioned to provide TA, though experts suggest that MFAs could play a meaningful role in channeling/supervising donor-sponsored TA initiatives.

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{125} Roland Gross, 2003 (p. 33).
{126} These functions can overlap with other services provided by MFAs, such as training, public relations and awareness-raising, or lobbying/advocacy. Source: Roland Gross, 2003 (p. 34).
{128} Lobbying is generally understood as (often discreet) activities that serve internal clientele only, whereas advocacy is based a broader, more overt notion. Source: Roland Gross, 2003 (p. 38).
{130} Roland Gross, 2003 (p. 41).
{131} Roland Gross, 2003 (p. 41).
{132} Roland Gross, 2003 (p. 45).
- **Innovation generation and dissemination:** Like TA, innovation (e.g., of new microfinance products) is complicated and can require deep expertise. Because MFAs lack “practical knowledge and day-to-day contact with clients and their needs”, they are often considered better suited to disseminate knowledge regarding innovation, rather than spearhead the innovations themselves.\(^{133}\)

- **Credit information bureaus:** Credit bureaus aim to identify credit defaulters in order to “avoid overlapping credits and keep the defaulting risk low”. In some cases MFAs have attempted to develop such services on a regional level, while in other instances they have simply helped to facilitate credit bureaus (e.g., by encouraging the harmonization of creditor data across the industry).\(^{134}\)

- **Refinancing MFIs:** Most MFAs do not provide MFIs with access to loanable funds, though some may, e.g., facilitate contact between suppliers (e.g., banks) and MFIs or prepare their members regarding how to apply for funds.\(^{135}\)

- **Standards, regulation and supervision:** Most MFAs are active in developing standards and norms, either independently or in collaboration with government efforts. The German development group GTZ identifies eight activities which MFAs may perform, ranked according to the degree of MFA intervention required:
  - Establishing codes of conduct (generally non-binding but with a strong signaling effect)
  - Establishing performance standards and benchmarking (e.g., with support of international donors, e.g., CGAP or SEEP)
  - Establishing awards for best practice, and publicizing MFI performance
  - Establishing norms of competition
  - Supervising member MFIs (according to self-set standards)
  - Supervising member MFIs on behalf of the supervising authorities
  - Supervising both members and non-members (i.e., acting as a specialized auditor for MFIs)
  - Obligating that MFIs become members in MFAs (thus enhancing supervisory power)

However, many of these more invasive roles reveal clear conflicts (i.e., regulation of MFIs by MFAs is compromised by the fact that MFAs are member-controlled associations). A strong supervisory role for MFAs is generally limited by this conflict, as well as the “lack of effective sanctions and lack of supervision capacity.”\(^{136}\)

4.1.B. **MFI Members of the Pakistan Microfinance Network.**\(^{137}\)

- First MicroFinanceBank Ltd. (FMFB)

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\(^{133}\) Roland Gross, 2003 (p. 46).
\(^{134}\) Roland Gross, 2003 (p. 46-47).
\(^{136}\) Roland Gross, 2003 (p. 53).
\(^{137}\) The Pakistan Microfinance Network, *Microfinance Connect.*
• Development Action for Mobilization and Emancipation (DAMEN)
• Kashf Foundation
• National Rural Support Programme (NRSP)
• Orangi Pilot Project (OPP)
• Sarhad Rural Support Programme (SRSP)
• Sindh Agricultural & Forestry Workers' Cooperative Organization
• Sungi Development Foundation
• Taraqee Foundation (TF)
• Thardeep Rural Development Programme (TRDP)
• Punjab Rural Support Programme (PRSP)
• The Bank of Khyber (BOK)
• ORIX Leasing Pakistan Ltd.
• Rozgar MicroFinance Bank
• Community Support Concern
• Akhuwat
• Khushhali Bank
• Tameer Microfinance Bank
• Pak Oman Microfinance Bank
• Asasah

4.2 The Micro Level: Microfinance Institutions

Pakistan Microfinance Sector Operational Self-Sufficiency

<table>
<thead>
<tr>
<th>Name</th>
<th>Operational Self-Sufficiency (%)</th>
<th>Date Reported</th>
<th># of Active Borrowers (30 - Sept.)</th>
<th>Market Share (% of Active Borrowers)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MFBs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Khushhali Bank (KB)</td>
<td>79.7</td>
<td>12/31/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Network MicroFinance Bank Ltd. (NMFB)</td>
<td>46.04</td>
<td>12/31/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pak-Oman Microfinance Bank Ltd. (POMFB)</td>
<td>60.44</td>
<td>12/31/07</td>
<td></td>
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</tr>
<tr>
<td>Rozgar Microfinance Bank Ltd. (RMFB)</td>
<td>N/A</td>
<td>no info</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tameer Microfinance Bank Ltd. (TMFB)</td>
<td>46.31</td>
<td>12/31/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The First MicroFinance Bank Ltd. (FMFB)</td>
<td>90.43</td>
<td>12/31/07</td>
<td>185,202</td>
<td>9.9</td>
</tr>
<tr>
<td><strong>SMFIs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Akhuwat</td>
<td>73.13</td>
<td>6/30/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asasah</td>
<td>66.15</td>
<td>6/30/07</td>
<td></td>
<td></td>
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<tr>
<td>Kashf Foundation</td>
<td>164.1</td>
<td>12/31/07</td>
<td>322,669</td>
<td>17.2</td>
</tr>
<tr>
<td>Orangi Pilot Project (OPP)</td>
<td>109.7</td>
<td>6/30/07</td>
<td></td>
<td></td>
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<tr>
<td>Sindh Agricultural and Forestry Workers Cooperative Organization (SAFWCO)</td>
<td>80.89</td>
<td>6/30/07</td>
<td></td>
<td></td>
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<tr>
<td><strong>RSPs</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>---</td>
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<td>---</td>
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<tr>
<td>Lachi Poverty Reduction Project (LPRP)</td>
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<tr>
<td>National Rural Support Programme (NRSP)</td>
<td>101.18</td>
<td>6/30/07</td>
<td>604.776</td>
<td>32.3</td>
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<td>Punjab Rural Support Programme (PRSP)</td>
<td>65.75</td>
<td>6/30/07</td>
<td>76,938</td>
<td>4.1</td>
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<tr>
<td>Sarhad Rural Support Programme (SRSP)</td>
<td>15.36</td>
<td>6/30/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thardeep Rural Development Programme (TRDP)</td>
<td>40</td>
<td>6/30/07</td>
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<tr>
<td><strong>NGOs</strong></td>
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<tr>
<td>Centre for Women Cooperative Development (CWCD)</td>
<td>no info</td>
<td>no info</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Community Support Concern (CSC)</td>
<td>87.35</td>
<td>6/30/07</td>
<td></td>
<td></td>
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<tr>
<td>Development Action for Mobilization and Emancipation (DAMEN)</td>
<td>108.69</td>
<td>6/30/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jinnah Welfare Society (JWS)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Narowal Rural Development Programme (NRDP)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Organization for Participatory Development (OPD)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural Community Development Society (RCDS)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Save the Poor (STP)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sindh Rural Support Program (SRSP)</td>
<td>15.36</td>
<td>6/30/05</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sungi Development Foundation (SDF)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Swabi Women’s Welfare Society (SWWS)</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taraqee Foundation (TF)</td>
<td>27.97</td>
<td>6/30/06</td>
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<td></td>
</tr>
<tr>
<td><strong>CFIs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ORIX Leasing Pakistan Ltd. (OLP)</td>
<td>121.46</td>
<td>6/30/07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank of Khyber (BOK)</td>
<td>40.89</td>
<td>12/31/05</td>
<td>377,486</td>
<td>20.2</td>
</tr>
</tbody>
</table>

Operational Self Sufficiency = Financial Revenue (Total)/ (Financial Expense + Loan Loss Provision Expense + Operating Expense)  
Source: MIX Market, 2008
4.3 The Macro Level: Microfinance regulations

4.3.A. General Approach to Regulations by Institutions Type

The licensing, regulation and supervision of MFBs established/to be established under MFIs ordinance 2001 has been entrusted to State Bank of Pakistan under MFBs legal framework. No institution/person could commence operations as microfinance bank unless granted license by the State Bank under section 13 of the Microfinance Institutions Ordinance.

Microfinance and Microfinance Banks/Institutions-Definition
The State Bank defines microfinance “as the financial services needs including credit, savings, insurance and payment transfers etc, of the poor households and their micro enterprises,” and microfinance institutions as “specialized financial institutions, which cater to the financial services needs of the poor.” For the purpose of regulation those institutions offering microfinance services and licensed by the SBP will be referred to as Microfinance Banks/Institutions.

Licensing and establishment requirements
The State Bank defines the following capitalization requirements for establishment of MFBs:

- Capitalization:

4.3.B. Criteria for Establishment of Microfinance Banks/Institutions (MFB/MFI)

The licensing, regulation and supervision of MFBs established/to be established under MFIs ordinance 2001 has been entrusted to State Bank of Pakistan under MFBs legal framework. No institution/person could commence operations as microfinance bank unless granted license by the State Bank under section 13 of the Microfinance Institutions Ordinance.

Microfinance and Microfinance Banks/Institutions-Definition
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For the purpose of regulation those institutions offering microfinance services and licensed by the SBP will be referred to as Microfinance Banks/Institutions.

Licensing and establishment requirements
The State Bank defines the following capitalization requirements for establishment of MFBs:

- Capitalization:

138 Eric Duflos, 2007 (p.41).
Minimum paid-up capital and that 51% should be subscribed by the promoters;
- National MFBs - minimum paid-up capital of Rs.500 million,
- Provincial MFBs - minimum paid-up capital of Rs.250 million,
- Regional MFBs – minimum paid up capital of Rs 150 million,
- District MFBs - minimum paid-up capital of Rs.100 million
- Public flotation of share capital permitted through A rated underwriting firms
- Foreign investment allowed in accordance with the Government of Pakistan’s Foreign Investment Policy

It also specifies eligibility criteria and conditions for sponsors, directors, board members and CEO such as the minimum number, their net worth, and provisions for disqualification.

**Steps to obtain a license to operate as a MFB**
1. Commitment Letters by Sponsors/Directors/President
2. Completed application forms
3. Supplementary documents to be submitted with the application (feasibility study, organization structure details, CVs of CEO and Senior management team, short term and long term business plans)
4. Application Processing Fee
5. Grant of License
6. Commencement of Business, no later than six months of the grant of license
7. Compliance with Legal Framework & Prudential Regulations for MFBs
(Adapted from Criteria and Conditions For Grant Of License For Establishing Microfinance Banks/Institutions, State Bank Pakistan)

**4.3.C. CGAP Consensus Guidelines**

Followings are specific recommendations on each regulation issue from CGAP Consensus Guidelines.

**Prudential regulations**

*Who should these regulations apply to?*

Prudential regulations should ideally apply to specialized MFIs, microfinance operations in commercial banks or finance companies and unsecured lending by financial cooperatives. A prudential regulation should not be imposed on “credit-only” MFIs that merely lend out their own capital or whose only borrowing is from foreign commercial or non-commercial sources or from prudentially regulated local commercial banks.

*Minimum Capital Requirement*
The trade-offs are involved in setting minimum capital requirements for MF. The lower the minimum capital, the easier it will be to obtain new licenses and the more entities will have to be supervised. The higher, the minimum capital, the fewer entities will operate and the less access to capital people will have. Moreover, higher minimum capital requirement lead to greater market stability. Thus it would seem reasonable to allow flexible adjustment depending on regulatory experience of the authorities, demands for licenses, and practicalities of microfinance supervision.

Capital Adequacy

It is controversial whether the capital adequacy requirements for MFIs should be higher than those applied to commercial banks. Volatility of MFI portfolio, high operational costs, relatively inexperienced management and lack of supervisory expertise over MFIs demand more stringent capital adequacy rule for MFIs. On the other hand, applying higher requirements to MFIs lowers returns on equity in micro-lending and delinquency rates of well-managed MFIs are actually lower than those of commercial banks. Applying capital adequacy requirements to financial cooperatives presents more complicated challenge as their capitals are based on member money which can be withdrawn anytime at members’ convenience. The Guideline suggests that limiting members’ right to withdraw capital when capital of cooperatives drop to dangerous level. Or these cooperatives may be required to build up a certain level of institutional capital (e.g., retained earnings).

Unsecured Lending Limits and Loan-Loss Provisions

Regulations limiting unsecured lending to certain portion of a bank’s equity should not be applied microcredit. With such rules, it would be practically impossible for MFIs to leverage its equity with deposits or borrowed money.

Loan Documentation

Commercial banks are required to generate loan documentation including collateral registration, financial statements of borrowers’ businesses or evidence of formal registration of such businesses. These rules should be waived for micro-sized loans.

Frequency and Content of Reporting

Reporting financial position should be simpler for MFIs. Reporting can be substantial burden on MFIs which are often located in rural area and specialize in very small transactions.

Reserves against Deposits

Requirement to maintain certain portion of deposits as reserves raise minimum deposit size that MFIs can manage profitably. This needs to be factored into deciding reserves requirements.

Ownership Suitability and Diversification Requirements

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145 Christen Robert Peck, 2002 (pp.19-20).
146 Christen Robert Peck, 2002 (pp.20-21).
147 Christen Robert Peck, 2002 (pp.20).
148 Christen Robert Peck, 2002 (pp.22).
149 Christen Robert Peck, 2002 (pp.22).
150 Christen Robert Peck, 2002 (pp.22-23).
Most of banking regulations control the nature of permissible shareholders as well as the minimum number of shareholders and a maximum percentage of ownership for any shareholder. While these rules serve legitimate prudential purpose, they sometimes block NGOs to start microfinance business. The Guideline recommends that the licensing agency consider the particular situation of microfinance applicants and waive ownership suitability and diversification requirements on a case-by-case basis.

**Non-prudential regulatory issue**

*Permission to Lend*

CGAP guidelines explains “Where the legal power to lend is either ambiguous or is prohibited to institutions that are not prudentially licensed, a strong justification exists for introducing non-prudential regulations that explicitly authorizes non-depositary MFIs to lend.” They also recommend “regulations of permission to lend should be relatively simple”.

*Consumer Protection*

Protection against abusive lending and collection practices and truth in lending are the two important consumer protection issues relevant to MF. First, abusive lending happens, as lenders often make loans without examining of the borrower’s repayment capacity and recollect loans through unacceptable loan collection methods. CGAP guideline suggests that “this needs protection but does not necessarily require prudential supervisory authority”. Second, truth-in-lending rule means “disclosing lenders’ effective rates to loan applicants.” There are upside and downsides of applying this rules to microfinance lending. It can help consumers better informed while the public prejudice against seemingly exploitative interest rates might jeopardize microfinance operations given the inevitably high interest rates of MF.

*Fraud and Financial Crime Prevention*

CGAP guidelines suggest that “Concerns about securities fraud and abusive investment arrangements such as pyramid schemes, and money-laundering concerns are relevant to MF.” They continue to recommend that the existing anti-fraud and financial crime regulations should apply to MFIs. There is no need to create new rules for the MFIs.

*Credit Reference Services*

It means “collecting information on clients’ status and history with a range of credit sources and allowing lenders to access such data base.” Lack of access to this database allows excessive lending when MFIs compete with each other for customers. However, CGAP guidelines also suggest that the need for the government to create a credit bureau varies from country to country.

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151 Christen Robert Peck, 2002 (pp.7).
152 Christen Robert Peck, 2002 (pp.7).
153 Christen Robert Peck, 2002 (pp.7).
154 Christen Robert Peck, 2002 (p.8).
155 Christen Robert Peck, 2002 (p.9).
156 Christen Robert Peck, 2002 (p.9-10).
Interest Rate Limits
Guideline cautions that regulatory attempts to cap interest rates are often led to interest rates that are not high enough to allow the development of sustainable microcredit because of the political backlashes.

Limitations on Ownership, Management, and Capital Structure
The guideline indicates the problem of limitation on foreign investment. As microfinance business relies on international sources, such limitation can be significant hurdle to microfinance operation.

Tax and Accounting Treatment of Microfinance
There are huge controversies over tax policies with respect to MFIs but the guideline suggests some starting points for regulations. The Guidelines recommend that “with respect to taxes on financial transactions, favorable transaction tax treatment should be based on the type of transactions regardless of institutional types.” With respect to profit tax, not-for-profit NGO MFIs need to be exempted from profits tax like other NGOs. (Adapted from CGAP Consensus Guidelines, 2002)

4.3.D. Prudential Regulations of Microfinance Banks in Pakistan
The following are the main provisions of the “prudential regulations” issued by SBP:

1. Capital Requirements
MFBs must observe the minimum capital requirements specified according to the area of operation. They must maintain a minimum capital adequacy ratio of 15 percent of risk weighted assets; applied weights are delineated in Prudential Regulations, Annex A

2. Cash Reserve & Liquidity
MFBs must maintain cash reserve equivalent to not less than 5 percent of Time and Demand Liabilities in a current account opened with the State Bank or its agent, and liquidity equivalent to at least 10 percent of time and demand liabilities in the form of liquid assets i.e. cash, gold and unencumbered approved securities

3. Maximum Loan Size
The maximum loan size per borrower is fixed at Rs.150,000. At least 80% of loan portfolio amount of an MFB should be within the loan limit of Rs. 100,000 or below. The MFB must perform due diligence and formulate appropriate policies to ascertain the repayment capacity of the borrower

158 Christen Robert Peck, 2002 (p.11).
159 Christen Robert Peck, 2002 (p.11).
4. Maximum Exposure of a borrower from MFBs / MFIs / Other Financial Institutions / NGOs
The total exposure of its clients from banks / MFIs / MFBs / Other Financial Institutions / NGOs is capped at Rs.150,000 in aggregate. For verification, MFBs can obtain a certificate from the clients regarding borrowings from banks and other MFIs/MFBs/NGOs.

5. Depositor Protection Fund
The MFB are required to maintain a Depositors’ Protection Fund or scheme for the purpose of mitigating risk of its depositors. The MFB shall credit not less than 5% of its annual profit after taxes to this fund.

6. Pricing of microfinance Products and Services
The MFB are required to “implement appropriate pricing policies, which ensure access to affordable financial services to the poor as well as operational and financial sustainability of MFB.”

7. Disclosure of Basic Terms & Conditions of Financial Products
MFBs must disclose the annual percentage rates for loans and deposits in written and verbal form. MFBs shall also display important terms and conditions of their products in visible locations at branch sites.

8. Classification of Assets and Provisioning Requirements
(a) Loans & Advances
All loans or advances that are over due for 30 days or more shall be classified as Non-Performing Loans (NPLs). The regulations further state that, “the unrealized interest / profit / mark-up / service charges on NPLs shall be suspended and credited to interest suspense account.

Classification of NPLs:
   i. **Substandard**: loans in arrears (payments/installments overdue) for 30 days or more but less than 90 days
   ii. **Doubtful**: loans in arrears (payments/installments overdue) for 90 days or more but less than 180 days
   iii. **Loss**: loans in arrears (payments/installments overdue) for 180 days or more (MFBs shall maintain a Watch List of all accounts delinquent by 5 – 29 days. However, such accounts may not be treated as NPL for the purpose of Classification / Provisioning.)

Provisioning Requirements:
   i. **General Provision**: The MFB shall maintain a General Provision equivalent to 1.5% of the net outstanding advances (advances net of specific provisions).
   ii. **Specific Provisions**: In addition to the general provision, the MFB shall make specific provisions against NPLs at the following rates:
      a. **Substandard**: 25% of outstanding principal net of cash collaterals
      b. **Doubtful**: 50% of outstanding principal net of cash collaterals

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162 State Bank Pakistan, 2007 (p.3).
c **Loss**: 100% of outstanding principal net of cash collaterals.

(MFB shall undertake “Classification and Provisioning” exercise at the end of every month. The MFB at their discretion may also apply more stringent classification and provisioning criteria for NPLs)

**Rescheduling / Restructuring of loans**

The MFB shall reschedule / restructure the NPLs as per the policy approved by their Board. The rescheduled/restructured loans shall, however, remain classified unless serviced regularly for 6 months.

**Writing-off Non-Performing Loans (NPLs)**

All Non-Performing Loans (NPLs) shall be written off, one month after the loan is classified as “Loss”, this shall, however, not extinguish the MFBs’ right of recovery of such written-off loans.”\(^{163}\)

(b) **Investments and Other Assets**

All investments should be valued on mark-to-market basis, subjective valuation in accordance with generally accepted accounting standards permitted where no market value exists.

9. **Investments of Funds**

The regulations allow MFB’s to invest their surplus funds in Government Securities, ‘A’ rated debt securities and units of those Mutual Funds which maintain their investment portfolio in fixed income securities or money market instruments.

10. **Restrictions on certain types of transactions**

MFBs are prohibited from dealing in foreign exchange, real estate (except for MFB’s own use), speculation, or creating a floating charge on the MFB’s assets.

11. **Record-keeping, auditing, reporting and disclosure**

**Reporting**: MFBs must submit bi-monthly statement of affairs to the SBP, quarterly balance sheets and other financial statements, annually audited financial statements.

**Credit rating**: Required for all MFBs within 3 years of grant of license or 1 year of commencement of deposit mobilization, whichever is earlier.

**Disclosure**: Annual audited financial statements must be published and available for public circulation.

12. **Standards for ownership and officers**

Board Members and CEOs must fulfill certain standards of personal integrity and honesty, as specified in Annex B of the Prudential Regulations. They must have appropriate qualifications and experience in fields such as microfinance, poverty alleviation, law, banking, technology, business management etc. Further criteria for size and composition of the Board are also specified, for e.g., the minimum size of the board is seven members (five for unlisted MFBs), number of members from the same family can not exceed 25 percent, no more than \(\frac{1}{4}\) of the Directors can be paid officers of the MFB, members of political parties are prohibited etc.

\(^{163}\) State Bank Pakistan, 2007 (pp.2-3).
Although NGO-MFIs & RSPs have been the major players in Pakistan’s Microfinance Sector since 1980s, their outreach levels remained modest over the years. In 2005, the SBP recognizing the need to assist the integration of non-bank MFIs into the formal financial sector issued a set of transformation guidelines. These guidelines provide a framework for those NGO-MFIs/RSPs/Cooperatives having an interest and the required capacity to transform into formal Microfinance Banks. They cover three main areas:

1. Decision to go for transformation based on organizational objectives and interest, and evaluation of costs and benefits.
2. Independent institutional assessment of capacity and advisability to transform; based on financial position, governance structure, human resources, accounting, control and other support systems.
3. Meeting the licensing criteria for establishing Microfinance Banks/Institutions that allows NGOs/RSPs/Cooperatives/other programs having potential and capacity to contribute up to 50% of the required capital in the form of credit and other assets portfolio subject to review by independent auditors.

Appendix 5: Microfinance Governance Challenges and Program Alternatives

Table 3 provides a summary of our analysis of the various program alternatives, ranked from most to least desirable. The program rankings are (1) refinement of MF regulations, (2) promotion of equity-based MF products, (3) transition of non-licensed providers, (4) consumer financial literacy and (5) management financial literacy. The table includes the goal as well as key points related to the program’s potential impact and feasibility.

Table 3: Assessment of Program Alternative

<table>
<thead>
<tr>
<th>Program</th>
<th>Goal</th>
<th>Impact</th>
<th>Feasibility</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rank 1:</strong> Refinement of MF Regulations</td>
<td>Create a more enabling financial system</td>
<td>• Improve operating environment for regulated MFI&lt;br&gt;• 8 regulated MFIs cover 34% of borrowers&lt;br&gt;• Spill-over effects to clients and non-regulated MFIs</td>
<td>• Leverages TAF’s competencies (research, mobilizing experts, coalition building)&lt;br&gt;• Openness and flexibility of Pakistani financial authorities&lt;br&gt;• Excellent PMN relationships with SBP</td>
</tr>
<tr>
<td><strong>Rank 2:</strong> Promotion of Equity-Based MF Products</td>
<td>Improve utilization of microfinance services and increase access to finance</td>
<td>• Likely to tap large, currently excluded market segment&lt;br&gt;• 25-30M potential Islamic microfinance customers in Pakistan&lt;br&gt;• ~40% of respondents in Muslim countries cite religious reasons for not using fixed interest microloans&lt;br&gt;• Only one MFB and one pilot program involved in this area</td>
<td>• Leverages Asia Foundation capabilities&lt;br&gt;• Experience working with microfinance in Indonesia&lt;br&gt;• Difficult to identify good practices&lt;br&gt;• May be difficult to find partners given uncertain profitability</td>
</tr>
<tr>
<td><strong>Rank 3:</strong> Transition of Non-Licensed Providers</td>
<td>Increase awareness of the importance and need for financial regulation of microfinance institutions</td>
<td>• 21 of 29 MFIs are unlicensed (covering more than 75% of borrowers)&lt;br&gt;• Likely to improve the financial sustainability of individual providers</td>
<td>• Leverages TAF’s strengths in coalition building and advocacy&lt;br&gt;• Potential partnerships with SBP and PMN&lt;br&gt;• Difficult to change providers’ firmly held beliefs about the social-service nature of microfinance&lt;br&gt;• Financial (e.g., tax) disincentives for providers to become regulated&lt;br&gt;• Spill-over effects of current economic crisis, high interest rates may make transition even less likely</td>
</tr>
<tr>
<td><strong>Rank 4:</strong> Consumer Financial Literacy</td>
<td>Increase financial literacy amongst microfinance customers in Pakistan through educational programs</td>
<td>• Potential to impact Pakistan’s 1.8M active borrowers and savers&lt;br&gt;• However, many organizations are already addressing this challenge</td>
<td>• Many strong potential partner organizations with experience developing educational programs&lt;br&gt;• Strong curriculum already available&lt;br&gt;• Achieving scale could prove difficult given hard-to-reach customer base</td>
</tr>
<tr>
<td><strong>Rank 5:</strong> Management Financial Literacy</td>
<td>Build MFI management and board capacity by improving corporate governance and financial literacy</td>
<td>• Potential to impact all 29 MFIs&lt;br&gt;• Success could encourage growth in the number of MFIs&lt;br&gt;• Strong leverage: improving MFI operations will have trickle-down effects for clients</td>
<td>• Many strong potential partner organizations with experience developing MFI management training programs&lt;br&gt;• Strong curriculum already available&lt;br&gt;• Easy to attain scale given limited number of MFIs</td>
</tr>
</tbody>
</table>
However, many organizations are already addressing this challenge.

Appendix 6: Next Steps

6.1 Logical Framework for Selected Alternatives

The following logical frames are designed as a first draft to be developed further with by TAF program and country experts.

Program Alternative 1: Refinement of Microfinance Regulations

Overall, Pakistan has a sound regulatory framework and significant support from the policy makers towards the needs of the industry. Despite these positive aspects, certain regulations have been identified as limiting the growth potential of the microfinance banks. In particular, caps on loan sizes, stringent loan loss provisioning requirements, exclusion from “scheduled bank status”, bar on transacting in foreign exchange, and limited options for investment of surplus funds are some prudential regulations that have been identified as restricting the expansions of licensed providers.

In addition there is a lack of strong, sustainable institutions in the non-licensed sector in Pakistan. As our research has pointed out, microfinance in Pakistan has been largely conceived as a social rather than a financial service, and thus sustainability has not been regarded as an important goal amongst the non-licensed providers. Some regulations at the macro level such as provision of subsidized funds by the government and tax status of licensed providers have created further disincentives for transformation of non-licensed providers to prudentially regulated providers.

The following table outlines the logical framework that can be adapted from developing this program further:
### Program Alternative 1: Refinement of Microfinance Regulations

<table>
<thead>
<tr>
<th>Goal</th>
<th>Measurable Indicators</th>
<th>Means of Verification</th>
<th>Important Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Create a more enabling financial system in order to achieve the financial sustainability of MF providers in Pakistan</td>
<td>Financial sustainability</td>
<td>Data on total asset, financial and operational self-sufficiency, average loan size etc.</td>
<td>Financial sustainability should be the main goal of MF providers</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Purpose</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fix the limitations in current regulations</td>
<td>Subsidize credit delivery</td>
</tr>
<tr>
<td>GoP should not provide microcredit directly to clients</td>
<td>Interest rates above market level</td>
</tr>
<tr>
<td></td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Outputs</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Research on specific alternative regulations</td>
<td>Number of stakeholders involved</td>
</tr>
<tr>
<td>Find a strategy to advocate regulatory changes</td>
<td>Adaptation of new regulation</td>
</tr>
<tr>
<td>Involve key stakeholders including financial authorities</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Identify and target the current limitations of regulations in Pakistan</td>
<td>Number of experts contacted</td>
</tr>
<tr>
<td>Partner with financial experts</td>
<td>Regulatory research</td>
</tr>
<tr>
<td>Create a partnership with key stakeholders and governmental authorities</td>
<td></td>
</tr>
</tbody>
</table>

### Program Alternative 2: Equity Based (Sharia compliant) Microfinance Products

Islamic finance, also called Sharia compliant finance, refers to financial services which
respect Islamic legal principles. These include:¹⁶⁵

- Conventional interest is not allowed, on loans or savings, as a fixed return without sharing any risk, is considered unjust.
- Muslims cannot profit from activities considered immoral. For example, investing in casinos, pornography, or weapons of mass destruction is not allowed.
- Muslims are not allowed to sell what they do not own (“short selling” is impermissible).
- In sales contracts, the product or service that is bought or sold must be clear to both parties.

Microfinance is fundamental for the Islamic finance industry to meet the requirements of the Muslim population, much of which is poor. Islamic finance focuses on financing tangible economic activity (as opposed to financial speculation, for example) therefore the Sharia promotes savings and investment, rather than excessive consumer debt.

In particular, because many Muslims only have interest-based savings accounts which do not respect their principles, there has been less incentive for them to have bank accounts at all; having Sharia compliant savings accounts will help mobilize deposits and promote a culture of savings as well as contribute to economic development.¹⁶⁶ The following table outlines the logical framework that can be adapted for developing this program further:

### 6.2 Criteria for Further Assessment of Program Alternatives

Moving forward, TAF may want to assess the attractiveness of these candidate programs in

<table>
<thead>
<tr>
<th>Program Alternative 2: Equity Based (Sharia compliant) Microfinance Products</th>
<th>Measurable Indicators</th>
<th>Means of Verification</th>
<th>Important Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Goal</strong></td>
<td>• Improve utilization of microfinance services&lt;br&gt;• Increase access to finance in Pakistan</td>
<td>• Number of clients reached relative to benchmark&lt;br&gt;• % of population using Islamic MF services</td>
<td>• Customized surveys</td>
</tr>
<tr>
<td><strong>Purpose</strong></td>
<td>• Ensure the widespread availability of microfinance products&lt;br&gt;• Offer Islamic microfinance services&lt;br&gt;• Promotion of equity based (profit and loss sharing) model</td>
<td>• % of Islamic MF products on the total MF products&lt;br&gt;• Conventional interest not allowed, on loans or savings, as a fixed return (without sharing any risk)</td>
<td>• Impact Assessment</td>
</tr>
<tr>
<td><strong>Outputs</strong></td>
<td>• Research on Islamic microfinance practices&lt;br&gt;• Research on internal Pakistani demand&lt;br&gt;• Contact and build relationships with Microfinance providers interested</td>
<td>• Data comparison (loan size, financial sustainability, etc) between Pakistan and similar Islamic MFIs in other countries</td>
<td>• Impact Assessment</td>
</tr>
<tr>
<td><strong>Activities</strong></td>
<td>• Identify and target the needs of the clients in Pakistan&lt;br&gt;• Adapt MF Islamic practices to Pakistan&lt;br&gt;• Engage key stakeholders and conduct a pilot project</td>
<td>• Number of key stakeholders involved&lt;br&gt;• Offer targeted products</td>
<td>• Market research on the demand side&lt;br&gt;• Analysis of the demand based by age, location, socio economic status&lt;br&gt;• Type and number of key stakeholders involved&lt;br&gt;• Securitization of Shariah-compliant microfinance portfolios</td>
</tr>
</tbody>
</table>
greater depth. While a variety of assessment approaches exist, excellent work has been done by scholars at Harvard and other institutions to develop criteria for assessing program attractiveness. The following table synthesizes criteria developed by these authors, and is supplemented with input from TAF representatives.167

<table>
<thead>
<tr>
<th>Focus Area</th>
<th>Criteria</th>
<th>Explanation</th>
</tr>
</thead>
</table>
| **Internal TAF Criteria** | Relevance to TAF’s mission | • Alignment with TAF mission  
• Alignment with TAF’s short term/long term strategy |
|              | Linkages with other TAF’s activities          | • Ability to leverage existing skills (current in-house abilities vs. need to scale-up / hire external experts)  
  o Technical, fund-raising, advocacy, organizational (administrative/ managerial, etc.), communication and research skills, local contacts, etc.  
  • Synergy with other TAF programs  
  o Ability to share costs/resources/expertise with other existing TAF programs |
| **External Criteria** | Need/Demand analysis                          | • Existence of a demand for the program  
• Responsiveness to an identified need / gap  
• Relevance of the program to respond to that need |
|              | Economic Feasibility                          | • Entry cost  
• Funding availability  
• Cost/benefits analysis and cost opportunity  
• Sustainability |

| **External Feasibility/Oppportunity** | • Presence of other actors  
  o Is it a crowded area?  
  o If yes is there a niche for TAF to have a significant added value?  
• Appeal to support groups  
  o Visibility and appeal to constituencies  
• Complementarities/synergies with existing non-TAF programs  
• Likelihood of resulting in networking / relationships that could be leveraged elsewhere  
• Appeal to donors (i.e., fundability and funding stability)  
• Degree to which funding is currently available and is it likely to remain available and stable in the future |
| **Political Feasibility** | • Political support for the program  
  o At local, national, international level  
• Appeal to beneficiaries/ recipients (e.g., MFA/MFI/Government interest) |
| **Social Feasibility** | • Is the program acceptable by the community? The society? |
| **Visibility** | • Likelihood of increased publicity / visibility for The Asia Foundation |
| **Impact criteria** | **Size** | • Size and concentration of beneficiary base  
  o With larger numbers of beneficiaries making programs more visible and increasing economies of scale  
• Degree of foreseeable impact  
  o i.e., in improving microfinance governance  
• Growth rate of beneficiary base  
  o e.g., Will problem exist in the future? |
| **Scalability** | • Program scalability across different country contexts |
| **Measurability** | • Measurability of results  
  o With more measureable results proving more attractive to internal stakeholders, clients and funders |