

MIFA

Promoting Microfinance in Asia



PAKISTAN: MICROFINANCE AND FINANCIAL SECTOR DIAGNOSTIC STUDY

FINAL REPORT



APRIL 2008



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Acknowledgments

This report, written in April 2008, was commissioned from the Frankfurt School of Finance & Management by the Microfinance Initiative for Asia (MIFA), a joint venture of KfW Bankengruppe and the International Finance Corporation (IFC) of the World Bank Group. The report is one of a series of microfinance diagnostic studies of Asian countries commissioned by MIFA.

Abbreviations and Exchange Rate

ADB	Asian Development Bank
AJK	Azad Jammu and Kashmir
AKAM	Aga Khan Agency for Microfinance
AKFED	Aga Khan Foundation for Economic Development
AKRSP	Aga Khan Rural Support Program
AROA	average return on assets
ATM	automated teller machine
ASA	ASA Bangladesh
BRAC	Building Resources Across Communities
CAR	capital adequacy ratio
CDC	Central Depository Company
CDN	Central Directorate of National Savings
CFI	commercial financial institution
CGAP	Consultative Group to Assist the Poor
CLEAR	Country-level Effectiveness and Accountability Report
DFI	development finance institution
DFID	Department for International Development, UK
EC	European Commission
EMO	Expanding Microfinance Outreach strategy, State Bank of Pakistan
FANA	Federally Administered Northern Areas, Pakistan
FATA	Federally Administered Tribal Areas, Pakistan
FMAP	Financial Markets Association of Pakistan
FMFB	First Micro Finance Bank Ltd.
FMiA	First Microinsurance Agency
GDP	gross domestic product
HRDI	Human Resource Development Initiative
IAFSP	Improving Access to Financial Services Program
IASB	International Accounting Standards Board
IB	Islamic Bank
IDB	Islamic Banking Department, State Bank of Pakistan
ICAP	Institute of Chartered Accountants of Pakistan
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMFB	Islamic Microfinance Bank
JCR-VIS	JCR-VIS Credit Rating Co. Ltd.
Kashf	Kashf Foundation
KB	Kushhali Bank
KfW	Kreditanstalt für Wiederaufbau
KSE	Karachi Stock Exchange
LCU	local currency units

MCR	minimum capital requirements
MF	microfinance
MFB	microfinance bank
MFI	microfinance institution
MFP	microfinance provider
MIFA	Microfinance Initiative for Asia
MIFF	Microfinance Industry Funding Facility
MIS	management information system
MSME	micro and small enterprise
NWFP	North West Frontier Province, Pakistan
NBFI	nonbanking financial institution
NBP	National Bank of Pakistan
NCSS	national clearing and settlement system
NGO	nongovernmental organization
NIFT	National Institutional Facilitation Technologies (Pvt) Limited
NPL	nonperforming loan
NRSP	National Rural Support Programme, Pakistan
NSC	nonshareholding companies
OCR	ordinary capital resources
OCR	other capital resources
OCT	Orangi Charitable Trust
OPP	Orangi Pilot Project
PARCA	Credit Rating Agency of Pakistan
PBA	Pakistan Bank Association
PKR	Pakistani rupee
PML	Pakistan Muslim League
PMN	Pakistan Microfinance Network
POS	point of sale
PPAF	Pakistan Poverty Alleviation Fund
PPP	Pakistan People's Party
PRSP	Punjab Rural Support Programme
PSS	payment settlement system
ROA	return on assets
ROE	return on equity
RSP	Rural Support Programme
S&P	Standard & Poor's Rating Agency
SBP	State Bank of Pakistan
SCBPL	Standard Chartered Bank Pakistan Limited
SDC	Swiss Development Corporation
SECP	Securities and Exchange Commission of Pakistan
SME	small and medium enterprise
SMEDA	Small and Medium Enterprise Authority, Pakistan
TFC	term finance certificate
TMFB	Tameer Microfinance Bank
TRDP	Thardeep Rural Development Programme

UNDP	United Nations Development Programme
USD	United States dollar
USAID	United States Agency for International Development
WHAM	Widening Harmonized Access to Micro Finance, USAID-Shorebank project
ZTBL	Zarai Taraqiati Bank Limited

Exchange Rate

US\$ 1 = 66.7 PKR, as of June 1, 2008

Executive Summary

The microfinance sector in Pakistan is still at an early stage. The CGAP CLEAR report of 2007 provided a roadmap for all microfinance stakeholders in Pakistan, identifying ways to intervene and overcome the gaps in the financial system.¹ The report concluded that microfinance in Pakistan has been regarded as a social rather than a financial service; it called for a new approach and a sustainable business model in order for microfinance to thrive in the country.

Since the review, many recommendations for intervening in the sector have been addressed and positive changes are currently enhancing the sector on all levels—micro, meso, and macro. Most notably at the micro level, microfinance providers are moving towards cost-recovery interest rates. At the meso level, efforts to spur the creation of a commercial wholesale market have been initiated. Finally, at the macro level, the State Bank of Pakistan (SBP) has increased the flexibility of the regulatory framework governing the sector, as evidenced by the recent move to allow microfinance banks (MFBs) to raise Tier II capital, including subordinate debt, in local currency.

However, many gaps remain in Pakistan’s microfinance sector. Competition in the market is somewhat limited: there are very few microfinance players in Pakistan that have achieved a size sufficient to benefit from economies of scale; of these, only two are operationally sustainable—Kashf Foundation and First Microfinance Bank. Both of these institutions are financially well supported; Kashf, for example, is currently weighing multiple offers from investors, including the IFC. New, experienced regional players are also entering the market. These include BRAC, ASA, and a planned greenfield² initiative sponsored by Advans/Horus and potentially supported by KfW. For these new entrants, flexible and comprehensive funding is essential, given start-up, technical assistance, and expansion costs.

Even for the limited number of players in the market, the existing funding supply for microfinance providers and microfinance wholesale investment vehicles (e.g., the Pakistan Poverty Alleviation Fund, or PPAF) is inadequate—it is estimated that loan demand will exceed \$650 million by 2010.³ This situation is due to a combination of factors, including recent rising inflation and lack of interest in the microfinance market on the part of most commercial banks, since microfinance providers have different business models and their pricing, or spread, is influenced by the government.

The regulatory constraints of the State Bank of Pakistan, which prohibit microfinance banks from pledging security or sourcing foreign currency loans, are the biggest obstacle to the supply of microfinance funding. Efforts are underway to close the funding gap. The Pakistan Microfinance Network, for example, is in the process of establishing an alternative investment vehicle that will provide a domestic currency facility.⁴ Other alternative commercial financing options include an

¹ CGAP, 2007, “Pakistan: Country-level Effectiveness and Accountability Review (CLEAR), with a Policy Diagnostic,” CGAP, Washington, DC.

² Greenfield refers to a start-up microfinance institution.

³ Shorebank International Ltd. and USAID, 2007, “A Primer on Debt Financing for Microfinance in Pakistan,” USAID WHAM Project, Islamabad, Pakistan.

⁴ To ensure clarity and purpose, this facility—the Microfinance Industry Funding Facility (MIFF)—will be designed to operate separately from the Secretariat of the Pakistan Microfinance Network and will have an independent Investment Committee. Its decisions and deliberations will be made confidentially, without reference to the PMN, in order to steer

initiative of the Standard Chartered Bank Pakistan, which is preparing to issue term finance certificates (TFCs) for microfinance providers in Pakistan.⁵

Existing vehicles in the microfinance market, moreover, have varying objectives and are generally not commercially driven. Pakistan receives significant support from international donor agencies; donor or state funding for microfinance is therefore often priced at concessional rates.

Many smaller institutions currently lack scale and sustainability, but show a positive trend and may qualify for donor support at a later stage. Further support could also be provided to the Microfinance Industry Funding Facility once it is established by the Pakistan Microfinance Network, as well as other credit enhancement facilities with a few interested commercial banks, such as Standard Chartered.

clear of any conflicts of interest. PMN, 2007, "Microfinance Industry Funding Facility —A Concept Note," Islamabad, Pakistan.

⁵ TFCs—bond-like instruments with tenures of between five and seven years—are debt instruments issued for the purpose of raising funds in the form of redeemable capital. TFCs are the chosen investment vehicle for microfinance providers because they can be issued unsecured, overcoming the regulation that prohibits microfinance banks from providing security to lenders.

Introduction

Political Environment

Pakistan's political environment has undergone vast changes over the past year. President Pervez Musharraf has dominated the political scene since the 1999 coup, but his power in Pakistan is now weakening. Despite winning a second five-year presidential term in late 2007, he was forced to step down as Chief of Army Staff. Then in February 2008, his party, the Pakistan Muslim League-Quaid, was defeated in parliamentary elections. The winners of those elections, the Pakistan People's Party (PPP) and the Pakistan Muslim League, formed a coalition government. A power-sharing agreement was signed in March 2008 and President Musharraf swore in Yousaf Raza Gilani as Pakistan's new prime minister. Gilani, who replaced Benazir Bhutto following her assassination as leader of the PPP, now leads the newly formed coalition government.

In the short time since the coalition has been in power, many positive changes have taken place, including efforts to reinstate the judges that were ousted in November 2007.⁶ This latter move signifies positive movement towards lessening the army's role in politics, although the coalition government is unlikely to provide a permanent solution to the political crisis because of the history of mistrust between the two parties. In the event of widespread civil disorder, therefore, the prospect of further direct military intervention cannot be ruled out.

Pakistan's long-term outlook is unpredictable because terrorism, sectarian tension, and deepening socioeconomic divisions are undermining stability. Security concerns are being raised by threats from militant groups and regional conflicts. The Government of Pakistan's perceived bias towards Punjab, the most affluent province in the country, has caused disgruntlement among the population of underdeveloped areas, such as Baluchistan. This unrest often results in political violence, with militants sabotaging important infrastructure, such as natural gas lines. Regionally, there remains the potential for further conflict with India over Kashmir, although the peace process currently appears to be generating dividends, albeit small.

The government welcomes foreign investment and has supported the privatization of public sector assets over the years. However, corruption remains a key concern of doing business in the country. This concern, coupled with the security threats highlighted above, makes Pakistan a challenging country for foreign investment.

⁶ Economist Intelligence Unit (EIU), 2008, *Pakistan: EIU Country Report* (London: EIU).

Macroeconomic Context

Inflationary pressures continue to threaten Pakistan's economy, adversely affecting growth and making financial intermediation costly, as high interest rates raise prices and lower long-run real returns. As a result, the State Bank of Pakistan (SBP) maintains a tight monetary policy stance, which promotes economic growth and price stability by targeting monetary aggregates, such as the broad money supply and reserve levels, in accordance with real gross domestic product (GDP) growth and inflation targets set by the government. Over the past five years, economic management has improved as a result of new legislation to decrease public debt. Moreover, the SBP has strengthened its treasury capacity and the government has established a Monetary and Fiscal Board to ensure formal monetary and fiscal policy coordination.⁷

In July 2008, the State Bank raised the benchmark interest rate, or KIBOR, by 1.5 percent in an effort to fight inflation. This benchmark is used to determine the pricing of all rupee-denominated corporate and commercial bank lending, which in turn increased from 10.5 to 12 percent,⁸ increasing the cost of borrowing and doing business in general. Pakistan has also come under pressure to reduce high domestic oil subsidies as a stipulation of a potential World Bank loan, which would improve the budget deficit but potentially aggravate inflation.⁹

The Economist Intelligence Unit expects real annual GDP growth in the country to slow from 6.7 percent to an average of 5.2 percent in fiscal years 2008–2009, owing to slower investment resulting from increased political and security risk, greater inflation, and recessionary pressures from world markets.¹⁰ Over the past five years, investment has been the main driver of economic growth—20 percent per year—but is expected to slow to a sustainable level. This growth was spurred by government efforts to progressively liberalize the economy and create an environment in which the private sector could thrive, which in turn helped attract foreign direct investment. Despite the expected slowdown in foreign investment overall, China plans to increase investment in Pakistan from \$1 billion to \$15 billion by 2012.¹¹ Private consumption growth is expected to remain strong, at an average of 5.8 percent a year in 2008–2009, and government spending, to increase—driven by increasing expenditures on anti-terrorism security measures as well as welfare and poverty reduction programs.

⁷ Dr. Shamshad Akhtar, 2006, "Perspectives on Pakistan's Monetary Policy Developments," State Bank of Pakistan, Karachi, Pakistan.

⁸ "SBP Raises Interest Rates to Fight Inflation," *The Nation* on the Web, May 22, 2008, <http://www.nation.com.pk/pakistan-news-newspaper-daily-english-online/Business/22-May-2008/SBP-raises-interest-rates-to-fight-inflation> (accessed February 2009).

⁹ Farhan Bokhari, "Pakistan Must Strive to Restore Investor Confidence," *Financial Times*, June 9, 2008.

¹⁰ EIU, 2008, *Pakistan*.

¹¹ "Pak-China Investment Company Set Up—Trade Volume to Increase to \$15BN," *Tech Lahore* (online publication), December 30, 2007, <http://techlahore.wordpress.com/2007/12/30/pak-china-investment-company-setup-trade-volume-to-increase-to-15bn/> (accessed February 2009).

According to table 1 below, GDP reached \$109.6 billion in 2007, representing 7 percent growth over 2006.

Table 1. Pakistan Economy at a Glance, 2002–2007

	2002	2003	2004	2005	2006	2007
GDP in USD (billions)	60.8	69.4	77.7	87.6	97.6	109.6
% GDP growth	2.8	5.1	6.4	8.4	6.6	7.0
GNI per capita, Atlas method (USD)	419	470	515	569	622	685
Inflation	NA	NA	7.4	9.1 ^a	7.9 ^a	7.6 ^a
Exchange rate LCU:USD	58.53	57.22	59.12	59.83	60.92	61.62
Official unemployment rate (%)	NA	12.4	11.6	10.7	10.4	10.2
% GDP in agriculture	24.2 ^b	23.3	NA	22.2	20.5 ^c	22
% GDP state-owned enterprises	NA	NA	NA	NA	NA	NA

Source: World Bank, “Pakistan profile,” World Development Indicators database, http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?&CF=1&REPORT_ID=9147&REQUEST_TYPE=VIEWADVANCED&HF=N&WSP=N (accessed April 2008).

Notes: ^a World Bank data was adjusted for these figures, based on multiple Pakistani sources.

^b Food and Agriculture Organization (FAO).

^c Data for 2005–2006, World Bank, “Pakistan profile,” World Development Indicators database (see “Source” above).

Despite strong economic growth, poverty in Pakistan continues to be a major issue. According to *Poverty in Pakistan*, an Asian Development Bank report of 2006, nearly one-quarter of the population is classified as poor. The World Bank and the United Nations Development Programme (UNDP) estimate that the poverty rate in Pakistan ranges between 25.7 and 28.3 percent, whereas the government estimates the rate to be 23.9 percent.¹² Since 2001, the government has spent over \$22 billion on poverty-related and social sector programs through its Poverty Reduction Strategy papers (2001 and 2003).¹³

Rating

As discussed above, political instability remains a key challenge to attracting new foreign investment, which is an important growth driver. In February 2008, Moody’s confirmed its negative outlook on Pakistan’s B1 rating until the two main parties could demonstrate an ability to restore political stability; the outlook had been changed to negative in the immediate aftermath of the imposition of emergency rule in November 2007. In May 2008, Standard & Poor’s (S&P) revised Pakistan’s long-term currency debt rating to B from B+, citing expanding fiscal and external imbalances as a result of the volatile

¹² Figures are cited from World Bank and UNDP databases as of June 2006.

¹³ CGAP, 2007, “Pakistan: CLEAR.”

political setting. S&P also reduced the long-term local currency rating to BB- from BB.¹⁴

Government Priorities

Since 2000, the government and the State Bank of Pakistan have taken various steps to promote the growth of the microfinance sector, including the establishment of a microfinance unit within the SBP, promulgation of the Microfinance Bank Ordinance in 2001, and an investment in Khushhali Bank in the same year. In 2007, the SBP developed a new strategy, “Expanding Microfinance Outreach (EMO),” that aims to reach 3 million microborrowers by 2010. The strategy stresses commercialization of the sector as the key to financial and social sustainability. It sets forth further recommendations as to how outreach can be increased from the initial target of 3 million to 10 million people over the next five to six years by strengthening the foundation of microfinance and making it more efficient and sustainable.

Among key recommendations made by the strategy document are allowing multiple and international players to enter the microfinance market, promoting all-encompassing financial services, and launching innovative solutions for product delivery.¹⁵ The SBP clearly considered the recommendations set forth by stakeholders and used a consultative process to design the strategy. As a result, new international players, such as BRAC and ASA, have now entered the market, and policies on branchless banking and Islamic banking have also been introduced. The SBP has strengthened its own institutional capacity and is prepared to support the EMO strategy with dedicated trained staff and timely and efficient processes, as evidenced by the short time frame instituted for approving applications for microfinance bank licenses—generally three months.¹⁶

Private Sector / Small and Medium Enterprise

Overview

The small and medium enterprise (SME) sector is the backbone of Pakistan’s economy. According to recent estimates, there are approximately 3.2 million business enterprises in Pakistan. Enterprises employing up to 99 persons constitute over 90 percent of all private enterprises in the industrial sector and employ nearly 78 percent of the nonagricultural labor force. They

¹⁴ “Pakistan Stocks Slump as Standard & Poor’s Cuts Rating,” *The Earth Times* (online publication), May 16, 2008, <http://www.earthtimes.org/articles/show/205953,pakistan-stocks-slump-as-standard--poors-cuts-rating.html#> (accessed February 2009).

¹⁵ State Bank of Pakistan, 2006, “Performance of Microfinance Sector,” SBP, Karachi, Pakistan, <http://www.sbp.org.pk/fsr/2006/English/Microfinance.pdf> (accessed February 2009).

¹⁶ Regarding the role of SBP, see the later section entitled “Challenges in Microfinance,” on p. 17.

represent 30 percent of national GDP, 25 percent of exports of manufactured goods, and 35 percent of manufacturing value added.¹⁷

No single definition of SMEs at the country level exists in Pakistan. The Government of Pakistan defines SMEs as enterprises that employ up to 250 people, have paid-up capital of up to 25 million Pakistani rupees, and annual sales of up to 250 million Pakistani rupees. Yet as shown in table 2, the State Bank of Pakistan, the Federal Bureau of Statistics, the SME Bank, the Punjab Small Industries Corporation, and the Small and Medium Enterprise Development Authority all have different definitions of the term.

Table 2. Varying Definitions of Micro, Small, and Medium Businesses in Pakistan

Institution/ Definition	Micro	Small	Medium
State Bank of Pakistan	N/A	Capital assets up to PKR 20 million	N/A
Federal Bureau of Statistics	N/A	Less than 10 employees	N/A
SME Bank	N/A	Productive assets of PKR 20 million	Productive assets of PKR 100 million
Punjab Small Industries Corporation	N/A	Fixed inventory up to PKR 20 million	N/A
SMEDA	Less than 10 employees, productive assets up to PKR 2 million	10–35 employees, productive assets of PKR 2–20 million	36–99 employees, productive assets of PKR 20–40 million

Source: SMEDA, n.d., “Creating a Conducive Policy Environment for Micro, Small and Medium-Sized Enterprises in Pakistan,” presentation by Anjum Ahmad, SMEDA Pakistan, available online at http://info.worldbank.org/etools/docs/library/49247/ses3.2_ahmad.pdf (accessed February 2009).

Obstacles to Growth

Banks provide only 7–8 percent of the total funding requirements of SMEs in the country.¹⁸ While credit to previously underserved markets has expanded, large segments of the economy continue to operate with little formal credit. Pakistani authorities will need to sustain their efforts to promote new business models and technologies that will broaden access to financial services in a sustainable, cost-efficient manner.

Access to finance has thus been identified by SMEs as the single most important impediment to their growth. This problem increases in magnitude as firm size and experience decrease.¹⁹ For SMEs, most resources for

¹⁷ Government of Pakistan, SMEDA (Small & Medium Enterprises Development Authority), 2007, “SME Policy 2007: SME Led Growth—Creating Jobs and Reducing Poverty,” Ministry of Industries and Production, Lahore, Pakistan, <http://www.smeda.org/downloads/smpolicy2007.pdf> (accessed February 2009).

¹⁸ SMEDA, n.d., “Pakistan: Creating a Conducive Policy Environment for Micro, Small, and Medium-Sized Enterprises in Pakistan,” presentation by Anjum Ahmad, SMEDA Pakistan, available online at <http://info.worldbank.org/etools/docs/library/49247/ses3.2%5Fahmad.pdf> (accessed February 2009).

¹⁹ Iqbal Mustafa and Farrukh M. Khan, “Small and Medium Enterprises in Pakistan,” *South Asian Journal* (The South Asian Free Media Association, Lahore, Pakistan), no. 9 (July–September 2005), http://www.southasianmedia.net/Magazine/Journal/9-small_Medium_enterprises_pakistan.htm (accessed February 2009).

financing long-term fixed investments come from retained earnings, personal sources, and borrowing from family and friends. Commercial sources, supplier/buyer credit, and even the high-interest informal market seem to be a very small source of such funding. Commercial banks only contribute roughly 6.1 percent of total SME financing.²⁰ More banks are downscaling to reach SME clients, but are still hesitant to venture further downmarket to reach micro, small, and medium enterprises (MSMEs).²¹

In addition to financing, the SME sector needs assistance in strengthening its human resource capacity and information technology infrastructure. Since 1988, the Small and Medium Enterprise Authority (SMEDA) has been actively developing SMEs in Pakistan by providing trainings and services, such as business planning and financing.

Demand for Financial Services

Current Status

Overall, financial penetration in Pakistan is quite low. Pakistan has the highest number of people per bank branch in the region, second only to Bangladesh. Currently 37 percent of adults have bank accounts and the number of borrowers—5.5 million—constitutes only 3.5 percent of the population. There are only 171 deposit accounts and 30 loan accounts per 1,000 people. Agriculture and SME credit reach 1.5 and 0.16 million borrowers, respectively. Outreach of the documented microfinance sector was 1.13 million as of March 2007.²²

Demand/Supply Gap

Financial inclusiveness is critical, given that 42 percent of Pakistan's population is under 15 years of age and about 24 percent of the population—nearly 40 million people—live below the national poverty line. Financial exclusion exists for a number of reasons. Geographic constraints play a large role, with 67 percent of the population living in rural and remote areas. Innovative delivery channels, such as branchless banking, are not yet utilized.

Financial institutions are reluctant to venture into new areas and do not have the capacity to assess demand and deliver financial services downmarket. Information on borrowers is inadequate because institutions do not report standardized information and do not maintain databases. Banks also do not serve a large segment of the population because they require collateral or specific documents. In most cases, land records are not suitable documents for security and the lack of legal recourse in the event of nonpayment

²⁰ Pakistan Microfinance Network (PMN), 2008.

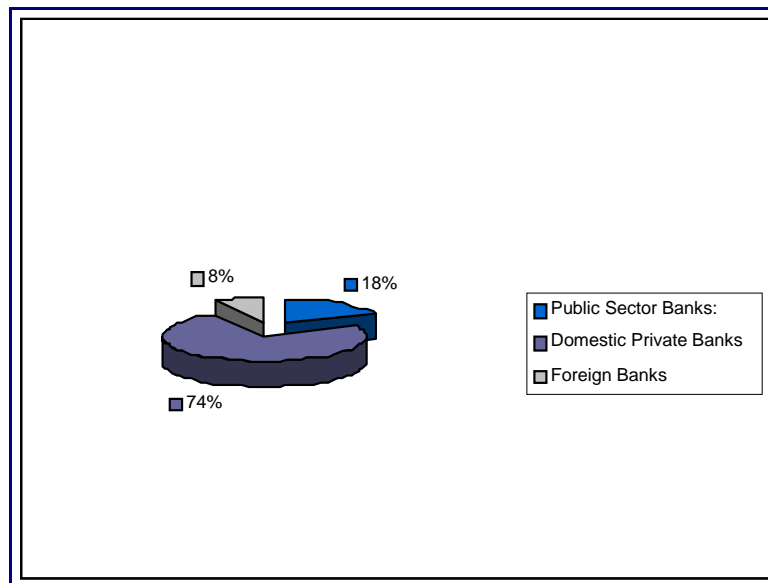
²¹ The PMN has undertaken an MSME demand study using the FinMark model; results were expected to be released before the end of 2008.

²² PMN, 2008.

restricts banks from lending. Finally, the population is excluded financially because illiteracy, as well as cultural and language barriers, limit awareness and understanding of financial services. Products and services, moreover, are not tailored to help the population overcome these obstacles.²³

Financial Sector Overview

Figure 1. Banking System Ownership Structure, as % of Total Banking System Assets



Structural economic reforms, particularly in the financial sector, were initiated in the early 1990s and consolidated after 1999. These reforms were characterized by greater openness, liberalization, and privatization of state-owned enterprises, including four of the five main public sector banks. At the same time, the State Bank of Pakistan, which had been under the control of the Ministry of Finance, was given a much greater degree of autonomy.²⁴ Between 1997 and 2004, the market share of local private banks increased from 26 to 65 percent, reflecting two large privatizations, several acquisitions by foreign banks, and more rapid growth overall.²⁵ These reforms led to radical changes in the ownership structure and management of the banking system—and increased competition. As figure 1 shows, the asset share of

²³ Dr. Shamshad Akhtar, Governor of the State Bank of Pakistan, “Building [an] Inclusive Financial System in Pakistan,” speech at the Financial Inclusion Conference cosponsored by the Department for International Development and the Treasury Ministry of the United Kingdom, London, June 19, 2007, <http://www.bis.org/review/r070814f.pdf> (accessed February 2009).

²⁴ DFID (U.K. Department for International Development), 2006, “Poverty and Social Impact Assessment: Pakistan Microfinance Policy,” DFID, London, UK, <http://www.dfid.gov.uk/Pubs/files/pakistan-micro-final.pdf> (accessed February 2009).

²⁵ State Bank of Pakistan, 2007, “Statistics on Scheduled Banks in Pakistan, 2007,” SBP, Karachi, Pakistan.

public sector banks has fallen from 92.2 percent in 1990 to less than 20 percent today.

Within the sector, the most notable change has been a rise in private sector credit from PKR 18 billion in FY 2000 to over PKR 400 billion in FY 2006. SMEs accounted for 17.4 percent of total outstanding loans by December 2006. Consumer credit rose from virtually negligible levels to 12 percent of the total loan portfolio by December 2006; and agricultural credit also increased—from less than PKR 40 billion in FY00 to 168 billion in FY07. Microfinance loans increased from about PKR 3 billion in 2003 to over PKR 10 billion by December 2006, and the aggregate number of borrowers rose from 2.7 million in 2003 to about 5.5 million in December 2006. While these statistics are impressive, growth has not been sufficient to close the significant remaining gaps in demand for financial services, as discussed earlier.

Banks are now extending their business focus from the corporate to the household sector. Table 3 demonstrates the increase in microlending as a result of both new players entering the market and governmental reforms in the recent years.

Table 3. Distribution of Sector Lending, 2003 and 2006

Sectors	December 31, 2003		December 31, 2006		% Growth December 2003–December 2006	
	No. of borrowers	Amount (\$ millions)	No. of borrowers	Amount (\$ millions)	Borrowers	Amount (\$ million)
Corporate	17,743	10,108	25,740	21,159	45	109
SMEs	91,663	3,583	168,233	6,965	84	94
Agriculture	1,411,508	1,745	1,480,214	2,364	5	36
Consumer Finance	721,201	1,024	2,665,423	4,605	270	349
Mortgage Loans	NA	69	24,313	819	-	1,094
Others	135,561	2,817	122,190	4,105	-10	46
Microfinance Loans	315,000	53	997,778	179	217	241
Total	2,692,676	193,987	5,483,891	40191,6	104	107

Source: State Bank of Pakistan, 2007, “Statistics on Scheduled Banks in Pakistan, 2007.”

Today, following a period of sustained restructuring, recapitalization, and privatization, the core of the system is made up of local private banks. Assets are growing robustly and, overall, nonperforming loans fell from 7.7 percent in 2003 to 2.3 percent at the end of September 2007. During this period, strong deposit inflows, offset by a decline in loans and a rise in investments by banks, led to improved bank liquidity. This trend has continued, providing banks with sufficient room to improve earnings on assets. Overall, there has been a shift away from loans to investments in the sector, primarily in government securities (i.e., domestic treasury bills and bonds). The solvency of the banking system has gained strength, supported by healthy

profits and fresh capital injections (the result of new minimum capital requirements). All banks are expected to meet the new requirements, which will encourage consolidation in the sector.

Although liquidity risk has improved, the rapid increase in consumer lending over the past year represents a looming credit risk—banks still need to strengthen their credit risk assessment systems. Finally, corruption in the banking sector remains widespread, undermining the progress made in improved regulation.

Table 4. Depth and Outreach of the Pakistani Financial Sector, 2003–2007

Financial depth and outreach	2003	2004	2005	June 2006	June 2007
Total loans (\$ millions)	27,055	31,199	38,629	31,717	36,172
% loan growth	121.5	115.32	123.81	82	114
Loans as % of GDP	38.98	40.15	44.10	32.50	33
Total deposits (\$ millions)	26,637	31,838	37,791	40,740	48,768
% deposit growth	122.77	119.52	118.70	117.8	119.7
Deposits as % of GDP	38.38	40.98	43.14	41.74	44.50
Loans as % of deposits	101.57	97.99	102.22	78	74
% cash of total deposits ^a	81.33	80	72.11	73.30	68.34
# loans per 1,000 people	n.a.	n.a.	n.a.	n.a.	n.a.
# deposits per 1,000 people ^b	192.46	180.94	171.51	165.54	149.52
Number of FIs per 100,000 people	n.a.	n.a.	n.a.	0.1 ^c	0.09 ^c
Number of branches per 100,000 people ^d	4.86	4.65	4.71	4.66	4.62

Source: State Bank of Pakistan, 2003–2007, “Statistics on Scheduled Banks of Pakistan,” SBP, Karachi, Pakistan; and Federal Bureau of Statistics, 2006, *Pakistan Statistical PocketBook 2006* (Islamabad: Federal Bureau of Statistics).

Notes: Figures for total loans and total deposits are rounded.

^a Percentage of current deposits and saving deposits to total amount of deposits as of June (2006 and 2007) and December (2003–2005).

^b Total number of deposits accounts was 28,606,883 as of December 2002; 28,524,844 as of December 2003; 27,383,337 as of December 2004; 26,405,832 as of December 2005; 26,321,688 as of June 2006; and 25,083,039 as of June 2007.

^c Financial institutions are banks, insurers/reinsurers, and non-bank financial companies (as listed with the Securities and Exchange Commission of Pakistan). Total for both years is 44 banks, 61 insurers/reinsurers, and 49 NBFCs.

^d Total number of branches of all banks was 7,196 in 2003; 7,028 in 2004; 7,248 in 2005 (Source: Federal Bureau of Statistics, 2006, *Pakistan Statistical Pocket Book 2006*); 7,412 as of June 2006; and 7,755 as of June 2007 (Source: SBP, 2007, “Statistics on Scheduled Banks in Pakistan, 2007”).

Islamic Financing

Financial institutions providing Islamic financing have been allowed to choose among three operational alternatives: (i) a full-fledged commercial Islamic Bank in the private sector; (ii) a subsidiary of an existing commercial bank; or (iii) a stand-alone Islamic banking branch of an existing commercial bank. As a result of these choices, the network of Islamic banks has increased in Pakistan, as shown in table 5 below. By the end of June 2006, four full-fledged Islamic banks with a total network of 60 branches, plus 40

stand-alone branches of commercial banks, were providing Islamic banking services in the country.²⁶

Table 5. Number of Islamic Banks and Branches

Type of institution	June 02	June 03	June 04	June 05	June 06
Islamic banks	1	1	2	2	4
Branches of Islamic banks	6	10	23	37	60
Stand-alone branches	0	7	25	33	40
Total	6	17	48	70	100

Source: Islamic Banking Department (IDB), State Bank of Pakistan, “Introduction,” SBP Web site, <http://www.sbp.org.pk/departments/ibd.htm> (accessed April 2008), as updated by IDB staff.

The SBP devised the financial system in Pakistan as a dual system in which Islamic banking coexists with conventional banking. This practice gives users of such banking services the choice of a range of instruments compatible with their religious beliefs. Historically, conventional banking has been dominant, consistent with the country’s position as an emerging market integrated into the global economy.²⁷

The SBP has formulated additional guidelines for the provision of Islamic microfinance products and services by financial institutions. Entitled “Guidelines for Islamic Microfinance Business by Financial Institutions,” the strategy aims to broaden the coverage of microfinance products and services to low-income segments of Pakistani society in a Shariah-compliant manner. These guidelines stipulate four types of institutional arrangements for offering Islamic microfinance: (i) a full-fledged Islamic microfinance bank; (ii) Islamic microfinance services offered by full-fledged Islamic Banks; (iii) Islamic microfinance services offered by conventional banks; and (iv) Islamic microfinance services offered by conventional microfinance banks. Currently, microfinance institutions (MFIs) such as NRSP are only piloting Islamic microfinance products. Certain asset management companies and commercial banks have launched Islamic products that include house and car financing, as well as insurance and savings products. Overall, the lack of Islamic microfinance products is not cited as a main cause for poor people being excluded from the financial system.

²⁶ Among commercial banks, the Muslim Commercial Bank Ltd. has the largest network of stand-alone Islamic banks.

²⁷ Dr. Shamshad Akhtar, Governor of the Bank of Pakistan, 2007, “Pakistan—Islamic Banking: Past, Present, and Future Outlook,” SBP, Karachi, Pakistan.

Current Status of Islamic Financing

To date there has been no detailed assessment of the market demand for Islamic microfinance products, market prices, distribution channels required for market penetration, or geographic areas where such products could be launched successfully. Furthermore, stakeholders in the microfinance sector have communicated that scale and outreach are more important than the introduction of Islamic finance products.

Islamic microfinance products and financial instruments in general may bring welfare benefits—especially to rural households potentially inclined to favor Islamic instruments—provided that they are further developed and standardized. Currently, the Islamic banking sector is less transparent than the conventional banking sector, especially with respect to accounting and auditing standards. While Islamic banking products are similar to some conventional investment products, they entail specific credit risks that will require closer attention as the Islamic banking sector grows. Therefore, a specific framework needs to be developed for risk management in Islamic banks. In addition, lender-of-last-resort arrangements for the Islamic banking sector also need to be put in place.

Number and Type of Financial Institutions

The financial sector in Pakistan is comprised of commercial banks, development finance institutions, microfinance banks, non-bank financial institutions (e.g., leasing companies, housing finance companies, insurance companies, venture capital companies, mutual funds, etc.), Modarabas (nonbank Islamic finance institutions), and the Stock Exchange.

As in most developing countries, the financial sector is dominated by banks. Although the financial sector in Pakistan has undergone substantial reform and privatization, the banking sector continues to serve only a small proportion of the population: around 5.5 million borrowers, or 3 percent of the population, compared with 20 million depositors, as discussed earlier.²⁸ Most services are concentrated in Karachi and other urban centers, leaving large parts of the country underserved. The banking system, which includes commercial banks and four small, state-owned specialized banks, accounts for approximately two-thirds of total financial sector assets. Nonetheless, nonbank financial institutions play a significant supporting role overall. Additionally, National Savings Centres account for another one-fifth of the financial sector and compete directly with banks for deposits.

Under the current legislative structure, supervisory responsibility for conventional and microfinance banks fall within the legal authority of the

²⁸ IMF, 2005, "Pakistan: Selected Issues and Statistical Appendix," in "Pakistan," IMF Country Report No. 05/408, IMF, Washington, DC.

State Bank of Pakistan, while the remaining financial institutions are monitored by other authorities, such as the Securities and Exchange Commission and the Controller of Insurance.

Banks

As of June 30, 2007, there were 47 banks operating in Pakistan with a total of 7,746 branches, including public sector, local private, foreign, and specialized commercial banks.²⁹ Foreign banks that have operations in Pakistan include HSBC, Citibank, and Deutsche Bank. Barclays Bank is expected to start operations in 2008.³⁰ The largest bank in the country is the National Bank of Pakistan, with a market share of approximately 20 percent; it remains state owned and its privatization prospects are uncertain at this stage, although the government divested approximately 25 percent of its capital in 2001–2003.

Very few banks provide microfinance services, with the First Women’s Bank and the SME Bank among the exceptions. Standard Chartered Bank Pakistan has expressed interest in entering the microfinance sector in order to support microfinance providers. Of foreign-owned banks operating in the country, only Citibank and Deutsche Bank provide services to microfinance providers. Citibank views these relationships as part of its corporate social responsibility initiatives, not as a strategic investment. Deutsche Bank has invested in Asasah through its Community Development Finance Group Fund. Apart from Standard Chartered and Deutsche Bank, commercial banks in Pakistan have shown little interest in entering the microfinance sector. Rather, the SME market is their focus at this point in time. Growth and progress toward sustainability of microfinance providers is necessary in order for commercial banks to consider them attractive, profit-oriented investments.

The SBP has issued regulations allowing banks to open microfinance windows, but no banks have yet demonstrated an interest in extending their services downmarket. In rural areas, the Pak Post Savings Bank provides elementary savings and payment systems to microentrepreneurs. Additionally, the government is the primary source of funding for the agricultural sector, through Zarai Taraqati Bank Limited, the former Agricultural Development Bank.

²⁹ State Bank of Pakistan, 2007.

³⁰ Foreign banks accounted for 4 percent of GDP in 2008, and 6.8 percent in 2003 (State Bank of Pakistan, 2007, “Statistics on Scheduled Banks in Pakistan, 2007”).

Table 6. Financial Service Providers in Pakistan

	2003	2004	2006	2007
Total number of banks	39	43	47	47
Foreign banks	22	17	13	12
Domestic	17	24	22	26
State-owned commercial banks	5	4	8	8
MFIs	2	4	6	6
Leasing companies	n.a.	31.	29	n.a.

Source: State Bank of Pakistan, 2008, “Statistics on Scheduled Banks in Pakistan, June 2008” (data for banks and foreign banks, http://www.sbp.org.pk/publications/schedule_banks/June_2008/Appendices.pdf); Pakistan Microfinance Network, 2006, “Performance of Pakistan Microfinance Network,” Islamabad, Pakistan (MFIs, 2006); and Pakistan Leasing Association, “11th Edition of the Leasing Yearbook,” 2007, <http://www.pakistanleasing.org/statistics.php> (accessed April 2008)[leasing companies, including Modarabas, 2004 and 2006]. The number of leasing companies in 2005 was 31.

Microfinance

The origin of microfinance in Pakistan can be traced back to the early 1990s and two projects: the Orangi Pilot Project and the Aga Khan Rural Support Program (AKRSP). In 1999, the AKRSP and the National Rural Support Programme accounted for 84 percent of total microfinance services; Kashf Foundation was then the only specialized microfinance institution.³¹

Today, a multitude of institutions provide microfinance services in Pakistan. Twenty of these institutions are registered on The Microfinance Information eXchange (MIX) Market (an online information service), 19 of which are members of the Pakistan Microfinance Network (PMN). Most of these institutions are not specialized in microfinance, but combine microfinance with other development programs, such as health and education. Microfinance providers in the country can be classified into the following groups:

- microfinance banks (MFBs): specialized institutions that operate as microfinance banks;
- Rural Support Programmes (RSPs): programs that run microfinance operations as a part of integrated rural development initiatives;
- nongovernmental organizations/microfinance institutions (NGO-MFIs): nongovernmental organizations that run microfinance operations as part of integrated development programs or that focus exclusively on microfinance;
- commercial financial institutions: commercial institutions involved in microfinance; or

³¹ Estimate based on data provided by the PMN and NRSP, 1999.

- government-owned institutions: institutions involved in microfinance that are owned by the government.

Microfinance Banks

MFBs are licensed by the State Bank of Pakistan under the Microfinance Ordinance of 2001. MFBs can be established at either the district, province, or national level, based on their volume of capital and geographic area. At present, there are six MFBs in the country with loan portfolios ranging from \$846,000 to \$43 million, as follows:

1. Khushhali Bank (\$43 million)
2. Network Microfinance Bank Limited (\$846,000)
3. Pak-Oman Microfinance Bank Limited (\$1.5 million)
4. Rozgar Microfinance Bank Limited (n/a)
5. First Microfinance Bank Limited (\$11 million)
6. Tameer Microfinance Bank Limited (\$6.6 million)

The First Microfinance Bank is the only MFB that has reached operational self-sufficiency. All MFBs operate at the national level except for Rozgar Microfinance Bank and the Network Microfinance Bank.

Rural Support Programmes

In 1982, the Aga Khan Foundation started offering microcredit services in the Northern Areas of Pakistan under the Aga Khan Rural Support Program (AKRSP). In the 1990s, the Government of Pakistan acknowledged the idea of microfinance by establishing the National Rural Support Programme (NRSP) at the national level and, later, by establishing other such programs at provincial and regional levels.

RSPs are involved in various community development initiatives related to health, education, and infrastructure development. They provide microcredit services under the overall umbrella of social development. RSPs have the largest infrastructure network of microfinance providers in the country, accounting for approximately 53 percent of total program offices. The largest RSP and provider of microcredit is NRSP, which has more than 400,000 active borrowers. It expected to receive a license from the State Bank of Pakistan to transform into the NRSP Microfinance Bank by the end of 2008. The second-largest RSP is the Punjab Rural Support Programme (PRSP).

**Overview of
Microfinance
Players**

**Nongovernmental Organizations-
Microfinance Institutions**

NGOs either provide dedicated microfinance services or offer them as part of integrated development programs. There are several NGO-MFIs providing microcredit services in Pakistan, the most established of which is Kashf Foundation. Created in 1996, Kashf has over 295,000 active borrowers and was the first MFI to become sustainable—in 2004. Similar to NRSP, Kashf Foundation was planning to transform into a microfinance bank as of April 2008.

Commercial Financial Institutions

Apart from their core business line, CFIs provide microfinance services by creating separate microfinance departments or divisions. For example, ORIX Leasing (Pvt) Limited provides microfinance services through separate branches, with its other business lines subsidizing the microfinance operation.

Government-owned Institutions

The National Bank of Pakistan (NBP) provides a range of services to microentrepreneurs, including credit and savings accounts, through the Rozgar scheme. This initiative provides credit facilities to selected youth groups, with loans of up to \$1,500 at highly subsidized rates. The National Savings Centre provides savings services through 12 savings programs that operate through 12 regional directorates and 366 savings centres. Finally, the Pakistan Post Savings Bank has the largest savings bank network in the country.

Currently the network of microfinance providers in Pakistan spans 1,343 branches and services about 1.5 million clients with a gross loan portfolio of PKR 15.1 billion (\$250 million). The sector is dominated by one or two players within each of the groups described above. Table 7 evidences the heavy concentration of a few institutions in the sector: just three (NRSP, Khushhali Bank, and Kashf Foundation) serve 70 percent of the market.³² The largest and fastest-growing providers in the sector, these institutions have outpaced the rest of their competitors. A more detailed breakdown of the top providers, active borrowers, and geographic outreach is presented in tables 7 and 8 below.

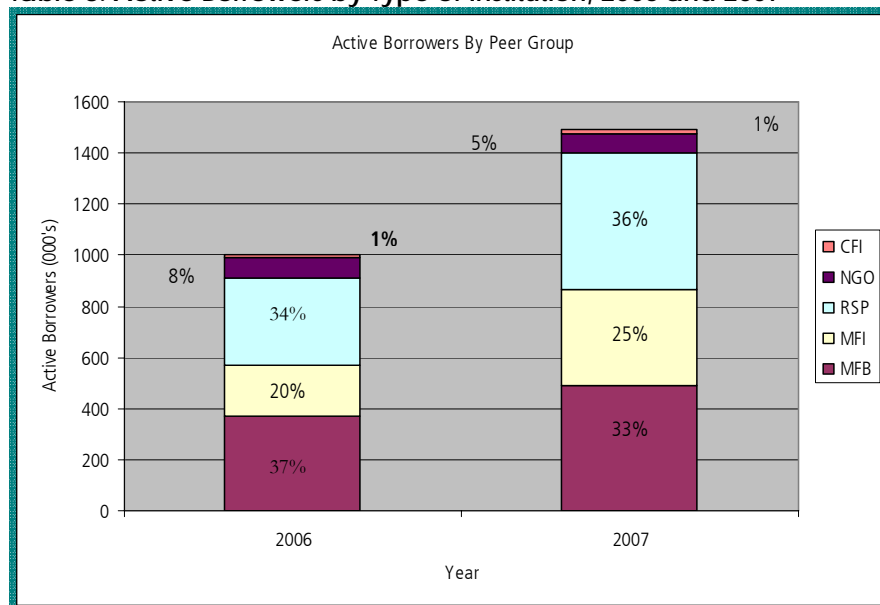
³² *MicroWatch* (Pakistan Microfinance Network, Islamabad) no. 6 (Jan–Dec 2007).

Table 7. Largest Providers of Microcredit (active borrowers), 2007

	Provider	Active borrowers (31-Dec-07)	Market share (% of active borrowers)
1	NRSP	407,641	27.7
2	KB	330,952	22.5
3	Kashf	295,275	20.1
4	FMFB	102,604	7.0
5	PRSP	69,361	4.7

Source: *MicroWatch*, no. 6 (Jan–Dec 2007).

Table 8. Active Borrowers by Type of Institution, 2006 and 2007



Source: *MicroWatch*, no. 6 (Jan–Dec 2007).

Most microfinance providers are concentrated in the Punjab and Sindh provinces. Their infrastructure and higher population density, relative to other provinces, are the likely cause of more specialized MFIs being active in Punjab than in any other province. A comparison of the data by province shows that almost 60 percent of total active borrowers in the country are from the Punjab, followed (with a considerable lag) by Sindh Province, with 23 percent of active borrowers. Punjab and Sindh are the two most densely populated provinces in the country, with 56 and 25 percent of the total population of Pakistan, respectively. The uneven penetration of microfinance between provinces may therefore be attributed to the population distribution in the country.

Table 9. Microfinance Providers with Largest Geographic Outreach, 2007

	<i>MFP</i>	<i>Geographic outreach (no. of districts)</i>
1	KB	86
2	NRSP	50
3	FMFB	42
4	Kashf	22
5	PRSP	20

Source: MicroWatch, no. 6 (Jan– Dec 2007).

Typical loan sizes range between \$100 and \$500 and are disbursed through a group lending model; credit is used primarily for agriculture, livestock, and trade businesses. While the regulatory loan ceiling is \$2,500, very few institutions offer loans at this level. Moreover, microfinance providers are hesitant to increase their exposure to individuals because of the risks of non-social collateral associated with larger loan sizes. This hesitancy is a result of the lack of resources for product development, combined with a lack of confidence in the legal system (i.e., ability to collect collateral in cases of default).

Microfinance providers reached 133,000 borrowers in 2003 and are expected to reach 3 million by 2010. At present, all types of microfinance institutions combined serve an estimated 1.5 million clients out of an estimated market of 6 million households, or 30 million people.³³ As a result, market penetration is only around 5 percent. However, microfinance in Pakistan is evolving at a rapid pace with new entrants, new products and practices, and a fast-growing client base. Most of the growth is expected to be driven by the seven leading existing institutions, which have strong track records and/or management backgrounds that will enable them to expand. These seven organizations include four microfinance banks with national licenses (Khushhali Bank, First Microfinance Bank, Tameer Bank, and Pak Oman Microfinance Bank) and three NGO-MFIs (NRSP, Kashf Foundation, and Asasah), two of which (NRSP and Kashf) will be transforming into microfinance banks in 2008.³⁴

Challenges in Microfinance

The primary challenges facing all MFPs in Pakistan are lack of adequate human resources, securing sources of funding, and reaching profitability. In general, microfinance is still viewed as a social intervention to alleviate poverty. This viewpoint has been the primary reason for lack of growth in the sector and is the source of its current challenges. More than \$400 million

³³ Ibid.

³⁴ Ibid.

in donor funding³⁵ has, moreover, been injected into the sector over the past five years.

With microfinance seen primarily as a socially driven business, a limited number of university graduates and middle managers are interested in developing a career in it, particularly because the salary structure is very low and there are no clear indications of career development. These facts, coupled with the physical challenges and long work hours, result in low management capacity and high staff turnover among all microfinance providers.

In addition to human resources constraints, microfinance institutions face a shortage in funds for growth. Medium-to-long-term debt funding is available on a limited basis and conditional on the regulations of the State Bank of Pakistan. Banks are hesitant to lend to microfinance providers because of their lack of knowledge about the sector and because providers are both not profitable and lack lengthy track records. Finally, these institutions have been unable to generate operational surpluses to build their balance sheets, invest in growth, or service debt. The primary reason is loan pricing. Seeing loans as a social tool for poverty reduction, providers are unwilling to price their products according to their real costs and instead, pass along subsidized credit to their clients.

These challenges can be overcome and additional sources of funding channeled to the sector once existing providers are able to further develop their human resource capacity, especially at the management level. Over the long term, as discussed above, the hurdle is changing the mind-set at all levels of the microfinance sector so that people view microfinance as a business. In the short-to-medium term, however, resources are needed to support individual institutions to improve their human resource capacity. Improved management know-how, in turn, can help institutions improve efficiency and put them on a path toward sustainability.

Since 2000, the government and the State Bank of Pakistan (SBP) have taken various steps to promote the growth of the microfinance sector. Nevertheless, the SBP still has shortcomings when it comes to its role in the sector, such as remaining focused on supervision and regulation and avoiding the role of financier, which it took on when it created an internal “SBP Funding Window”³⁶ under the Financial Inclusion Program. Its “Prudential Regulations for Microfinance Banks (MFBs)” should also continue to be amended and updated to keep pace with market dynamics, and thus remain aligned with the position of the SBP on investment in the sector. If the SBP wants commercial banks to lend to microfinance banks, it must change the current regulation that prohibits the latter from offering

³⁵ CGAP, 2007, “Pakistan: CLEAR.”

³⁶ The structure proposed by the SBP requires commercial banks to provide rupee funding at T-bill yields to an account at an SBP subsidiary or a special-purpose vehicle (SPV) managed by the SBP.

security on such loans. The SBP is also very risk averse when it comes to allowing foreign currency funding.

Finally, other regulatory requirements, including a per-borrower loan exposure limit and stringent equity requirements, should be reviewed so that MFBs are able to reach scale and become sustainable.

New Trends in Microfinance

Partnerships

A new collaboration between the First Micro Finance Bank Ltd. (FMFB) and the Pakistan Postal Service began in late 2007. FMFB, an MFI that operates under the aegis of the Aga Khan Development Network, signed an agreement with the Pakistan Post in October 2007 to provide microfinance services through post offices across the country. Funding to provide loans is provided by FMFB. Under the agreement, the postal service provides office space and verifies clients in support of loan appraisal, disbursement, and collection services. The parties were planning to expand this strategic partnership to 42 locations and disburse 7,426 loans, totaling \$137,000, by third quarter 2008.

Another current strategic partnership is between Asasah, an NGO-MFI, and Tameer Bank, a microfinance bank, in which Asasah acts as an agent of Tameer for savings mobilization in rural areas. Asasah benefits from using a portion of the deposits it mobilizes for Tameer as loan capital. Tameer benefits by extending its outreach and earning returns on the money it lends to Asasah.

Product research and development

Some microfinance providers have begun to offer branchless banking services on a limited basis. Certain of them are using vehicles to access areas where there are no branch networks, while others are exploring mobile phone banking on a pilot basis. Tameer received funding through CGAP and the Gates Foundation to explore branchless banking using mobile phones. This pilot project was expected to start in third quarter 2008. Kashf Foundation is also planning to pilot mobile phone banking. The State Bank of Pakistan supports these initiatives through a bank-led model. If successful, SBP will consider supporting telco-led models, whereby telecommunications companies act as direct agents instead of the banks. In addition to mobile banking, many resources have been invested into research on savings products.³⁷

Microsavings

Growth in microsavings is increasing—both in terms of active savers and the volume of savings. However, according to interviews conducted for this study, most microfinance banks view savings as a service, not as a low-cost financing alternative. This view is due in part to the lack of commercial

³⁷ Shorebank International Ltd., 2008, “Mobilizing Savings from the Urban Poor in Pakistan: An Initial Inquiry,” Shorebank International, Islamabad, Pakistan.

business culture among microfinance providers, as discussed above, and their focus on poverty alleviation instead of profitability. Although this orientation is changing, more know-how and investment is needed to develop savings products and other innovative initiatives, such as the partnership between Post Bank and FMFB. The Rural Support Programmes have proven the most successful at mobilizing savers through partnerships with commercial banks, but in terms of volume, the microfinance banks account for 69 percent of total microsavings due to their ability to generate larger institutional deposits.

Table 10. Largest Providers of Microsavings (Active Savers) as of Year-end 2007

	MFP	Active savers (31-Dec-07)	Market share (% of active borrowers)	Increases (Dec 2006–Dec 2007)	
				Net	%
1	NRSP	760,425	49.7	178,686	30.7
2	PRSP	333,714	21.8	163,289	95.8
3	TRDP	210,271	13.7	7,699	3.8
4	FMFBL	81,158	5.3	41,997	107.2
5	TMFB	44,560	2.9	20,099	82.2

Source: *MicroWatch*, no. 6 (Jan–Dec 2007).

Table 11. Pakistani Districts with Highest Outreach (Active Savers), 2007

	MFP	Active savers (31-Dec-07)	Increases (Dec 2006–Dec 2007)	
			Net	%
1	Tharparkar	114,747	5,073	4.6
2	Bahawalpur	73,254	30,994	73.3
3	Karachi	53,065	15,339	40.7
4	Badin	45,582	2,996	7.0
5	Attock	44,013	3,314	8.1

Source: *MicroWatch*, no. 6 (Jan–Dec 2007).

Leasing Companies

The assets of nonbanking financial institutions (NBFIs) in Pakistan comprise 5.9 percent of total financial sector assets; of this volume, the leasing sector is the largest single component. Leasing assets comprise 46 percent of NBFI assets, valued at PK\$ 53 billion. The next largest component is comprised of

investment banks, which account for 38 percent of total NBFIs assets.³⁸ There are 24 leasing companies in Pakistan; certain commercial banks also have leasing products. Orix Leasing is the largest leasing company in the country, using both assets and personal guarantees as security for its various leasing products (e.g., corporate, operating, and micro). The company has been innovative in service delivery, using point of sale (POS) devices to improve efficiency and reach rural areas. It is also exploring the use of microcards instead of issuing checks to clients.

Insurance Companies/ Microinsurance

The insurance sector represents only 3.1 percent of total financial sector assets³⁹ and is very concentrated; three companies command 80 percent of the general insurance market. These companies underwrite health, life, and asset insurance policies. EFU General Insurance claims the largest market share (33 percent), followed by Adamjee Insurance Company (30 percent) and New Jubilee Insurance (10 percent).⁴⁰

In 2000, the government enacted a new law to regulate the insurance market. The Insurance Ordinance 2000 has several objectives, which are mainly to promote Pakistan's insurance market and provide better governance and compliance by raising the capital adequacy standard and enhancing policyholder protections. The regulation of the insurance industry is vested in an autonomous body, the Securities and Exchange Commission of Pakistan, replacing the previous Department of Insurance of the Ministry of Commerce. In October 2007 the government approved three crucial insurance programs for low-income borrowers: foreign business travelers insurance, crop insurance, and microinsurance.

The government's strategy for the promotion of microinsurance in Pakistan is to mandate public as well as private sector insurers (particularly for health insurance), develop a regulatory framework, and facilitate specialized human resources training. According to the State Bank of Pakistan, microinsurance will help increase the market penetration of insurance from its existing level of 0.67 percent of GDP to well over 3 percent of GDP in the next few years.⁴¹

Microinsurance remains a new financial service in the country. Yet among all microfinance services offered in Pakistan in 2007, microinsurance grew the fastest. Although microfinance banks and NGO-MFIs contributed to this expansion, Rural Support Programmes (RSPs) were the star performers, with 60 percent growth in insured clients in third quarter 2007 alone. Basic life

³⁸ Securities and Exchange Commission of Pakistan, March 2005, SECP, Islamabad, Pakistan.

³⁹ State Bank of Pakistan, 2002, "Financial Sector Assessment," Karachi, Pakistan.

⁴⁰ *Pakistan Daily Times*, 2008, Riots after Benazir's Assassination to Cost Insurers Rs 3-4bn," January 18, 2008.

⁴¹ Sajid Chaudhry, 2007, "PM Widens Scope of Insurance Schemes," *Pakistan Daily Times*, October 12, 2007, http://www.dailytimes.com.pk/default.asp?page=2007%5C10%5C12%5Cstory_12-10-2007_pg5_1 (accessed February 2009).

insurance products are developed in-house by the RSPs, while health and more sophisticated life insurance products are provided through third parties, such as the First Microfinance Agency and Adamjee Insurance Company. At present, health insurance clients represent 55 percent of the microinsurance market, with the remaining 45 percent comprised of life insurance clients.

Table 12. Largest Providers of Microinsurance , as of Year-end 2007

	<i>MFP</i>	<i>Policyholders (31- Dec- 07)</i>	<i>Market share (% of all policyholders)</i>
1	NRSP	419,113	53.6
2	FMFB	102,604	13.1
3	KB	93,365	11.9
4	DAMEN	32,627	4.2
5	TMFB	26,029	3.3

Source: MicroWatch, no. 6 (Jan–Dec 2007).

First Microinsurance Agency (FMiA), the country’s first dedicated microinsurance agency, was launched in February 2007. FMiA provides innovative life and health microinsurance products tailored to the needs of low-income clients. The agency works in partnership with New Jubilee Life, a subsidiary of the Aga Khan Foundation for Economic Development (AKFED) and one of Pakistan’s leading insurance companies, which acts as the principle insurer. Funding for FMiA was provided by the Aga Khan Agency for Microfinance (AKAM) and the Bill & Melinda Gates Foundation.

FMiA works through various distribution channels, partnering with microfinance banks, MFIs, and local support organizations created by the first Aga Khan Rural Support Program in the 1980s. In rural areas, FMiA provides innovative services tailored to local residents’ needs. One such service is a medical hotline, which reduces the costs of both insurer and client by allowing medical information to be accessed by telephone. FMiA is partnering with Kashf to pilot a life and health insurance product in Lahore, and with Tameer Bank in other areas. In the future, the agency will bundle products, including life, health, and asset insurance.

Table 13. Districts with Highest Microinsurance Outreach, 2007

	<i>Microfinance provider</i>	<i>Policyholders (31-Dec-07)</i>	<i>Increase (Dec 2006–Dec 2007)</i>	
			Net	%
1	Bahawalpur	65,896	28,191	74.8
2	Lahore	65,651	8,246	14.4
3	Bhawalnagar	57,654	21,587	59.9
4	Rahimyar Khan	51,218	13,596	36.1

Source: MicroWatch, no. 6 (Jan–Dec 2007).

Most microfinance players, for example, Kashf, require clients to purchase credit-life insurance. This insurance is tied to a loan in case of an accident or the death of the client, so that the family is never burdened with debt. Kashf designed the product in-house to mitigate loan risks. The benefit is up to \$125 for funeral expenses, plus the outstanding loan amount is written off. The insurance product serves a dual purpose. On one hand, it drastically reduces Kashf's credit risks related to client death because it pays off the balance of his or her outstanding loan; on the other hand, it provides specific but limited protection to clients. As mentioned earlier, Kashf has increased its insurance product line through a partnership with FMiA.

The National Rural Support Programme offers a voluntary health insurance product that it created in-house and introduced to rural clients in October 2005. Today, NRSP offers a combination of health, accidental death, and disability insurance to their clients in cooperation with Adamjee Insurance Company. The benefit is up to \$147, with disability pro-rated depending on the severity of the situation.

Table 14 below shows the largest providers of microinsurance in Pakistan as of December 2007. As noted, the Rural Support Programmes, in particular, NRSP, has the majority market share (53.6 percent). Three of the largest microfinance providers (which are microfinance banks) hold a combined 28.3 percent market share.

Table 14. Overview of Structure of Commercial and Microfinance Banks in Pakistan, as of December 2007 (\$ millions)

	<i>Assets</i>	<i>Deposits</i>	<i>Loans</i>	<i>Asset share (%)</i>
State-owned banks (i.e., public sector banks)	18,056	8,257	9,951 ^a	16.11
Commercial banks (nonstate)				
Domestic private and foreign banks	89,043	34,062	35,292 ^a	79.42
Microfinance banks and institutions				
	448 ^b	34	121	0.40
Nonbank intermediaries (3)				
Leasing companies	767	n.a.	n.a.	0.68
Finance companies	622	n.a.	n.a.	0.56
Modarabas	261	n.a.	n.a.	0.23
Insurance	2,917	n.a.	n.a.	2.60
Social security system	n.a.	n.a.	n.a.	n.a.
Total system (\$millions) ^e	112,114			100

Source: State Bank of Pakistan, 2007, "Statistics of Scheduled Banks in Pakistan 2007," and 2006, "Financial Stability Review 2006;" Securities and Exchange Commission of Pakistan (SCEP), SECP, Islamabad, Pakistan.

Notes: Asset, deposit, and loan figures are rounded.

^a Total of advances and investments in securities and shares as of December 2006.

^b Figure derived from Pakistan Microfinance Network, 2007, "Pakistan Microfinance Review 2006," Islamabad, Pakistan. Total assets include those of microfinance banks, NGO-MFIs, and Rural Support Programmes.

^c Figures refer to investment banks as of December 2005 (SCEP, Islamabad, Pakistan).

^d Financial companies operating in conformance with Islamic law as of December 2005 (SCEP, Islamabad, Pakistan).

Market Structure

The continued process of mergers and acquisitions in the banking sector, along with institutions upgrading their risk management systems, has caused a slowdown in lending in Pakistan. These trends, plus the need to meet higher capital requirements, have forced banks to look for fresh capital injections. Banks in the country are more focused in investing in government securities and issuing term finance certificates (TFCs) in the corporate debt market than they are in extending their loan portfolios.⁴²

For microfinance providers, borrowing and equity investments contributed 85 percent of the total fund base of microfinance players over the past five years, indicating that deposit mobilization still plays a weak role as a source

⁴² State Bank of Pakistan, 2008, "Money and Banking," *Statistical Review Bulletin*, SBP, Karachi, Pakistan.

of funding.⁴³ While savings are a priority for most microfinance banks, savings deposits take time to accumulate, even with major investments in market research and product development. These banks, moreover, are still relatively new to the market and clients are only gradually becoming more aware of their products.

The average MFI in Pakistan will need to diversify its sources of funding to become financially sustainable by 2010. That means leveraging operations with different sources of debt and mobilizing savings deposits, a strategy that will require microfinance providers to create internal asset and liability committees to better manage their sources and uses of funds.

Assets of the financial sector and the microfinance sector

The asset composition of any surplus funds of commercial and microfinance banks in Pakistan is concentrated in cash and investments instead of loans. For banks, these surpluses are generated from returns on investments in government treasury notes and bonds, while the surpluses of microfinance banks are generated from short-term credit lines. These facts signal weak asset and liability management. While loan portfolios are growing, the volume of loans will not support the commercial sustainability of microfinance banks if these surpluses are not channeled into loan portfolio growth. At present only 50 percent of the assets of MFIs and other microfinance providers are deployed in loans.⁴⁴ Commercial banks also need to improve asset management and use their liquidity to increase returns and their overall performance. However, as discussed earlier, new capital adequacy requirements have forced banks to raise more equity; any excess liquidity is now invested in government securities instead of loans because the former do not carry capital requirements.

⁴³ Data from the PMN and NRSP, 1999.

⁴⁴ PMN and ShoreBank International, 2007, "Microfinance Industry Funding Facility: Concept Note," PMN and Shorebank International, Islamabad, Pakistan.

Table 15. Financial Sector Assets, 2003–2005

	2003	2004	2005
Assets (USD millions)	36,762	44,002	52,911
Banks	14,278	14,156	13,571
CDNS ^a	3,776	4,702	5,612
NBFIs	2,189	2,525	2,917
Insurance	62	82	123
MFBs ^b	57,066	65,468	75,133
Overall			
Share in overall assets of financial sector (%)	64.4		
	25	67.2	70.4
Banks	6.6	21.6	18.1
CDNS	3.8	7.2	7.5
NBFIs	0.1	3.8	3.9
Insurance	100	0.1	0.2
MFBs		100	100
Overall			
As % of GDP	52.7	53.9	55.6
Banks	20.5	17.4	14.3
CDNS	5.4	5.8	5.9
NBFIs	3.1	3.1	3.1
Insurance	0.1	0.1	0.1
MFBs	81.8	80.3	79.0
Overall			

Source: State Bank of Pakistan, “Financial Sector Assessment 2005,” SBP, Karachi, Pakistan.

Notes: Asset figures are rounded.

^a Central Directorate of National Savings, a government program for saving.

^b Microfinance banks.

Liabilities of the Financial and Microfinance Sectors

In 2006 and 2007, several private banks and non-bank financial institutions (NBFIs), such as Orix Leasing, issued term-finance certificates (TFCs)⁴⁵ to raise debt in the capital markets. Additional equity has been injected into the banks in order to comply with new capital adequacy requirements. Microfinance providers have benefited from large amounts of grant funding over the past few years and as a result, most are under-leveraged. The liabilities of these institutions are in the form of subsidized debt or small credit lines from local banks, signaling a weak financial position. These liabilities act as a limiting factor on their ability to diversify their funding sources via commercial banks and international investors.

⁴⁵ See footnote 5.

Performance

Financial Sector Performance

The banking sector in Pakistan has managed to grow substantially in the past several years, and profitability and asset quality have both improved. In 2000, the return on bank assets was –0.2 percent and the return on equity was –3.5 percent. Today, the return on assets stands at 2 percent and the return on equity, 20 percent. These earnings are in part due to changes in bank ownership structures and professional management by the private sector, which now holds over 80 percent of total banking assets. Growing foreign ownership and acquisitions have also paved the way for strengthening the capital base of banks and are helping enhance competition. In addition, in line with empirical evidence from other countries, it is expected that the market entry and growth of foreign banks will contribute to higher average loan growth, better risk management practices, greater provisioning, and improved loan loss absorption capacity.

Asset quality has benefited from loan restructuring and write-offs, stronger regulations, prudent lending, and growth in advances. The ratio of nonperforming loans (NPLs) to gross loans fell from 17 percent in 2003 to 7.7 percent in September 2007; net NPLs fell from 7 to 2.3 percent over this same period. Concurrently, provisions for the NPL ratio improved from 64 to 72 percent.⁴⁶ The capacity of banks to absorb losses has grown as the ratio of net nonperforming loans to capital declined from over 150.5 percent in 2001 to merely 11.4 percent in September 2007. Furthermore, growth and sector diversification of loan portfolios have helped reduce the risk of overexposure.⁴⁷

Looking forward, rising inflation and credit risks from increased exposure in the consumer lending sector will be challenges for the financial sector.

Performance of the Microfinance Sector

The performance of microfinance in 2007 was significant in terms of growth in outreach and the expansion of product lines. Approximately PKR 22.6 billion (\$337 million) was disbursed via 1.8 million microloans. Microsavings grew in value to a total of PKR 4 billion (\$60 million) and microinsurance coverage reached PKR 9.9 million (\$147 million).

There is a clear trend of urban over rural expansion, with the large microfinance players focusing on urban and peri-urban areas. The Rural Support Programmes and Khushhali Bank have the largest portfolio of rural clients. Nevertheless, many microfinance players consider rural outreach a

⁴⁶ PMN, 2007, “Microfinance Industry Funding Facility.”

⁴⁷ State Bank of Pakistan, 2007, “Annual Report 2006–2007,” SBP, Karachi, Pakistan.

strategic initiative going forward. In terms of gender coverage, women borrowers grew substantially and now comprise 50 percent of all borrowers.

Looking into the future, microfinance players will not be able to maintain this level of performance unless they achieve sustainability—the critical element for continued growth of the sector. At present there are only two sustainable microfinance players: First Microfinance Bank and Kashf Foundation. Given this situation, microfinance providers must focus on a number of performance indicators, including sustainability, profitability, asset and liability management, and efficiency.

Financial Infrastructure

Capital Markets

Pakistan's capital markets have grown, but remain both relatively narrow and shallow relative to larger regional markets. As of December 20, 2007, 671 companies were listed on the Pakistan Stock Market with total market capitalization of PKR 4.364 trillion (\$73 billion) and listed capital of PKR 717.3 billion (\$12 billion).⁴⁸ The stock market has since fallen 20 percent from its high of April 2008, indicating a loss in investor confidence due to concerns about Pakistan's political and economic situation.⁴⁹ Given the country's current risk profile, international investors may remain wary of its capital market. Although this market is regulated by the Securities and Exchange Commission of Pakistan, the country's access to financing from international markets is likely to become more expensive.

Debt financing will be a critical element of the expansion of microfinance in the next few years. However, organizations that require funding must overcome key hurdles before they can access it. The consolidated projections of the seven largest microfinance organizations, assuming expansion in the number of borrowers and loan balances, show a need of debt financing in the range of 40–44 billion PKR (\$600–\$660 million by 2010).⁵⁰ Since the Pakistan Poverty Alleviation Fund (PPAF) is the only wholesale fund and serves only nonregulated MFIs due to collateral requirements, there is a large gap in the supply of funding.

Microfinance banks find it difficult to raise secured financing because they cannot pledge their loan portfolios or assets, and are therefore left with unsecured and expensive financing options. Compounding the already difficult position of these banks is the prohibition on unsecured bank lending in Pakistan, and the requirement that banks have low spreads in

⁴⁸ See background information on the Karachi Stock Exchange (Guaranteed) Limited on the Wikipedia Web site, http://en.wikipedia.org/wiki/Karachi_Stock_Exchange (accessed June 2008). The URL of the Exchange itself is <http://www.kse.com.pk>.

⁴⁹ Frahan Bokhar, 2008, "Pakistan Must Strive to Restore Confidence," *Financial Times*, June 9.

⁵⁰ Estimate uses the exchange rate of US\$ 1 = 66.7 PKR as of June 1, 2008. See PMN and ShoreBank International, 2007, "Microfinance Industry Funding Facility."

deals with microfinance providers. Therefore, very few financing sources are available to microfinance banks. NGO-MFIs, nonshareholding companies (NSCs), and microfinance players formed under the Companies Ordinance have more debt financing opportunities, since NSCs may pledge their loan portfolios or other assets to add leverage to their capital structure. However, foreign exchange regulations make it difficult for all microfinance players to negotiate foreign currency loans.

In summary, there are four primary instruments currently available to microfinance institutions that facilitate transactions on the wholesale market: bank debt, term finance certificates (TFCs), foreign currency loans, and secured lines of credit. Bank debt financing is priced at LIBOR plus 1 to 4 percent, with short maturity periods of 2–3 years. TFCs are the most flexible form of debt financing, available to all microfinance players. Foreign currency loans have a price cap,⁵¹ which at times may be waived by the State Bank of Pakistan, but there is possible taxation on interest remittances. The repatriation of funds must also be cleared by the SBP. Finally, secured lines of credit are only available to NGO-MFIs or nonshareholding companies.

TFCs are the most flexible option because of their structure. These debt instruments are issued for the purpose of raising funds in the form of redeemable capital. Kashf Foundation has issued TFCs and Tameer Bank is also expected to float them as a source of funding. TFCs are regulated by the Stock Exchange Commission of Pakistan and can be issued either at fixed or variable rates. In the current regulatory environment, TFCs issued by microfinance providers are most likely to be on the unlisted market. Regardless of the category (i.e., secured/listed, secured/unlisted, unsecured/listed, or unsecured/unlisted), a facility rating from an approved rating firm is required.

Table 16. Four Primary Categories of Term Finance Certificates in Pakistan

	Listed (public)	Unlisted (privately placed)
Secured	For MFI-NGOs with strong ratings. Buyers would be general public.	For NGO-MFIs with strong ratings, assisted by credit enhancement. Buyers would be insurance companies, pension funds, mutual funds, or commercial banks.
Unsecured	For microfinance banks with strong ratings. Buyers would be general public.	For MFBs with strong ratings, assisted by credit enhancement. Buyers would be insurance companies or mutual funds.

Source: Shorebank International Limited and USAID, 2007, “A Primer on Debt Financing.”

Note: TFCs are secured by a pledge of assets.

⁵¹ Approximately 1–1.5 percent of the loan. Information on the potential for securitization and conducive market conditions was not available. The conclusion is that the market is too immature for this instrument at the moment.

To fill this large funding gap and respond to demand, Pakistan’s domestic capital market will have to be strengthened through diversification. Efforts are underway to create a commercial wholesale funding facility—the Microfinance Industry Funding Facility (MIFF)—which would serve all microfinance providers. The goal of MIFF is to provide investment information to investors, as well as to furnish credit enhancements and technical assistance to microfinance providers.⁵² A holistic view of the market for funding is important, but is a large burden for just one facility. Stakeholders are still evaluating the MIFF concept and are now envisaging a facility that would have a three-tier structure, allowing investors with different risk profiles to participate. Another idea is to implement a funding window for microfinance organizations through the Financial Inclusion Program of the State Bank of Pakistan.

Creating a commercially viable refinancing market for microfinance providers will take time. Therefore, strengthening alternative funding mechanisms in the short term through investment vehicles like TFCs is crucial, particularly to meet the financing needs of microfinance banks.

Payment System Overview

Since an efficient payment and settlement system (PSS) is a key component of the financial infrastructure, the State Bank of Pakistan has been actively working to reform the country’s PSS—both the retail payment and real-time gross settlement systems. The retail payment system in Pakistan comprises both paper-based and electronic transactions. While dominated by paper-based transactions, electronic transactions are steadily rising, with 50 percent of transactions related to automated teller machines (ATMs); 30 percent, to real-time online banking transactions; and 15 percent, to points of sale (POS) transactions. The remaining electronic transactions originate from call centers and other channels. To further improve ATM services—the most widely used mode of e-banking in Pakistan—the SBP has adopted international best practices, as outlined in operational guidelines. Furthermore, the clearance of intra- and inter-switch ATM transactions has been streamlined by shifting the settlement of interbank ATM transactions from switch operators to the SBP.⁵³

Interbank Money Market

The State Bank of Pakistan has outsourced interbank clearing activity to National Institutional Facilitation Technologies (Pvt) Limited (NIFT). A joint venture between a consortium of six major banks and the private sector, NIFT is responsible for the establishment and management of automated clearinghouse facilities in Pakistan. All types of conventional clearing services, including overnight clearing, same-day high-value clearing,

⁵² PMN and ShoreBank International, 2007, “Microfinance Industry Funding Facility.”

⁵³ State Bank of Pakistan, 2007, “Retail Payment Systems of Pakistan,” Third Quarter Report (January–March), FY2006–2007, Karachi, Pakistan, http://www.sbp.org.pk/psd/2007/Status_Report_Q_3_2006-07.pdf (accessed February 2009).

and intercity clearing are offered by NIFT.⁵⁴ Commercial banks participate in the interbank market for their short-term liquidity needs, however, microfinance banks are not eligible to borrow on the interbank market. In line with monetary policy, the SBP keeps tight liquidity conditions in the money market by keeping overnight rates close to the discount rate.⁵⁵

Deposit Insurance At present, no explicit deposit insurance is presently available to depositors in commercial banks in Pakistan. SBP provides financing for the short-term liquidity needs of commercial banks. Microfinance banks in existence five years or more must deposit at least 5 percent of their annual, after-tax profits in a Depositors' Protection Fund. The fund will reimburse deposits up to \$150 (PRK 10,000) upon liquidation of an institution.⁵⁶

Accounting Standards

Pakistan has developed three tiers of financial reporting standards that are intended for, respectively, public-interest entities, medium-sized entities, and small entities. The goal of the Institute of Chartered Accountants of Pakistan (ICAP) is to ensure that the public-interest tier is compliant with the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board by 2009. Currently, ICAP has not adopted the Pakistani equivalents of IFRS 1 and IFRS 4. Moreover, the Securities and Exchange Commission of Pakistan, the governmental body that must approve standards after ICAP adoption, has not yet approved the Pakistani equivalents of IAS 29, IFRS 7, and IFRS 8.⁵⁷ The banking sector is in compliance with 39 out of the 41 international accounting standards issued by the IASB. Microfinance banks are also required to follow IASB standards.

Audits Auditing of financial statements is required by microfinance players registered under the Companies Ordinance 1984 and the Microfinance Institutions Ordinance 2001. While Rural Support Programmes and NGOs that are registered under the Societies Registration Act or Trusts Act are not required to conduct external audits, it is common practice among most such organizations. Audits are conducted by local firms, such as Ford Rhodes Sidat Hyder and A.F. Ferguson, as well as branches of international firms, such as Ernst & Young and Price Waterhouse Coopers.

⁵⁴ The National Bank of Pakistan offers clearing and settlement services in cities where the State Bank of Pakistan does not have offices.

⁵⁵ State Bank of Pakistan, 2008, "Money and Banking."

⁵⁶ As per the Microfinance Institutions Ordinance 2001, Section 19; and Prudential Regulations for Microfinance Banks, Section 8 (Jeremiah Grossman, 2008 [February], "Pakistan," country entry in online comparative database of microfinance regulations, The Microfinance Gateway, Washington, DC, www.microfinancegateway.org/resource_centers/reg_sup/micro_reg/country/34/ [accessed February 2009]).

⁵⁷ Institute of Chartered Accountants of Pakistan (ICAP).

Rating & Credit Information

JCR-VIS Credit Rating Co. Ltd. is an agency approved by the Securities and Exchange Commission of Pakistan and the State Bank of Pakistan. The agency is a joint venture between Japan Credit Rating Agency, Ltd. (JCR), Japan's premier rating agency, and Vital Information Services (Pvt.) Limited (VIS), Pakistan's only databank and financial research organization. JCR-VIS operates as a full-service rating agency, providing independent rating services to all microfinance providers in the country. The agency was pre-approved by the MFI Rating Fund⁵⁸ for ratings of microfinance institutions in Pakistan and other South Asian countries.

The State Bank of Pakistan recently conducted a feasibility study for a separate, in-house microfinance credit bureau, which would be owned and managed by the SBP. In addition to providing services to regulated microfinance banks, the SBP would ensure that NGOs are part of the system by assisting them with the necessary reporting tools and resources and insisting that reporting be a standard requirement of funding contracts. Credit information on borrowers is expected to reduce risk and transaction costs as the market expands.⁵⁹ The Pakistan Microfinance Network is working closely with the SBP to develop the best model for the microfinance credit bureau.

Apex Banks

The Pakistani microfinance sector is growing fast. The rapid growth of the leading microfinance players over the last several years suggests that there will be a large demand for new funding over the next 10 years. The State Bank of Pakistan has set a goal of 3 million borrowers by 2010 (and another 10 million in a second phase).

The Pakistan Poverty Alleviation Fund

PPAF is the main provider of wholesale refinancing, but only to nonregulated microfinance players. It was launched with World Bank support in 1999 to address a range of development challenges, including lack of access to funding by nearly all unregulated microfinance providers. The apex fund represents an innovative model of public-private partnership. Incorporated under Section 42 of the Companies Act 1984, it follows the regulatory requirements of the Securities and Exchange Commission of Pakistan. The Fund is sponsored by the Government of Pakistan and funded by the World Bank and other leading donors, including the International Fund for Agricultural Development (IFAD), Asian Development Bank (ADB), and others.

As of February 28, 2007, PPAF had a resource base of PKR 49.5 billion (\$826.2 million). Before finalizing partnerships, PPAF ensures that partner

⁵⁸ The MFI Rating Fund sought to improve the quality, reliability, and availability of information on the risk and performance of MFIs by helping them obtain independent rating and assessment services by professional rating agencies. Managed and cofunded by the Consultative Group to Assist the Poorest (CGAP) and the Inter-American Development Bank (IDB), the Fund operated from 2001 through 2007.

⁵⁹ Interview with the microfinance unit of the State Bank of Pakistan, April 21, 2008.

institutions have well-targeted community outreach programs aimed at enhancing the economic welfare and income of disadvantaged people. The Fund refinances about 50 percent of the microloans disbursed by retail providers that are members of the Pakistan Microfinance Network. It is encouraging microfinance players to become sustainable by linking funding to performance criteria, with pricing tied to the institution's stage of development. However, PPAF loans are still priced between 6 and 10.5 percent below market rates. As of June 2006 its Microcredit Loan Fund had PKR 10.5 billion (US\$175.2 million) in lending funds and its outstanding loan portfolio to microfinance providers was PKR 4 billion (US\$66.9 million).

In addition to the PPAF, the Orangi Charitable Trust offers wholesale financing on a limited scale to a number of rather small microfinance providers in the provinces of Sindh and Punjab.

Potential New Ideas for Wholesale Structures

Given that the microfinance sector is growing rapidly and that existing vehicles will be insufficient to serve the market, the need for additional wholesale facilities is becoming more urgent. Therefore, different ideas are being discussed in the community. One such idea is a fund structure with several tiers of shares, which would allow investors with different risk profiles and return expectations to participate in the fund.

Shorebank International and PMN jointly proposed the Micro Finance Industry Funding Facility (MIFF) in November 2007. It is anticipated that the facility will be established under the umbrella of the Pakistan Microfinance Network in local currency. Further discussions to determine the exact structure of MIFF are underway.

Financial Industry Associations

The Financial Markets Association of Pakistan (FMAP) was formed in 1997 as a nonprofit professional association. Its members are drawn from national, foreign, and private sector banks. FMAP has more than 285 members, which annually elect the governing body.

The Pakistan Banks' Association (PBA) represents the Pakistan banking industry. Established in 1953, its main objective is to coordinate the efforts of the banking industry and share a common vision of progress and development with its members. PBA membership is institutionalized and is available only to banks operating in Pakistan. Over the years, the role of PBA has broadened considerably. It is now consulted by the State Bank of Pakistan when the latter formulates regulations for the banking industry; it has also been entrusted with regulating and monitoring certain services provided to the banking industry by outside service providers.

The Pakistan Microfinance Network (PMN) was created following a series of informal meetings among Pakistani delegates to the 1997 Microcredit Summit in Washington, DC, who recognized the benefits of having an industry association in the country. In 1999, the Microfinance Group Pakistan (MGP) was incorporated with funding from the Aga Khan Foundation and the Asia Foundation. It later became PMN, a legal entity under the 1984 Companies Ordinance. PMN's mission and vision is to help foster the emergence of strong retail microfinance providers that are able to provide diverse, quality financial services on a large-scale, sustainable basis. To pursue this goal, PMN advocates an enabling policy environment, encourages the acceptance of good practices throughout the sector, promotes the use of performance standards, and supports financial transparency.

The Pakistan Microfinance Network is one of the key sources of information and data on microfinance in the country. It gathers data from major MFIs in the country and publishes these statistics quarterly in its bulletin, *MicroWatch*. PMN also publishes a comprehensive *Performance Indicators Report of the Microfinance Sector* on an annual basis. In 2007, PMN received its first grant of \$256,000 from Citi Foundation USA through the Citi Network Strengthening Program. The three-year program disburses funding each year, subject to the previous year's performance and future proposals.

Training, Education, and Consulting

The microfinance sector relies heavily on the technical assistance programs of donors and the PMN. Currently, a microfinance training center is not available to provide high-quality training. In-house training is conducted only by the top microfinance players.

Presently, there are many donors providing technical assistance to microfinance providers in Pakistan. However, as the sector evolves, the institutional capacity of institutions will need to be further developed. Support and assistance will be required for the process of transformation, overall management (e.g., human resources, credit and risk management), and product development.

Technology

Information technology

The use of IT in microfinance operations is very underdeveloped in Pakistan. At a minimum, institutions need a proper management information system (MIS) to track the efficiency of operations. There is no indigenous MIS in place except at the Aga Khan Agency for Microfinance, which has developed its own in-house software. Tameer Bank is being supported by a CGAP grant and assistance to obtain an IT system. Lack of an IT system is inhibiting growth in the sector and is one of the main reasons why Khushhali Bank has not yet mobilized public savings. These basic technologies must be functioning in order to take advantage of new innovations, such as mobile phone banking, which can increase outreach, reduce costs, and improve the efficiency of service delivery.

Mobile phone banking

Two of the top microfinance players in the country (Kashf and Tameer) are about to launch pilot projects in mobile phone banking. However, all other microfinance organizations, with the exception of the First Microfinance Bank, do not have the IT infrastructure or human resources to handle this service at present.

Consumer Financial Education

Consumer financial education is still very limited in Pakistan. Recent donor grants will support financial literacy training for at least 1,000 people, with a special focus on women. This training aims to increase the knowledge, skills, and attitudes necessary for poor people to manage their own household finances. In addition, the Pakistan Microfinance Network is pushing to pursue truth in lending and consumer protection initiatives. Moreover, some transforming nongovernmental organizations plan to continue offering business development services and consumer financial education to clients as part of their business activities.

Legal, Regulatory, and Policy Framework

Regulation and Supervision

Pakistan is among the few countries in the world that has a separate legal and regulatory framework for microfinance banks. The framework allows microfinance and commercial banks to extend a range of microfinance services to poor and low-income customers through various arrangements.⁶⁰ Developed in consultation with microfinance stakeholders, the legal and policy framework does not cover the operations of nongovernmental organizations and Rural Support Programmes (RSPs); it is applicable only to regulated microfinance banks engaged in deposit mobilization from the public to finance their operations. While NGOs and RSPs are prohibited from mobilizing deposits for on-lending, they remain free to operate as they choose, determining their own client segment, pricing, funding sources, and loan sizes.

The State Bank of Pakistan is the regulatory authority for the formal banking sector, including microfinance banks. Commercial banks are regulated under the Banking Companies Ordinance 1962, and microfinance banks, under the Microfinance Ordinance 2001. The SBP recently approved Khushhali Bank's registration under this Ordinance—a positive step towards providing a level playing field for all microfinance banks in the country. The National Rural Support Programme has also submitted an application to the SBP to form

⁶⁰ SBP, "Prudential Regulations for Microfinance Banks (MFBs)," SBP, Karachi, Pakistan (available online on the Microfinance Gateway, Washington, DC, http://www.microfinancegateway.com/files/39173_file_Prudential_Regulations_for_Microfinance_Banks_MFBs_2007_.pdf [accessed February 2009]).

NRSP Microfinance Bank Limited; the applications of other institutions have been accepted to follow suit, including those of Kashf Foundation and Asasah.

The SBP requires microfinance banks to maintain a minimum paid-in capital at all times, dependent on their area of operation. Originally, all MFIs had to secure at least PKR 500 million (approximately \$8 million) at the beginning of operations, which could be waived later in the event that losses eroded their capital base. SBP current requirements are as follows: licensed microfinance banks operating in a specified district must keep PKR 100 million (\$1.5 million) as paid-up capital; those operating in a specified region, PKR 150 million (\$2.4 million); those operating in a specified province, PKR 250 million (\$4.0 million); and those operating at the national level, PKR 500 million (\$8.0 million). Finally, microfinance banks that do not meet the minimum requirement must make up any shortfall by December 31, 2008.

The SBP recently released new capital requirements guidelines. In particular, microfinance banks are required to maintain a capital adequacy ratio (CAR) of at least 15 percent of their risk-weighted assets. To meet this requirement, the central bank allows these banks to raise Tier II capital, including subordinated debt, in local currency. Other guidelines recently released by the SBP include those for branchless banking and Islamic microfinance.

The Securities and Exchange Commission of Pakistan (SECP) prudentially regulates nonbanking finance companies and insurance companies. NGOs and RSPs are also registered with the SECP as not-for-profit companies under Section 42 of the Companies Ordinance 1984 or by provincial registration authorities (either as societies under the Societies Registration Act 1860, or as trusts under the Trusts Act 1882).

Legal Environment

Neglect and a general lack of funding have produced a number of problems in the Pakistani legal system. Difficulties include long delays, lack of a centralized coordinating body to develop policy, lack of professional management, a shortage of judges, inadequate infrastructure, and meager public access to justice. These factors have been exacerbated by a decline in the standard of legal education and in professional standards, as well as undue political influence over the judiciary. Some changes have been made in recent years, but overall, the legal system needs extensive further development. It is widely mistrusted, partly for its slowness, but largely because it is seen as corrupt and a tool of the presidential administration. The legal system is not perceived as intrinsically antforeign, but its apparent inability to respond quickly makes it an inherent obstacle to business. Significant problems remain unaddressed, but it is still generally held that the system has potential for reform.

Corporate Governance

In March 2002, the Securities and Exchange Commission of Pakistan issued the Code of Corporate Governance (the Code) to establish a framework for

the governance of companies listed on Pakistan's stock exchanges (i.e., those in Karachi, Lahore, and Islamabad). The Code is a compilation of "best practices" designed to provide a framework by which companies listed on the stock exchanges will be directed and controlled, with the objective of safeguarding the interest of shareholders and promoting market confidence (i.e., enhancing companies' operational performance and regulatory compliance).⁶¹

Efforts to increase investor and depositor trust in financial institutions in the country are ongoing. For banks and development finance institutions, the SBP has outlined a roadmap toward Basel II implementation that sets forth dates for adopting standardized approaches to both credit and operational risks (by January 2008) and internal ratings of capital requirements (by January 2010). The banking sector is in compliance with most of the 25 core Basel principles.⁶² With respect to microfinance, the SBP encourages all players in the industry to maintain high standards and practices of corporate governance. For microfinance, this injunction includes the terms of external auditors and time periods in which accounts must be submitted in line with SECP guidelines on corporate governance.

Gap Analysis

Summary of Gaps

Retail microfinance service providers:

- perception of microfinance as a charity and social service
- lack of a sustainability strategy (many unsustainable institutions)
- pricing does not permit cost recovery
- passing of subsidized funding to clients
- lack of competent human resources
- inadequate IT/MIS infrastructure
- insufficient funding to increase outreach
- lack of diverse products and services (e.g., savings, insurance, various loan sizes)
- inability to raise debt due to regulatory restrictions on pledging security
- concentration in the sector and corresponding lack of competition

Wholesale funds, networks, other service providers:

- leading apex fund PPAF does not have a cost-recovery strategy
- social services and financial services are not differentiated

⁶¹ Securities and Exchange Commission of Pakistan, 2002, "Manual of Corporate Governance," SECP, Islamabad, Pakistan.

⁶² CGAP, 2007, "Pakistan: CLEAR."

- lack of flexibility when disbursing funds
- lack of strong training and technical assistance
- limited to almost obsolete commercial wholesale market

Government supervision, regulations, policies and laws:

- over-reliance on microfinance as a tool for eradicating poverty
- limited government understanding of best practices
- unwillingness to address the real costs of delivering microfinance products and services
- government involved in direct credit delivery
- confusion concerning supervision and the role of regulator; risk of regulator overstretching its mandate by becoming a funding agency
- risk of over-regulation (e.g., loan ceilings)
- SBP influence and regulations in structuring debt financings
- duplication of efforts by nongovernment stakeholders (e.g., SBP credit bureau, wholesale funds)

**IFC / KfW
Activities**

In Pakistan, the IFC has supported the establishment of Tameer Bank as a greenfield microfinance bank via technical assistance, loans, and equity investments. In addition to Tameer, the IFC has provided equity capital to the First Microfinance Bank. Jointly with CGAP, it has also funded market studies on mobile banking and is providing technical assistance for product development and branch manager training. KfW established an office in Islamabad in March 2008 with plans to become an active investor in the microfinance sector in Pakistan.

**Other Donor
Activities**

According to data collected by the Pakistan Microfinance Network and a CGAP study, major donor agencies have committed \$254 million for various microfinance projects and programs for the period 2006–2010.

The following paragraphs give a brief description of the support that donors are providing microfinance providers in Pakistan.

World Bank: The World Bank supports the PPAF through loans and grant funding.

IFAD (International Fund for Agricultural Development): IFAD funds the PPAF and encourages outreach into rural areas. The fund approved a five-year Program for Increasing Sustainable Microfinance (PRISM) in late 2007. The program will be financed through a long-term concessionary loan to the Government of Pakistan of approximately \$35 million from IFAD and \$11.6 million from local sources, including commercial banks. PRISM includes a credit enhancement facility, equity fund, and technical assistance for organizations.

UNDP (United Nations Development Programme): UNDP provides technical assistance to First Women's Bank, First Microfinance Bank, and Orix Leasing, with a special focus on microcredit for women.

DFID (Department for International Development, UK): DFID previously provided grants and loan capital to Kashf Foundation and other microfinance providers in the North West Frontier Province. DFID also supports the Pakistan Microfinance Network and has provided funding to the "Access to Finance" program, modeled after the FinMark Studies. DFID is interested in participating in future funding mechanisms and is involved in the structuring of such mechanisms.

EC (European Commission): The EC supports the training sector by funding the Centre of Excellence and developing a certification course for microfinance bankers. It also provides funding to the Orangi Charitable Trust.

SDC (Swiss Development Corporation): The SDC supports the Leasing Association of Pakistan, the Centre of Excellence (a training organization), the Pakistan Microfinance Network, and two regional networks. In addition, SDC funds capacity building in microfinance regulation and supervision for the State Bank of Pakistan.

ADB (Asian Development Bank): The ADB has been influential in the microfinance sector in Pakistan. It supported the adoption of the new regulatory framework for microfinance banks. More recently, ADB extended two loans totaling \$320 million to support "Improving Access to Financial Services Programme (IAFSP), Phase I," a reform program aimed at improving access to credit and other financial services: The loans will be accompanied by a technical assistance grant in the amount of \$2 million. The proposed ADB loans are as follows: (i) \$300 million from ADB ordinary capital resources with an interest rate to be determined in accordance with ADB's London interbank offered rate (LIBOR-based lending facility), with a term of 15 years and a grace period of 3 years; and (ii) Special Drawing Rights 13,425,000 (\$20 million) from ADB Special Funds resources, with a term of 24 years and a grace period of 8 years, and an interest rate of 1.0 percent per annum during the grace period and 1.5 percent per annum thereafter.

The expected completion date is 24 months after program launch; the program loan is expected to close three months after program completion. The loan will be released in two tranches. The first tranche of \$120 million will be made available when the Government of Pakistan meets the conditions of loan effectiveness and complies with the first tranche conditions. This tranche will consist of \$100 million from ADB's Other Capital Resources (OCR) and \$20 million from its Special Funds resources. The second tranche of \$200 million from OCR is expected to be released

within 24 months of loan effectiveness, upon satisfactory compliance with agreed-upon conditions.

USAID (U.S. Agency for International Development)/ Shorebank International: SBI is a technical advisory body with a staff of 12 young professionals; its head Pakistan office is in Islamabad. SBI initiated the USAID-sponsored “Widening Harmonized Access to Micro Finance (WHAM)” program in 2005. The three-year program concluded on March 31, 2008. SBI intends to continue to provide technical assistance to key MFIs and commercial banks in Pakistan. Currently, it works with eight microfinance providers: First Micro Finance Bank Ltd., Kushhali Bank, Tameer Micofinance Bank, National Rural Support Programme, Kashf Foundation, Asasah, BRAC, and ASA.

SBI provides technical advisory services in certain areas of microfinance, including capacity building, research, publications, and product development. Its Human Resource Development Initiative (HRDI) provides training on commercial terms. SBI has provided extensive technical advisory services to Kashf and the National Rural Support Programme to facilitate the transformation of their microfinance operations into microfinance banks. SBI-Pakistan plans to hold 10 percent of the equity of Kashf Bank. Furthermore, it plans to provide the new bank with an experienced banker for its Board of Directors. SBI has also provided Kashf with a pool of technical assistance funds, assisted them in developing an IT strategy and a framework for credit risk management, and trained its staff to use these tools. SBI-Pakistan is currently providing the National Bank of Pakistan with technical advisory services related to products for SMEs.

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