Proportionality in Practice: Challenges in Application of Standards and Guidance to support Financial Inclusion in Pakistan

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Outline

Snapshot of Pakistan

State of Financial Inclusion in Pakistan

Proportionality in Pakistan's Financial Inclusion Strategy

Challenges in Application of SSBs Standards and Guidance

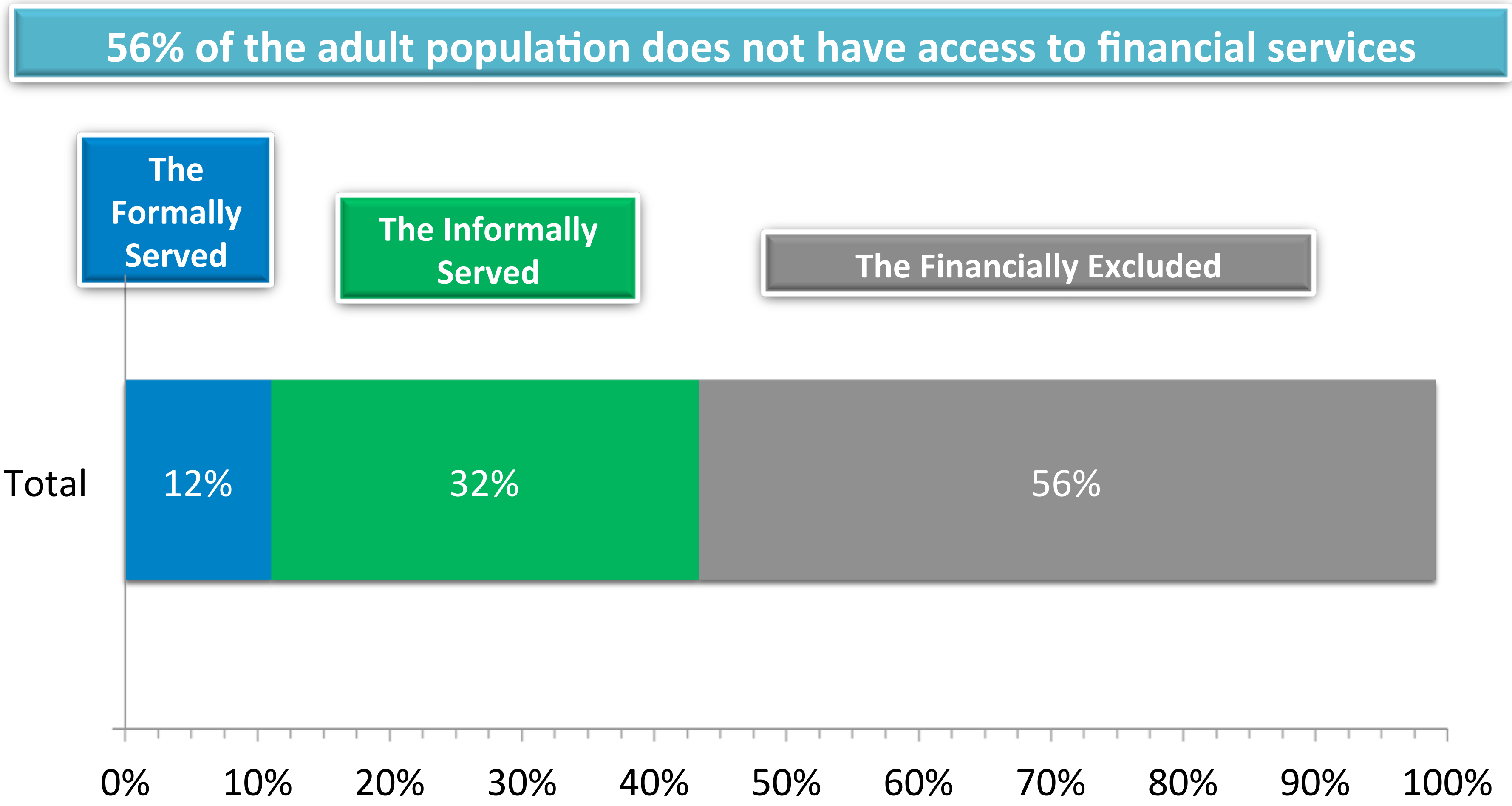

TAJIKISTAN
CHINA
NORTHERN AREAS
NWFP
Peshawar
JUMMU & KASHMIR
(Disputed Territory)
AFGHANISTAN
FEDERALLY ADMINISTERED TRIBAL AREAS
Islamabad
Lahore
Quetta
PUNJAB
PAKISTAN
BALOCHISTAN
INDIA
IRAN
SINDH
Karachi
ARABIAN SEA

Snapshot of Pakistan

Pakistan is a medium sized and lower middle income country

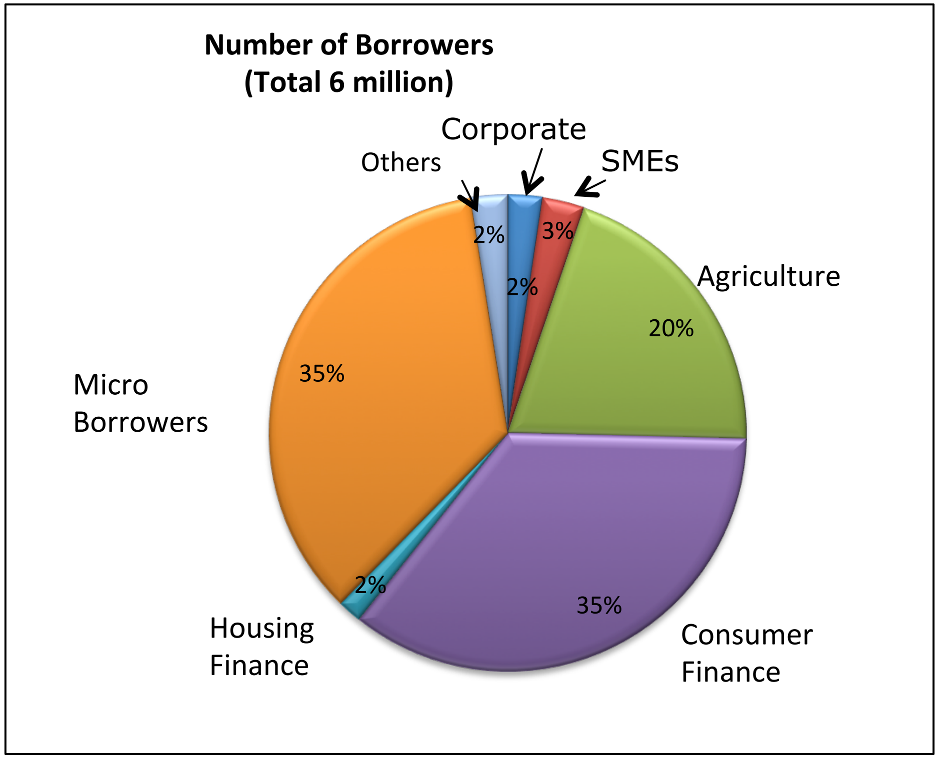
Surface area	796,095 sq.km
Population	185 million
• Rural	68%
• Urban	32%
Per Capita Income	USD 1250
Exchange Rate	1 USD= 95 PKR
Total Labor Force	55.4 million
• Agriculture	45%
• Manufacturing & mining	13%
• Construction	6.6%
• Other	21%

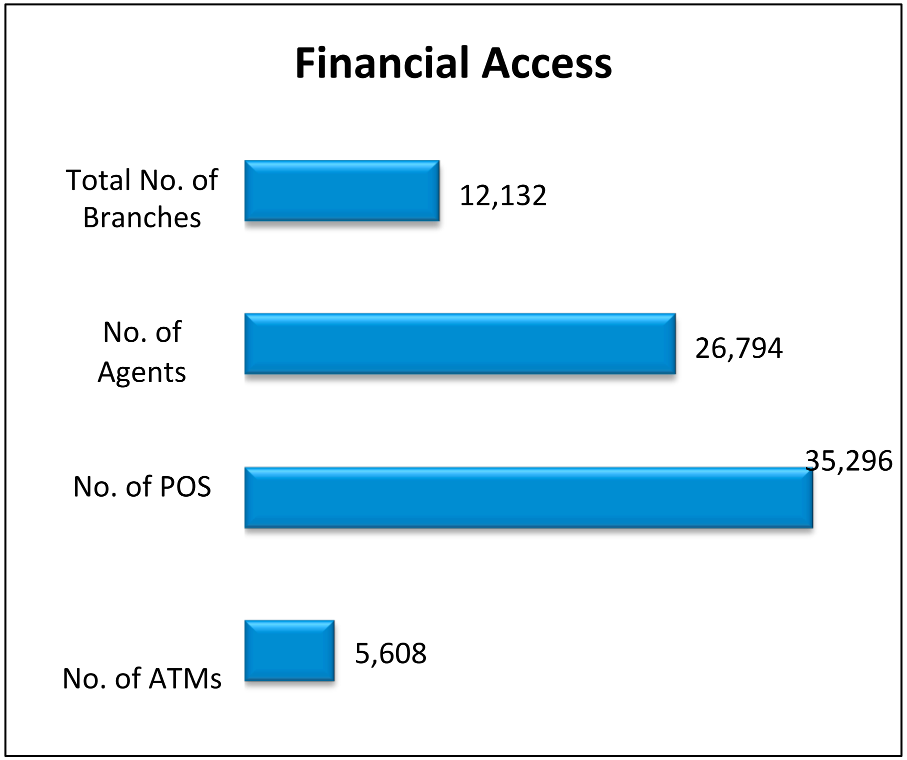
Financial Inclusion in Pakistan



Source: Access to Finance Survey conducted by WB/DFID/SDC/PMN/SBP 2007-08

Financial Inclusion & Access





Number of Deposit Accounts: 30 million
Number of M-wallets: 1.5 million

Sector Wise Development Finance Loans

As of 30th June, 2012

Sector	Total Outstanding Rs. Billion	As a share of total advances	As a percentage of GDP
SMEs	247.9	7.1%	1.3%
Agriculture	189.9	5.4%	1.0%
Microfinance (MFBs Only)	17.3	0.5%	0.1%
Housing Finance	57.7	1.7%	0.3%
Infrastructure Finance	286.3	8.2%%	1.5%
Total	799.1	22.9%	4.1%

Proportionality in Pakistan's Financial Inclusion Strategy

Promoting alternative models for broad-based financial services

Sector Specific Prudential Regulations for Banking

- To address sector specific risks and opportunities, SBP has issued separate prudential regulations for corporate, agriculture, SME and consumer finance. For example, Agri PRs deal with issues such as re-scheduling/classification of loans in case of calamities, cash-flow based financing etc.

Separate Licensing regime and regulations for Microfinance Banks (MFBs)

- To provide alternative to conventional banking to serve the lower end of the market which remains financially excluded.

Branchless banking to leverage technology and agent networks

- To overcome geographic barrier, Branchless Banking (BB) is helping achieve rapid scale while resulting in reduced transaction costs to banks and social cost to clients.

Consumer protection and financial literacy

- To address demand-side barrier, consumer protection and financial literacy are pillars of SBP's financial inclusion Strategy. Nationwide Financial Literacy Program launched in 2012 to impart awareness and understanding of basic financial concepts, targeting 47,500 beneficiaries (in pilot phase) through class room trainings, street theatres, and mass media campaign.

Consultative approach for developing policies and regulations

- Policies and regulations are developed through consultative committees with stakeholders

SBP Experience in Applying Guidance/Standards

Microfinance Regulations (1)

Capital adequacy

- CAR for MFBs is 15% (higher than the requirement for commercial banks of 10%) due to high risk of MFBs emanating from collateral-free lending, low deposit-base and reliance on donor/ commercial funding
- Capital requirements vary for MFBs depending on jurisdiction size of area of operations (district, regional, provincial, nation-wide)
- Tiered MCR have allowed investors to operate and expand according to their appetite and capacity

Risk management process

- MFBs are required to formulate operational policies for all areas of operations including micro-credit, investments, internal audit, human resource and rescheduling/restructuring/write-off of loans/advances etc.,
- All policies have to be approved by Board of Directors (BoD.
- These policies are also reviewed during statutory audits/on-site examination to further streamline operations. However, risk management requirements for MFBs are not as sophisticated as ordained for conventional banks.

SBP Experience in Applying Guidance/Standards

Microfinance Regulations (2)

Credit risk

- MFBs are allowed to finance activities under three categories after necessary CDD
    - General Loan size up to PKR 150,000/- against HH income of PKR 300,000/- net of business expenses
    - Housing Loans up to PKR 0.5 million against HH income of PKR 600,000/-
    - Microenterprise Loans up to PKR 0.5 million for setups that employing up to 10 persons
- Limits placed on Borrowers' Maximum Exposure
- Mandatory CIB for all loans sizes
- Maximum limits placed on Investments
- Provisioning requirements with instructions to charge-off infected portfolio within one month of classification as loss
- NPLs are rescheduled/restructured as per the policy approved by BoD. Such loans remain classified unless serviced regularly for 6 months
- Industry wide portfolio quality has historically remained quite high
- MFB have been able to keep NPLs below international benchmark of 5%
- Healthy performance and growing financials have attracted foreign investment in the sector

SBP Experience in Applying Guidance/Standards

Microfinance Regulations (3)

Abuse of financial services and related party exposures

- MFB shall make all reasonable efforts to determine the true identity of its clients and shall develop and implement effective procedures and methods for the purpose of KYC
- Maintain identification and transaction data for five years after termination of the business relationship
- MFBs are not allowed to
  - Finance speculative activities
  - Enter into leasing, renting and sale/purchase with its directors, officers, employees or persons who either individually or in concert with their family members own 5% or more of the equity of the MFB, without the prior approval in writing of the State Bank;
  - Hold, deal or trade in real estate except for use of MFB itself
- No insider abuse of institutional resources reported
- Continued improvement in governance and risk management processes and culture

SBP Experience in Applying Guidance/Standards

Microfinance Regulations (4)

Market, liquidity, and interest rate risks

- MFBs are allowed to borrow in Foreign Currency appropriately mitigating foreign exchange rate risks subject to prior approval of SBP
- MFBs shall maintain Cash Reserve equivalent to not less than 5% of its Deposits with the State Bank
- Statutory Liquidity Reserve equivalent to at least 10% of its total demand liabilities and time liabilities with tenor of less than 1 year, in the form of liquid assets i.e. cash, gold and unencumbered approved securities
- All MFBs except Tameer Microfinance Bank are indirect members of the payment system (Clearing House) and pose minimum systemic risk
- Coverage of interest rate risk has been left with MFBs

SBP Experience in Applying Guidance/Standards

Microfinance Regulations (5)

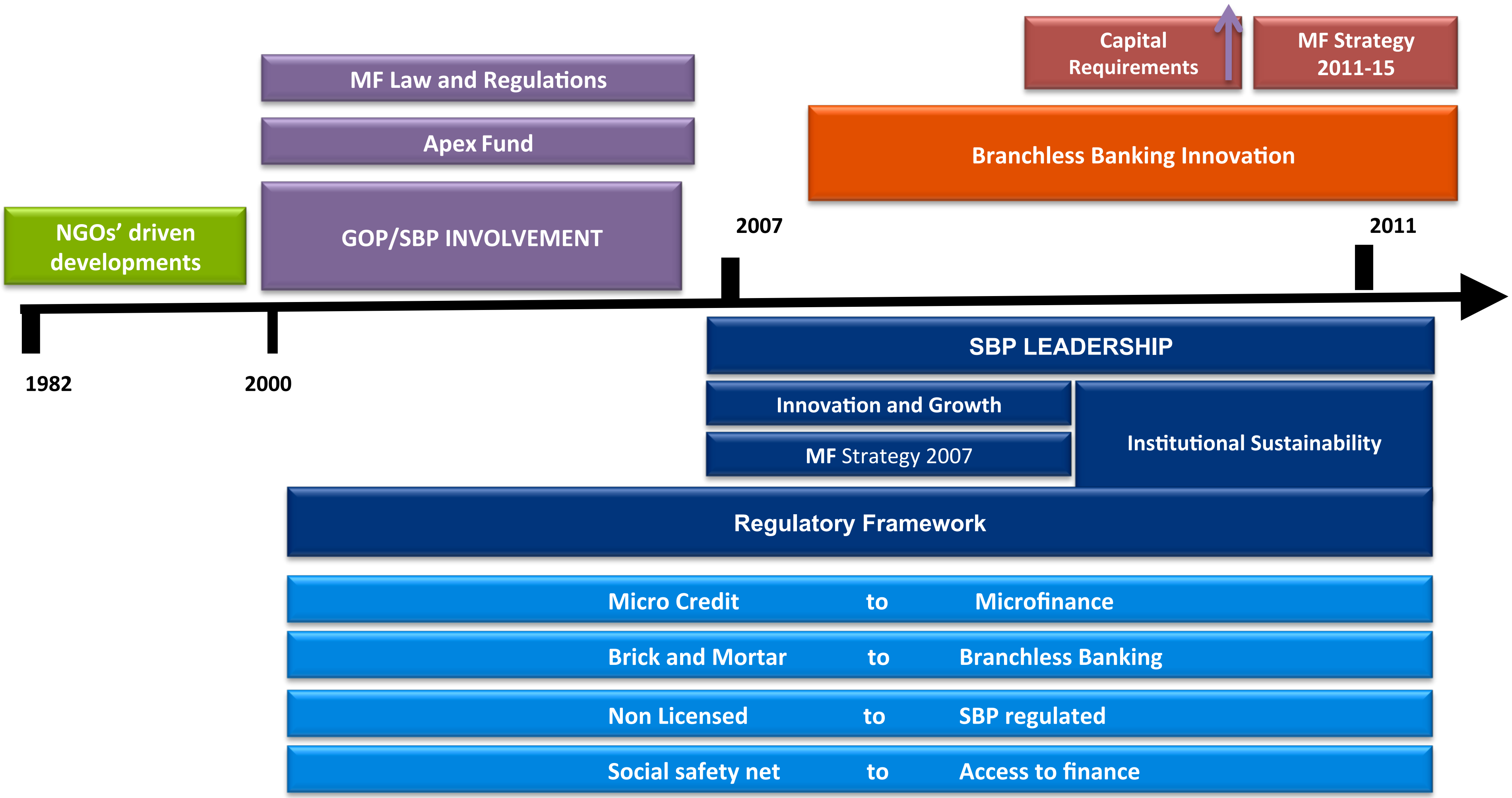
Operational risk, internal control and audit

- MFBs BoD and senior management ensure development of policies and risk management systems for areas of operations and oversee implementation
- MFB have an Internal Audit Department manned by professionals/persons having prior audit experience in banks/Financial Institutions
- Head of Internal Audit report directly to the Board or its Audit Committee

Supervisory approaches and tools

- Separate legal & Regulatory framework for Microfinance that entrust SBP with corrective and remedial powers
- The balance between risks and rewards is embedded in SBP's organizational structure:
  - Separate Onsite Inspection and Offsite Surveillance Departments
  - Dedicated teams for policy, strategy development and program management
  - Market Consultation Forums (MFCG, Branchless Banking Consultative Group)
  - Regulatory /Supervisory Returns
  - Well-established coordination mechanism among regulators (SECP, PTA, NADRA etc.)
  - Initiatives to enhance supervisory capacity
- SBP has adequate supervisory capacity to supervise the sector and take timely corrective and remedial measures utilizing legal authority

Evolution of Microfinance



SBP Experience in Applying Guidance/Standards

Branchless Banking Regulations

Salient features

- Only Bank-led model allowed
- Risk-based KYC/CDD (Level 0 to 3 for account opening) and associated transactional limits and security levels
- Agent assisted banking (Direct and Super Agents)
- Customers protection and awareness (Bank responsible for grievance handling mechanism)
- Level "0" BB Account has been introduced with flexibility to the Agent and the Financial Institution (FI) for opening of basic BB accounts while rationalizing the Know Your Customer (KYC) requirements in line with the transaction limits.
    - No physical documents handling
    - Agents are allowed to send the Digital Account Opening Form, customer's digital photo and an image of customer's CNIC to the FI electronically
- The existing requirement of obtaining biometric fingerprint scan at the time of opening Branchless Banking (BB) Account at the agent location was withdrawn in 2011
- Introduced a new category of fund transfer from BB accountholder to other persons (non-accountholder) up to the limit of Rs. 25,000 per month
- Person to person fund transfers allowed up to limit of Rs. 15,000 per month.

Mobile banking serving low income, unbanked

- Globally, providing financial services via agents costs on average 30 times less than bank branches
- Agents cost 76 times less than bank branches. Replacing agents with a mobile phone further cut costs in half.
- In 2011, CGAP conducted survey of Easypaisa customers at locations across rural, semi-urban, and urban Pakistan. The survey found:
    - 69 percent of Easypaisa users live on less than $3.75 per day
    - 41 percent live on less than $2.50 per day; and
    - 5 percent live on less than $1.25 per day.
    - strong correlation between the likelihood of being poor and the likelihood of not having had a bank account among users.
    - Customers from all walks of life seemed to value the service and felt that it was making their lives easier.
    - Three-quarters of the respondents (76%) felt the service has a positive impact on their lives and a high majority of users (88%) thought the service was easy to use.
    - 45 percent of users were previously unbanked

Key Indicators

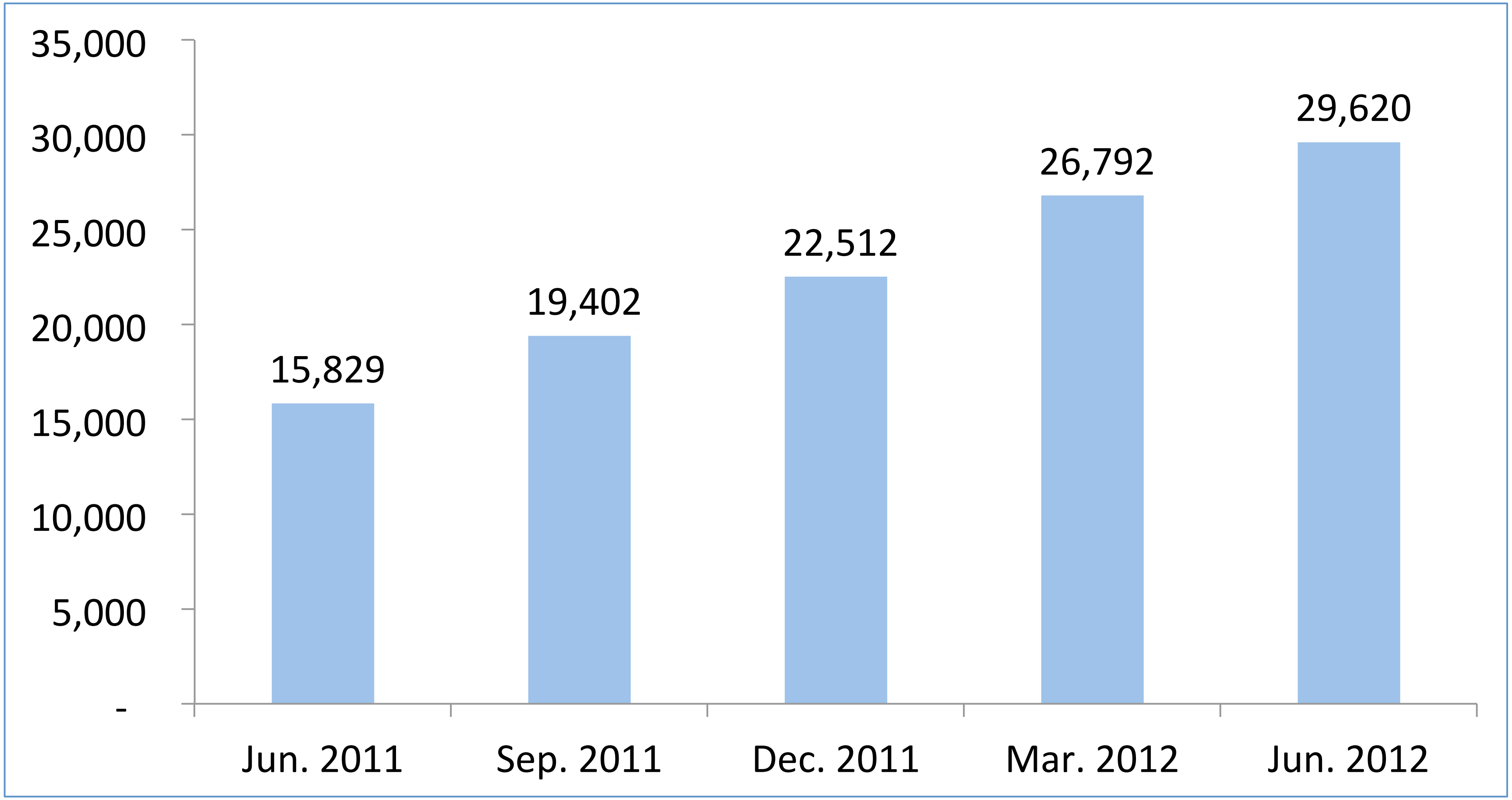
Indicators	March 2012	June 2012	Quarterly Growth
Total Number of Agents	26,792	29,525	10%
Total Number of Accounts	1,059,519	1,447,381	37 %
Total Number of Transactions (No. in Million)	25.3	28.4	12%
Average Size of Transaction (in Rs.)	3,367	4,065	21%

Challenges in Application of Proportionality

- Lack of clear guidance on how to apply proportionality in everyday practice of regulations and supervision or perhaps lack of the minimum acceptable level of applying standards and guidance
- Maintaining balance between financial stability and innovation
- Managing risks associated with mobilization of inexperienced customers
- Need for coordination among SSBs to jointly agree on financial inclusion and issue standards and guidelines in overlapping areas to address proportionality
- Create forums for deliberating on compliance issues facing developing countries.

Thank You!

Total Number of Agents



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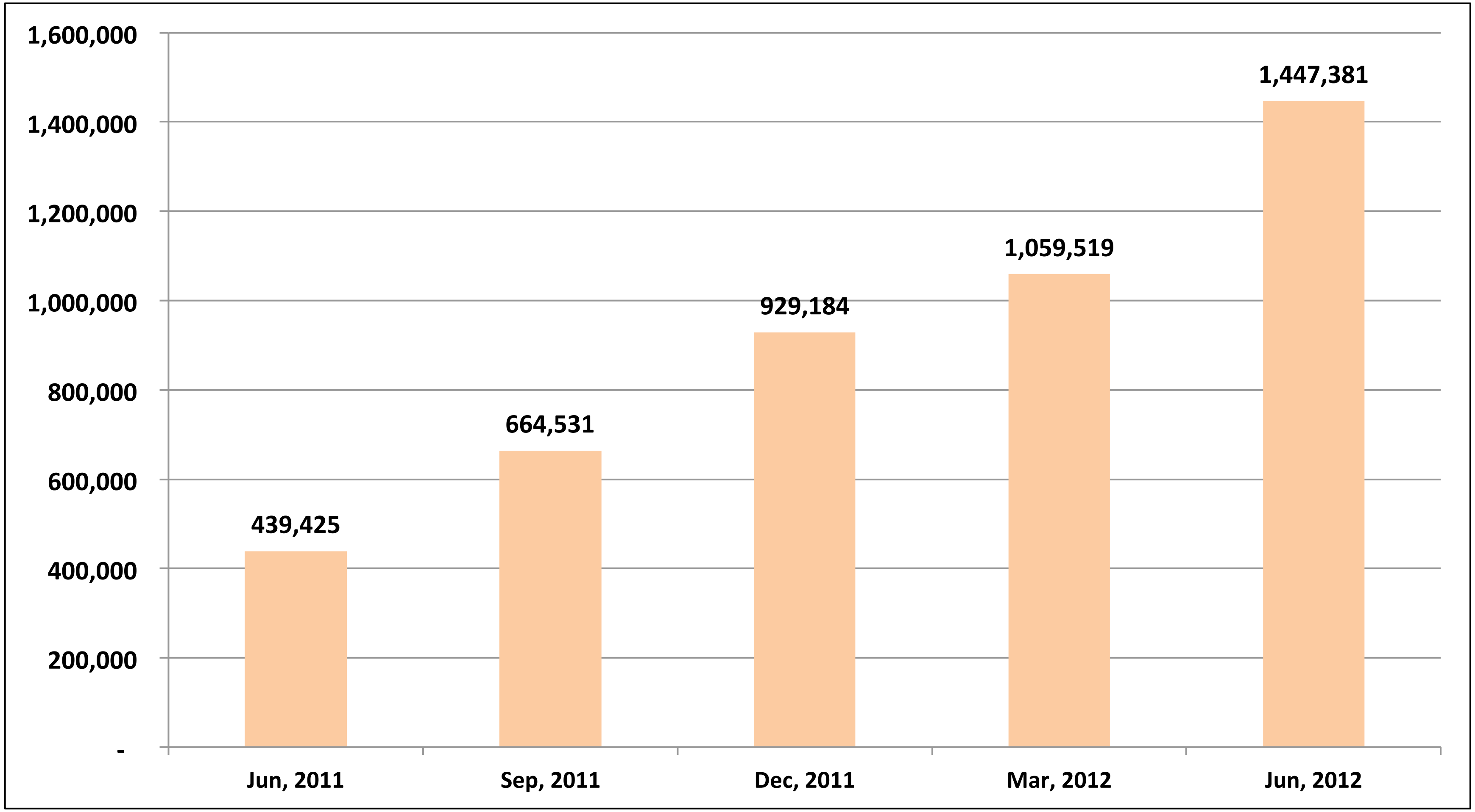
Total Number of Accounts



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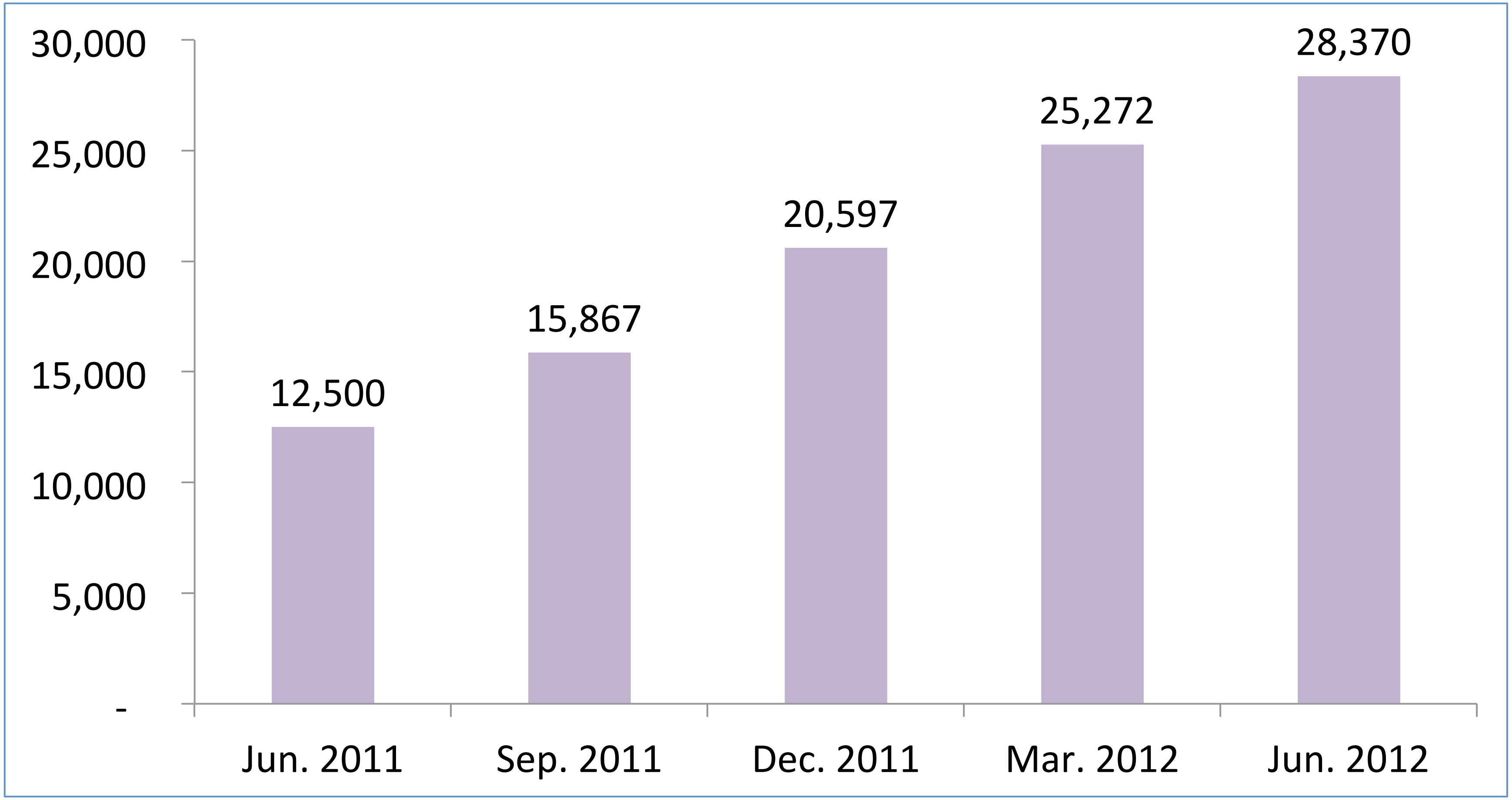
Total Number of Transactions

(in '000')



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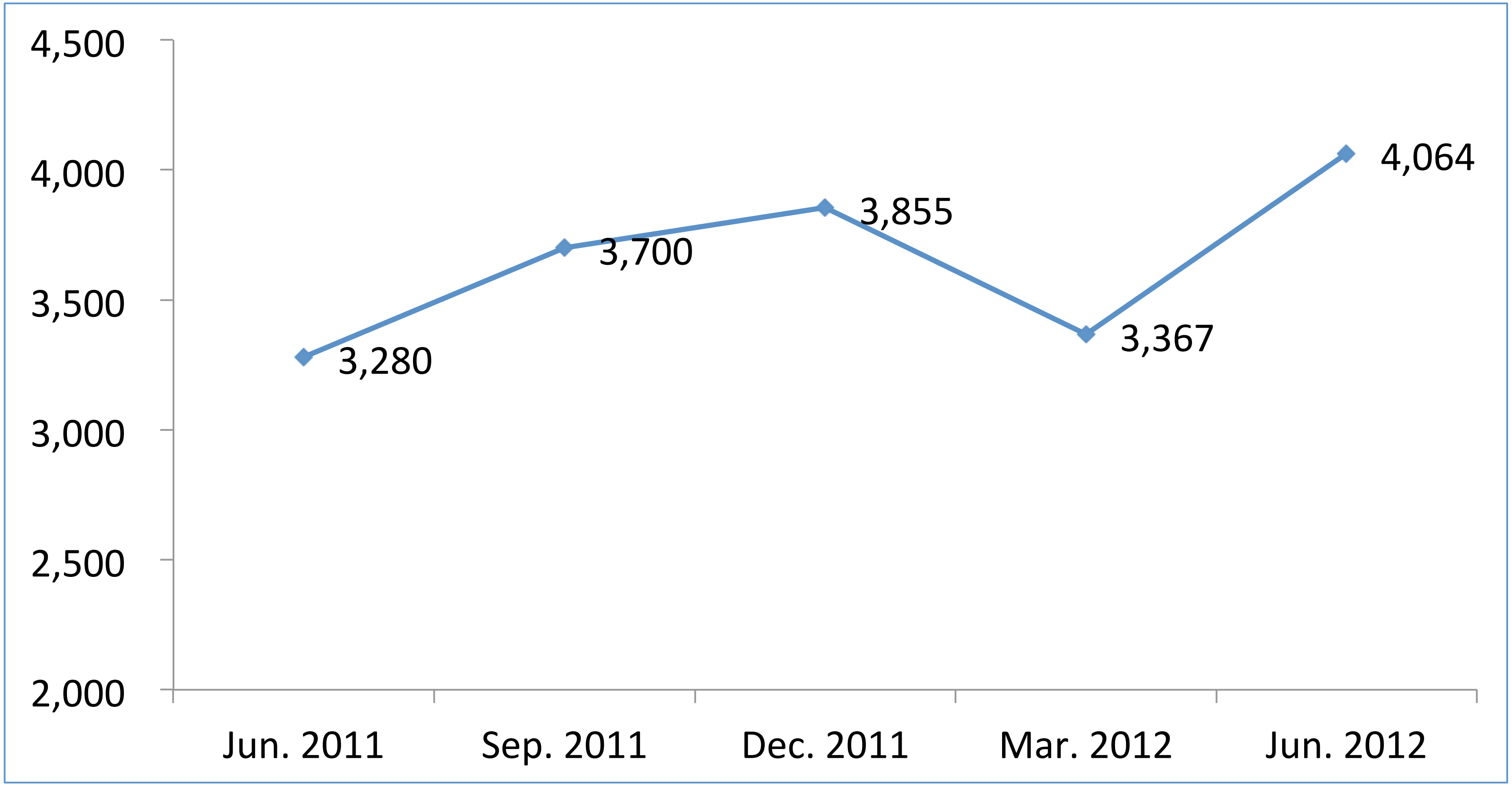
Average Size of Transaction

Amount in PKR
1 US$ = approx 95 PKR



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