

# Analyzing the Significance of Micro Credit in Pakistan

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## Abstract

Microcredit provides small loans to poor people and small enterprises. It is the best solution of removing poverty. This study provides an overview of the significance of microcredit in Pakistan. The major objective of the study is to show the microfinance sector performance and impact of the microcredit on the different poverty levels. This study is based on both quantitative and qualitative methods in order to answer the thesis questions. The result of the study was that microcredit helps in the poverty alleviation of different categories of poor people and has the positive effects on their living standards. It was found that there is a high interest rate on micro loans because of the administrative cost. We discovered that there are three types of organizations that provide services of microfinance in Pakistan. The government takes interest and supports the microfinance sector and of their main initiative is microfinance ordinance 2001. It was observed that there is improvement in the microfinance sector in the recent years in terms of investments, active borrowers, branches and personnel. The study suggests that government should provide microcredit in order to improve the standard of living of the people and to eradicate poverty.

## Introduction

Poverty has been a major development problem of Pakistan. Microcredit seems to be one of the effective solutions to removing poverty of the people. It can help to improve their income. It can help them establish their own business and decrease their vulnerability. It also works as an instrument of self-employment for men and women to bring about change. People with low income do not have access to formal financial institutions, are the main clients of microcredit.

The target market of microfinance sector is estimated to be 25 to 30 million borrowers and government has set the outreach goal posts to at least 3 million by 2010 and have moved it further to 10 million by 2015. To increase outreach the sector adopted extensive growth strategy and the overall growth rate of outreach varied from 100 percent in 2004 to a low level of 36 percent during 2005-06 and later to 52 percent in 2007. Outreach in terms of number of active borrowers increased from a low base of 240,000 in 2003 to 1.27 million in 2007. Gross loan portfolio increased from Rs. 2.3 billion in 2004 to 12.7 billion in 2007, loan size also increased from Rs. 6,629 in 2004 to Rs. 10,000 in 2006 and 2007. The number of savers increased from 888,000 to 1.14 million in 2007 and investment in the sector is as high as \$400 million during 1999-2005 (Pakistan Microfinance Network, 2007)

The vision of microcredit is quite simply to create systematic change in financial systems worldwide. The aim of microcredit is providing financial services to targeted poor people and small medium enterprises. Microfinance is the most important resource to provide the loans and other basic financial services to increase the employment rate and productivity and earning capacity. It will also create the empowerment of the people. Microfinance indirectly impacts on the poor people through removing poverty and improving living standards, such as health, education, food and other social impacts.

## 1.1 Background of the study

The microcredit approach is not so new. In the mid 1800s, individualist anarchist Lysander Spooner wrote about the benefits of numerous small loans for entrepreneurial activities to the poor as a way to alleviate poverty (Lysanderspooner.org). The importance of micro loans is a very old phenomena but microcredit is became very popular and in organized ways in the mid 70s by the Professor of Economics Dr Muhammad Yunus, a Noble Prize winner in (2006) in Bangladesh. When Muhammad Yunus realized that there was a whole sea of would-be entrepreneurs among the poor of his country. These were people who could be running thriving businesses but who could not start their startups due to a lack of capital. He endeavored to find ways of getting this startup capital to people who needed it. He quickly discovered that credit-lending institutions in Bangladesh were not providing the loans to poor without any collateral. So he finally established a bank that would take on risky propositions, and lend out a few hundred dollars at a time to individuals to start small businesses.

Professor Muhammad Yunus established the Grameen Bank in Bangladesh in 1983, fueled by the belief that credit is a fundamental human right. His objective was to help poor people escape from poverty by providing loans on terms suitable to them and by teaching them a few sound financial principles so they could help themselves (nobleprize.org).

Microcredit is defined as a credit provided to 'poor' free of collateral (the only collateral is the —peer collateral) through institutionalized mechanism. This credit is made available 'as and when' needed, at the doorstep of the client (Bajwa, 2001). Microcredit is generally defined as making small loans available directly to small-scale entrepreneurs to enable them either to establish or to expand micro-enterprises and small business. Microcredit is normally applied to target groups that would otherwise not qualify for loans from formal institutions. This includes the majority of those living below the poverty line (Commonwealth Secretariat, 2001).

Microfinance is defined as formal scheme designed to improve the well being of poor through better access to saving and services loans (Schreiner, 2000). Microfinance refers to small-scale financial services primarily credit and savings provided to people who farm or fish or herd; who operate small enterprises or micro enterprises where goods are produced, recycled, repaired, or sold; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing countries, both rural and urban. Many such households have multiple sources of income (Robinson, Marguerite 2001).

The difference between microcredit and microfinance is that microcredit refers to very small loans for unsalaried borrowers with little or no collateral, provided by legally registered institutions. Currently, consumer credit provided to salaried workers based on automated credit scoring is usually not included in the definition of microcredit, although this may change. Microfinance typically refers to microcredit, savings, insurance, money transfers, and other financial products targeted at poor and low-income people ([microfinancegateway.org](http://microfinancegateway.org)).

The term microfinance has been used interchangeably with microcredit in Pakistan, largely because other services and products in the sector have been far less developed than credit. Savings and insurance, for example, are still in their infancy as far as their provision by microfinance institutions is concerned, and even some microfinance banks have been slow to evolve their savings instruments and potential. Debate about microfinance in Pakistan continues to be largely about microcredit (Haroon Jamal, 2008).

Definitions of micro credit differ, of course, from country to country. Some of the defining criteria used include size-loans are micro, or very small in size target users micro entrepreneurs and low-income households utilization the use of funds for income generation, and enterprise development , but also for community use ( health/ education) etc. Terms and conditions most terms and conditions for microcredit loans are flexible and easy to understand, and suited to the local conditions of the community. The word microcredit did not exist before the seventies. Now it has become a buzz-word among the development practitioners. In the process, the word has been imputed to mean everything to everybody. No one now is shocked if somebody uses the term microcredit to mean agricultural credit, or rural or cooperative credit, or consumer credit, credit from the savings and loan associations, or from credit unions, or from money lenders. When someone claims microcredit has a thousand year history, or a hundred year history, nobody finds it as an exciting piece of historical information (Grameen –info.org).

## 1.2 Background to Pakistan

Pakistan became independent in August 14, 1947 after a long political struggle against British regime. Pakistan is located in very important strategic location in South Asia, share eastern border with India, north eastern border with China, while south-west border with Iran and Afghanistan is at western and northern edge. Country has total area 796,096 sq km. administratively, country is divided in four provinces, Sindh, Punjab, Balochistan and Khyber Pakhtunkhwa, with tribal area (Federal Administrative Tribal Area-FATA), Azad Jammu and Kashmir and Federal Territory Islamabad. Country has total 153.96 inhabitant contributing 2.5 percent of world population and 2nd largest country by population with PGR 1.8 percent (SBP Annual report). Sixty five percent of total population is living rural areas while 35% in urban areas. (Pakistan—Some Basic Facts-2008).

In Pakistan various different languages are being spoken, more than 55 languages. English is the official language and used in business, offices, education, and government etc. Urdu is the national language of Pakistan. The other major four languages that are used in four provinces are Panjabi, Pashto, Sindhi and Balochi. In Pakistan, the majority of the population is Muslim, about 95% and other 5% of population belongs to Christianity, Hinduism and Sikhs.

The health sector in Pakistan is progressing during the last few years in term of per capita health spending, life expectancy, infant and maternal mortality rates, and provision of immunization to children, provision of human and physical health infrastructure. Life expectancy is low in Pakistan, 63.2 years for males and 63.6 in females compare with other regional countries like 71.7 in male in Sri Lanka 70.2 in China. This low average in life expectancy in Pakistan is due to poverty, low health spending, lack of infrastructure and lack of awareness. Pakistan is using US\$18 per capita for health which is very less than that of recommended minimum amount of US\$34 set by WHO (SBP-a, 2007).

Education figures are not encouraging in Pakistan. Now the country's literacy rate is 54 percent which is still behind from other neighboring countries like Indian with 61 percent and Sri Lanka 90 percent. Currently, there are 0.23 million educational institutions in the country where 33.38 million students are enrolled and 1.35

million teaching staff are serving. While among these institutions, 0.08 million institutions are working in private sector where 0.632 million teaching staff are employed. Government is spending 1.84 % of total GDP on education (SBP-a, 2007).

### 1.3 Profile of Poverty in Pakistan

In Pakistan poverty has many dimensions. The poor in Pakistan have not only low income but they also lack access to basic needs such as education, health, clean drinking water and proper sanitation. The latter undermines and limits their capabilities, limits their opportunities to secure employment, results in their social exclusion and exposes them to exogenous shocks. Then the vicious cycle of poverty is accentuated when then government structures exclude the most vulnerable from the decision making process. Poverty is one of the most important problems that are faced by country. But due to increase of economic activities and policies of the government, there are some good numbers came on poverty and poverty reduction. In Pakistan, 24 % of the people live below the poverty line which was 34% in 2000-01. Poverty ratio almost is double in rural areas compared to urban. For example, in 2006 the poverty ratio was 14.96%, while in rural areas; it is 28% (SBP-a 2007). Table 1.1 presents extremely poor in the country is 1.1 % in 2001 and 1 % in 2005; Ultra poor is 10.8 % in 2001 and 6.5 % in 2005 and poor is 22.5 % in 2001 and 16.4 in 2005.

**TABLE 1.1 Comparative Poverty Profile (% of population) in Pakistan**

Poor/non-poor categories	2000-01	2004-05
Extremely Poor	1.1	1.0
Ultra Poor	10.8	6.5
Poor	22.5	16.4

Source: PRSP, 2006, p.8

Microcredit is not new in Pakistan but relatively young compared to other countries in the region. Initially microfinance started in 1960 by the agriculture banks; provide loans to the poor farmer to gain fertilizers, yielding seeds and machinery etc. In the early 1980s Aga Khan Rural Support Program (AKRSP) start its credit operation to the poor people by providing financial and social services. But know large number of organization work as a microfinance provider to poor people with objective of improving their income and living standards. It is considered one of the effective tools of poverty alleviation and helping the poor people. According to one estimate, there are about 20 to 30 Million clients requiring Micro Finance services in Pakistan (Pakistan microfinance network). Starting the program Pakistan poverty alleviation fund by the government of Pakistan is the key step to the microfinance. Some other micro finance institutions are banks such as Khushhali Bank and Bank of Khyber, nonprofit organization such as Islamic relief micro project and Rural Support Programmes etc, are also important microfinance provider institution.

### 1.4 Objective of the study

The purpose of this study is to understand the detail procedure and work of micro credit and the main goals and objectives to introduce micro loans.

The study aims to analyze the:

- Role and organizations of micro credit in Pakistan
- To check the performance of micro credit in Pakistan
- To observe the impact of micro credit in Pakistan
- To decrease the poverty in Pakistan
- To suggest policy recommendations.

### 1.5 Limitation of the study

The limitation of our study is to get the primary data. It is relatively difficult to get primary data related to research, that's why we depended on the secondary data. We don't have our own calculations to answer the question and we are depended on the other result and calculations.

### 1.6 Organization of the study

This study is organized as below:

Chapter 1 explain the history of microcredit, that when microcredit will start in the meaning full form. And also explain the purpose of our research. Chapter 2 deals with literature review related to the study. Chapter 3 explain the procedure that how we should collect the data and answer our question. In Chapter 4 the data is processed and analyze to present the answer of our thesis question. Chapter 5 present the conclusion of our study based on results and Policy recommendations.

## Literature Review

In this section we present different theories of previous research in microfinance. We explain microfinance, how it works, its role and user, and contribution in poverty alleviation.

### 2.1 Concept of Microfinance

Microfinance collectively refers to the supply of loans, savings, and other basic financial services like insurance, to the poor. As the poor people cannot avail these financial services from the formal commercial banks because of the collateral requirements, so microfinance tends to provide to them exclusive of these conditions. For these financial services, the poor people are willing to pay for because of the added advantage they receive for not collateralizing anything. The term also refers to the practice of sustainably delivering such services. More broadly, it is a movement that envisions a world in which as many poor and near poor household as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers (Christen, R. P., Rosenberg, R., and Jayadeva, V., 2004). Poor people are not able to get loans from commercial banks due to lack in guarantee and collateral. But there are also many other reasons that commercial banks not willing to provide fund to poor people, such as poor people have less education, no real experience and training, high cost for transactions of small loans and lower profit. Therefore, limited opportunity to access loans leads to people fall into more poverty. This situation resulted in the emerging idea for new market of micro financing to poor people.

### 2.2 Characteristics of Microfinance

The main characteristics of the microfinance are providing small loans to the business. According to the Murray, U and Boros, R (2002) microfinance has several characteristics that are:

1. Small amounts of loans and savings.
2. Short- terms loan (usually up to the term of one year).
3. Payment schedules attribute frequent installments (or frequent deposits).
4. Installments made up of both principal and interest, which is amortized over the course of time.
5. Higher interest rates on credit (higher than commercial bank rates but lower than loan-shark rates), which reflect the labor-intensive work associated with making small loans and allowing the microfinance intermediary to become sustainable over time.
6. Easy entrance to the microfinance intermediary saves the time and money of the client and permits the intermediary to have a better idea about the clients' financial and social status.
7. Application procedures are simple.
8. Short processing periods (between the completion of the application and the disbursements of the loan).
9. The clients who pay on time become eligible for repeat loans with higher amounts.
10. The use of tapered interest rates (decreasing interest rates over several loan cycles) as an incentive to repay on time. Larger loans are less costly to the MFI, so some lenders provide large size loans on relatively lower rates.
11. No collateral is required contrary to formal banking practices. Instead of collateral, microfinance intermediaries use alternative methods, such as the assessments of clients' repayment potential by running cash flow analyses, which is based on the stream of cash flows, generated by the activities for which loans are taken.

### 2.3 Micro credits as Development Tool

During the last two decades, micro-credit approach has been increasingly incorporated in the development discourse. Specially the credit is given to the women and the popular belief is that women are benefited and empowered and are being acknowledged for having a productive and active role and thus it is the gateway of gaining freedom for themselves. Since the start in Bangladesh by the NGOs, in the late 1970s, it has spread all over the world and is now believed to be a successful method of poverty alleviation. Such NGO Programs have reversed conventional top down approach by creating livelihood opportunities for the poorest citizen, especially for the women who are about 94 percent of their client. (Thente, Sofia, 2003). Microcredit is now considered the effective development tool of poor people especially for women. Women are become more empowered and play important role in generating income in the rural areas of Pakistan.

In most developing countries, policies for rural financial development have been based on three erroneous beliefs concerning their target groups:

1. Rural micro-entrepreneurs are unable to recognize themselves,
2. They are too poor to save; and
3. They need cheap credit for their income-generating activities or small enterprises (Harper, M, 2003).

The microfinance company analyzes the need of their target customer that they required small loans in term of microcredit to sustain their small enterprises.

## 2.4 Microfinance Institutions

A microfinance institution is an organization that arranges small loans and financial services to the poor people and small business. According to the definition on Microfinance Gateway an MFI is the organization that offers financial services to the low-income people (Microfinance gateway, 2008). There is a wide range of micro financial institutions. Mostly when we talk about these, financial NGO's come into the mind. These financial NGO's provide micro credit and micro finance services too and in most cases these financial NGO's are not allowed to capture saving deposits from general public. Many NGO's provide other financial services along with microfinance and similarly some commercial bank are also providing microfinance along with their routine financial activities so because of these micro finance services which are quite bit part of the whole of the activities of these commercial banks we can call these as a microfinance institutions (Rehman, 2007). There are some other MFI's that can be considered in the business of micro finance. These institutions are the community based financial intermediaries such as credit union; cooperative housing societies and some other are owned and managed by the local entrepreneur and municipalities. This type of institution is varying from country to country (Rehman, 2007).

## 2.5 Users of Microfinance

There are now nearly 70 million poor people who are getting benefits from 2500 micro finance institutions in over 100 countries by microfinance (Sengupta, Aubuchon, 2008). This fact shows how microcredit is important and useful, and how a huge number of people are facilitated by the microfinance institutions. This is the reason is that microfinance is gaining importance as an effective tool of social mobilization and poverty alleviation.

## 2.6 Islamic Microfinance (Interest Free)

According to Islamic law (Sharia) the payments or acceptance of interest fees are prohibited for the lending of money. But the borrower will share the profit, which he gets from the business with the lender.

As in Islam, charging interest (*Riba*) on liquid cash is prohibited by Islamic teachings. Money is not an asset for earning profit (Dhumale, Sapcanin, p.1). Islam emphasizes on social, ethical and moral factors for distribution of wealth and guide towards social and economic justice. Islam rather than interest, encourage profit because earning profit evolve productive activity and involve in profit and risk sharing between lender and borrower (Dhumale, Sapcanin, p.1-2). The Islamic microfinance institution provide loan to the poor people without any interest. This approach is very helping the poor people because interest rate of the micro credit is relatively high.

## 2.7 Role of Micro Credit in Poverty Alleviation

Microfinance is recognized as an effective technique to remove poverty by providing financial services for those who have no access to or are neglected by the banks and financial institutions. The poor people are very sharp in removing their poverty, they have good ideas and they are very hard workers but the problem is with them they have no resources. Microcredit is helping provide these resources by small loans, and help people improve their income level. According to Ahmad (2000), it is recognized that people living in poverty are innately capable of working their way out of poverty with dignity, and can demonstrate creative potentials to improve their situation when an enabling environment and the right opportunity exists. It has been noted that in many countries of the world, micro-credit programs, provide access to small capitals to people living in poverty.

The phenomenon of poverty was felt and observed more during the decade of 1990s, as the overall growth slowed down. While the slower economic growth contributed to poverty, the trickle-down effect once thought to improve living conditions, did not reach the lowest level owing largely to lack of accessibility of institutions, unjust and non-poor policies (Waheed, 2001). Poverty has been a major challenge since the known civilization came into existence. After the 1990s the poverty rate rose in the economy, and to control it, microcredit is the one of the best tools. Large numbers of poor people have improved their income as well as contribute to national economy.

In recent years, in its wider dimension micro-credit known as micro-finance, has become a much-favored intervention for poverty alleviation in the developing countries and least developed countries. There is scarcely a poor country and development oriented donor agency, (multilateral, bilateral and private) not involved in promotion (in one form or other) of a micro-finance program. Many achievements are claimed about the impact of micro-finance programs, and an outside observer cannot but wonder at the range of diversity of the benefits claimed. Various studies demonstrate that rapid and sustainable poverty reduction depends on interaction of a wide range of policy measures and interventions at macro and micro levels. (Ahmed, S, 2002)

## 2.8 Micro Entrepreneurship

Microfinance is an emerging tool for economic development, poverty alleviation, empowering of low income communities and contributing a new role in micro-entrepreneurship (Mondal, p.1-3). The microfinance sector analyzes the need of their target customer that they required small loans in term of microcredit to sustain their



small enterprises.

There are two types of microfinance borrowers; one is a Micro borrower and the other, a Micro entrepreneur. A micro borrower has mind like capitalist who is aim to earn profit while doing business. So a micro borrower gets finances from MFIs (Micro Finance Institutions), and after paying back, again they will get finances but only if the motive is to generate profit but not any entrepreneurial achievement. On the other hand, a micro entrepreneur finances their business and brings innovation, creativity and doing a different from others (Mondal, p.3).

### **2.9 Grameen Model**

A prominent economist and professor from Bangladesh, Muhammad Yunus in 1976, came up with a new concept and model, which is called, "The Grameen Model". During a field trip to a relatively poor village in Bangladesh with his students in 1974, Muhammad Yunus interviewed a woman who had a small business of making bamboo benches. Due to the shortage of the resources to purchase the raw materials, she was forced to borrow small amounts of money from a local lender. Without any collateral, she could only borrow enough money to buy the raw materials to build one piece at a time. The woman had to repay the lender with high interest rates. Sometimes the interest rate of that loan exceeded 10% of the principal amount. After repaying the lender, the woman was left with a profit margin that was not enough to even meet her basic daily needs. Had she had access to more complimentary terms for her loan, she would have been able to save enough money to protect her from future uncertainties and in the long run, would have been able to raise herself above the survival level. Discouraged by what he saw, Dr. Yunus took matters into his own hands and lent a small amount of money as a loan to some 42 rural basket-weavers. He found that these small loans went a long way, and almost everyone who had borrowed the money, were keen to repay their loans. Dr. Yunus found out that even with this tiny amount of money it is possible not only to help the poor to survive but also to create the spark of personal initiative and enterprise in the people, necessary to pull themselves out of poverty (Roy, Mark, A, 2003).

In Grameen model, a unique and innovative approach of group lending is used. As Sengupta, Aubuchon (2008) described, the group lending has many benefits. First, groups usually organize in members who are neighbors to each other; those can understand each other well and recognize their needs. Second, if anyone of the group members is not present in the group meeting, the leader or another member can pay its installment. We can say that there is a kind of mutual understanding between all members. Third, in south Asia generally, and specifically in Bangladesh, there are social pressures among members of society with social bindings with them. If one member of the group will not pay even one installment, social pressure will be levied from all eight groups on this member. Ultimately he will try to pay installments. This leads to the reduction of risk.

### **2.10 Microfinance provides Empowerment**

Microfinance provides empowerment to the women's. Misra (p.3) describes empowerment as a power to the people and self governance. He quoted "Empowerment builds self-reliance and strength in women, preparing them towards gathering the ability this adds to determine the choice of life. This adds to the command over resources outwit insubordination and signify their social role".

While according to PREM, WB (2002, p.11), "Empowerment is the expansion of assets and capabilities of poor people to participate in , negotiate with , influence, control, and hold accountable institutions that affect their lives".

From the above discussion, we conclude that theoretical studies have supported the idea of microcredit in poverty alleviation in the economy. The present study is an attempt in this regard to analyze the significance of microcredit in poverty alleviation.

## **Research Design and Methodology**

### **3.1 Method and Materials**

We used qualitative methods for our research questions as we deal with literature, articles, internet, numerical and non-numerical data. We mostly concentrate on the years from 1999 to 2005 for statistical data through which we analyze the performance of microfinance. We look at the growth rate of the potential borrower of micro credit and also look at the investment growth in the microfinance institutions. Information we get from the statistical data and the information we get from the microfinance organization employ and borrower of microfinance will get us the answer the question of our thesis.

### **3.2 Research Strategy and Tool**

The research approach of our thesis is to identify the role of microcredit in removing poverty in poor peoples, and also shows the achievements of the microcredit in Pakistan.

We have a large availability of literature, articles and material on internet on our research questions, so

we can use the deductive approach. It is developing a little easier road to a solid background in research topic rather than inductive approach.

We first use the qualitative method for our research questions. The first question of our thesis consists of a theoretical portion. We examine the role of microcredit in Pakistan. What are the interest rates apply on these loans? What are the different types of microfinance institution work in Pakistan and the government role in microfinance industry? For our second thesis question we use qualitative methods based on quantitative data and quantitative analysis performed in the literature. We use the past statistical data to analyze the performance of micro finance sector.

The net impact of micro credit borrower is derived from the given formula.

$$P^* = (Pbt1 - Pbt0) - (Pnbt1 - Pnbt0)$$

Where  $P^*$  is Net impact of micro credit on poverty status of borrower households;  $Pbt1$  is the poverty status of the borrower households with current income level;  $Pbt0$  is the poverty status of the borrower households with previous income level;  $Pnbt1$  is the poverty status of the non borrower household with current income level;  $Pnbt0$  is the poverty status of the non borrower household with previous income level, and 't1' represents the duration from Jan 2004 to Jan 2005 and 't0' stands for the duration from Jan 2003 to Jan 2004 (Shirazi ,Khan ,2009).

### 3.3 Data and Data Sources

There are many ways to get the information to answer the research questions. The ideal way would be to collect information from different sources and including all kinds of necessary information. To select the proper and correct method of information several steps has been taken including analysis and reporting resources, resources available, credibility and competence of evaluator etc.

We collected the statistical data and literature from different resources which helped to answer our thesis questions. We collected the statistical data from the Pakistan microfinance network, Pakistan poverty alleviation fund, performance of micro credit in Pakistan and internet. This statistical data consist of the number of active borrowers, assets, investment, branches and employees of microfinance institutions. We get to use this data to analyze the performance of microfinance sector. To find out the micro credit help in removing poverty of people by comparing data of different years to know about the improvement in the active borrower's, investments, new microfinance branches and personnel. We look at the different micro financial institutions works in Pakistan, and looking their role in poverty alleviation. These institution statistical data is very reliable and relevant to our research topic. These institutions have large data and research on the microcredit

### 3.4 Secondary Data

We used most of the secondary data in our thesis from several sources. Secondary data sources have sharper critical information that is already proven and researched by the researcher.

We got the secondary data from the Microfinance network, State Bank of Pakistan, Pakistan poverty alleviation fund, and Sarhad rural support programs. This data is very reliable and valid to answer our thesis question. This secondary data includes all the facts and figures derived by the researcher to make performance reports and annual reports of the microfinance institution. We will use this statistical data to analyze the micro finance sector performance and achievements in Pakistan. We compare the statistical data of one year with different years to know about the progress of micro finance sector. In our research we also use university data base which is good source of online books and articles.

## Results and Discussions

### 4.1 Role of Micro Credit in Poverty Alleviation

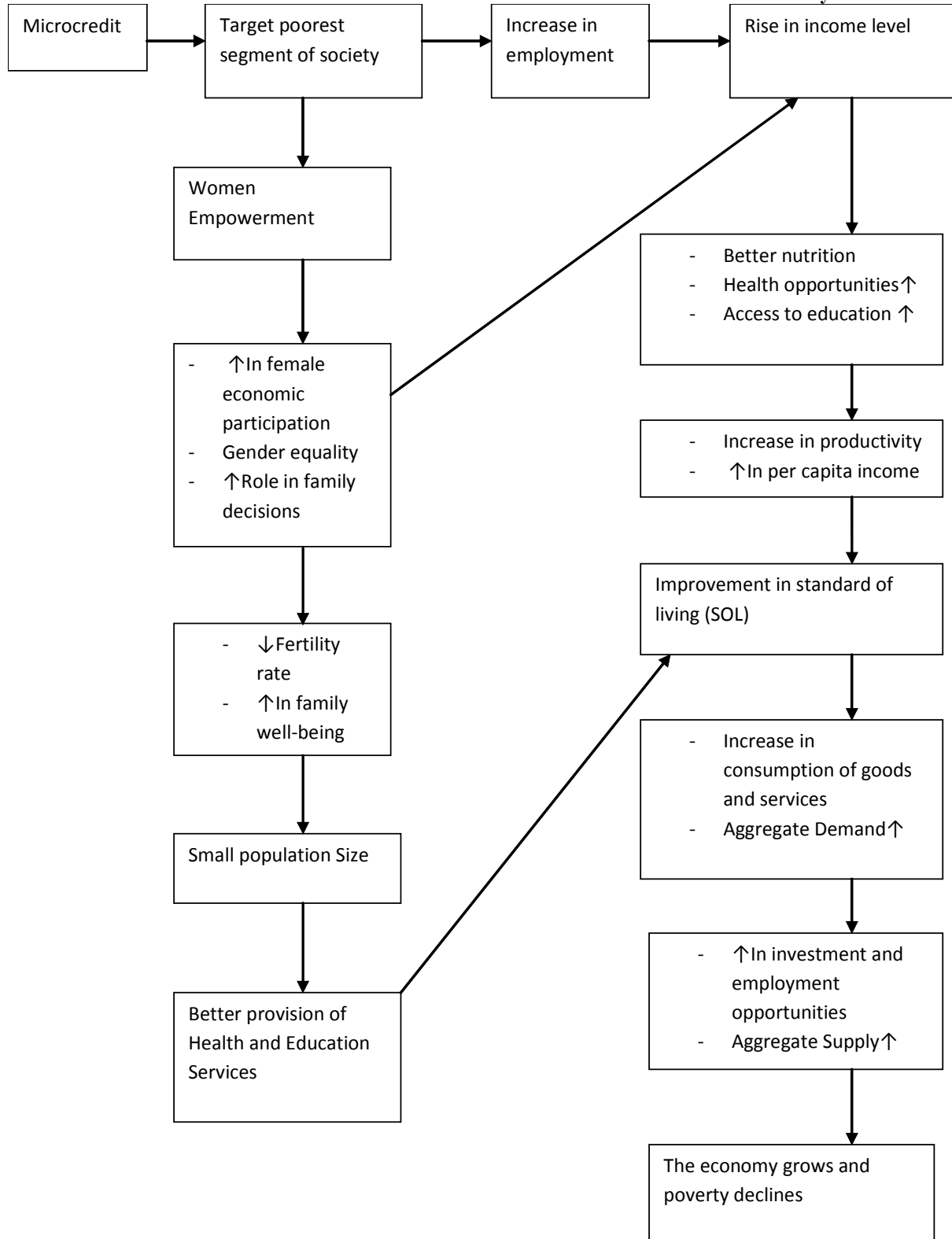
Nowadays, the world faces the daunting challenge of poverty reduction. The world has 2.8 billion people living on less than 2 dollars a day and 1.2 billion people living on less than 1 dollar a day. Of these 1.2 billion people, 500 million people live in South Asia (microcredit summit, 2004). Microfinance helps the government's aim of removing poverty by providing financial help to small business and poor people.

**The General Assembly of the United Nations has recognized the positive impact of microcredit in poverty reduction. Microfinance impact studies have demonstrated that:**

1. Microfinance helps poor households meet basic needs and protects them against risks.
2. The use of financial services by low-income households leads to improvements in household economic welfare and enterprise stability and growth.
3. By supporting women's economic participation, microfinance empowers women, thereby promoting gender-equity and improving household well being.
4. The level of impact relates to the length of time clients have had access to financial services.

Microcredit helps in removing poverty by access of poor to small loans to start a small business. Microfinance not only improve the economic situation of poor people but also has the positive effects on their living standards and social life such as with better access to good education, health facilities and empowerment etc.(see flow chart 4.1).

**Flow Chart 4.1: Transmission Mechanism of Microcredit to Poverty Alleviation**



Source: First Quarterly Report for FY05



#### 4.2 Interest rates on Microfinance

The interest rates charged on the microcredit loans is higher than other loans. This happens because the credit services provided are for small sums of money and the cost of these small loans makes the interest on them very high. For example, a single loan of 100,000 taken from a commercial bank is a small transaction cost, while the same amount of loan given to more persons by microfinance institutions have higher transaction and administrative costs.

"There are three kinds of costs the microfinance institution has to cover when it makes microloans. The first two, the cost of the money that it lends and the cost of loan defaults, are proportional to the amount lent. For instance, if the cost paid by the MFI for the money it lends is 10%, and it experiences defaults of 1% of the amount lent, then these two costs will total \$11 for a loan of \$100, and \$55 for a loan of \$500. An interest rate of 11% of the loan amount thus covers both these costs for either loan.

The third type of cost, transaction costs, is not proportional to the amount lent. The transaction cost of the \$500 loan is not much different from the transaction cost of the \$100 loan. Both loans require roughly the same amount of staff time for meeting with the borrower to appraise the loan, processing the loan disbursement and repayments, and follow-up monitoring. Suppose that the transaction cost is \$25 per loan and that the loans are for one year. To break even on the \$500 loan, the MFI would need to collect interest of  $\$50 + 5 + \$25 = \$80$ , which represents an annual interest rate of 16%. To break even on the \$100 loan, the MFI would need to collect interest of  $\$10 + 1 + \$25 = \$36$ , which is an interest rate of 36%. At first glance, a rate this high looks abusive to many people, especially when the clients are poor. But in fact, this interest rate simply reflects the basic reality that when loan sizes get very small, transaction costs loom larger because these costs can't be cut below certain minimums." CGAP (2002 b)

The simplified formula for calculating interest rates for financial sustainability is:

$$R = \frac{AE + LL + CF + K - II}{1 - LL}$$

Where:

**R** is the effective annualized interest rate

**AE** is administrative expenses

**LL** is loan losses

**CF** is the cost of funds

**K** is the desired capitalization rate, and

**II** is investment income.

#### 4.3 Government initiatives in Microfinance

The government of Pakistan has taken a number of initiatives in the last 9 years to improve the microfinance sector. The most important initiative is that microfinance is considered a separate entity in the financial sector. The government of Pakistan intends to grow and diversify the microfinance sector due to which microfinance institution ordinance 2001 was passed by the government of Pakistan on the 16th October 2001. The aim of this ordinance is to regulate the establishment, business and operations of microfinance institutions.

It is expedient to promote the establishment of microfinance institutions for providing organizational, financial, and infrastructural support to poor persons, particularly poor women, for mitigating poverty and promoting social welfare and economic justice through community building and social mobilization and to provide for matters connected therewith or ancillary thereto; and it is essential to regulate microfinance institutions to protect the depositors and customers and to safeguard these institutions against political and other outside interference ([Khushhalibank.com.pk](http://Khushhalibank.com.pk)).

The government, with the lending support of the Asian Development Bank, also supported the creation of the Khushhali Bank. This was the first retail microfinance bank in Pakistan, owned by a group of private and public commercial banks. In addition to this project, ADB support has resulted in the establishment of several funds available to regulated microfinance banks, such as the Social Development Fund, the Community Investment Fund, a Risk Mitigation Fund and a Deposit Protection Fund ([bwtp.org](http://bwtp.org)).

#### 4.4 Microfinance Providers in Pakistan

There are three types of microfinance providers in Pakistan and further it has expanded to different organizations.

##### a. Microfinance banks

The large number of population in rural areas faces problems of access to the loans from commercial banks. MFBs were founded with the objective that poor people have access to the loans. Now MFBs have high progress in providing loan and financial service to poor. The Khushhali bank is the one of the most leading and most successful bank in microfinance sector. The state bank of Pakistan gives license and set the regulation for MFBs to exclusive service in microfinance market. There are six MFBs working currently in Pakistan which is Khushhali Bank (KB), Tameer Microfinance Bank Ltd. (TMFB), Rozgar Microfinance Bank Ltd. (RMFB), The

First Microfinance Bank Ltd. (FMFB), Network MicroFinance Bank Ltd. (NMFB), and Pak-Oman Microfinance Bank Ltd (POMFB).

#### **b. Microfinance institutions**

Microfinance institutions are providing specialized microfinance services to the people. Microfinance institutions normally did not invest in consumer finance, but only in providing financing for micro enterprises. MFIs encourage people to raise their standards by doing business and earning power from them and this is a logical and sustainable manner. Kashf Foundation is the leading and most successful MFI in Pakistan. The other MFIs in Pakistan are Orangi Pilot Project (OPP), Akhuwat, Sindh Agricultural and Forestry Workers Cooperative Organization (SAFWCO), Asasah, Community Support Concern (CSC), and Development Action for Mobilization and Emancipation (DAMEN).

#### **c. Rural Support Programs**

RSPs programs run microfinance as a part of their multidimensional program for rural development. SRSP is the most successful rural program. The other RSPs is National Rural Support Program (NRSP), Lachi Poverty Reduction Project (LPRP), Thardeep Rural Development Program (TRDP), and, Punjab Rural Support Program (PRSP).

### **4.5 Microfinance Network in Pakistan**

The creation purpose of microfinance networks in Pakistan is group based trainings for the personnel of different MFIs, in which Pakistan Microfinance Network is the large one. The Pakistan Microfinance Network (PMN) is a network of organizations working in microfinance and dedicated to the improvement of the coverage and sustainability of microfinance in Pakistan.

The Pakistan Microfinance Network finds its origins in 1995 as an informal association based on the exchange of thoughts and experiences between microfinance providers operating in Pakistan. In 1999 a loose collaboration, the Microfinance Group Pakistan, sought and received financial support from the Aga Khan Foundation and the Asia Foundation. Through its expanding and more formalized operations it continued to build confidence and trust amongst donors, government and microfinance institutions. In 2001 it moved successfully to become a separate legal entity under the name of the Pakistani Microfinance Network (PMN).

PMN is a network of organizations engaged in microfinance and dedicated to improving the outreach and sustainability of microfinance in Pakistan. PMN acts as a disseminator of microfinance information with the aim of enhancing the scale, quality, diversity and sustainability of microfinance providers in Pakistan.

**PMN pursues three objectives:**

#### **1. Enhancing the capacity of retail MFIs**

Through training courses, the network seeks to build up technical expertise and disseminate operational best practices. During training events, members are also encouraged to present historical overviews of their organizations, illustrate key issues in their current operations and divulge financial information on their organizations.

In the past, PMN has organized training courses in market research, credit methodologies, management skills, business planning and financial modeling and others. For 2004, it proposes nine training courses, run by Pakistan practitioners and international trainers in gender, financial management, credit operations, and business development services.

#### **2. Developing and disseminating the use of performance measures and promoting financial transparency in retail MFIs.**

PMN started in 1999 to promote transparency among its members, asking them to self-report their performance indicators, which are then aggregated, analyzed and published bi-annually as a nation-wide report, the Performance Indicators Report. It is widely acknowledged that PMN is one of the leading national networks in the world in managing and producing performance indicators for the microfinance industry.

#### **3. Helping to create an enabling environment for retail MFIs.**

PMN organizes policy seminars on regulatory issues as well as nation-wide conferences, and has representation on the Consultative Group for Microfinance run by State Bank of Pakistan. In addition, PMN publishes position papers on issues reflecting a consensus among its members. ([bwtp.org](http://bwtp.org))

### **4.6 Significance of Microfinance in Pakistan**

#### **4.6.1 Pakistan poverty alleviation fund (PPAF)**

The Pakistan poverty alleviation fund was started in 2000. Their aim is poverty alleviation by providing funds through the NGOs and community based organizations. Initially, PPAF had signed agreements with five Partner Organizations (POs) to disburse Rs.5 billion over the next five years. These five POs are: Taraqee Trust, Quetta (Balochistan), Agha Khan Rural Support Program (AKRSP), Gilgit (Northern Areas), National Rural Support Organization (NRSP), Islamabad (Federal Area), Family Planning Association of Pakistan (FPAP), Lahore

(Punjab) and Kashf Foundation, Lahore (Punjab). The target population of the PPAF project is poor and disadvantaged rural and urban communities. The benefits of the project will accrue directly to poor through: (a) Income generation opportunities; (b) Improved community physical infrastructure in the underserved areas; and (c) Greater economic integration of women (Shirazi, Khan, 2009).

The World Bank funded Pakistan Poverty Alleviation Fund Project was designed to reduce poverty and empower the rural and urban poor in Pakistan. The project provides access to much-needed microcredit loans and grants for infrastructure and capacity building. As such, the PPAF project aims to help the rural poor in Pakistan get out of a cycle of misery, and get into a virtuous cycle of opportunities. (worldbank.org)

#### 4.7 Growth in Branches and Personnel

Table 4.I shows the performance of microfinance in term of physical structure. One will clearly observe that growth is higher in the years from 2004 to 2007. Increases in staff of microfinance providers from 2913 to 9529 and increases in branches from 362 to 1165 show the positive performance of microfinance in Pakistan. The growth in the employees and branches reflects the importance and demand of microcredit for poor people. Growth in the personnel and branches will help the microfinance sector in the achievement of potential customer and also increasing in the total number of active borrowers.

**TABLE 4.1 Personnel and Branches of Microfinance Sector 2004-07**

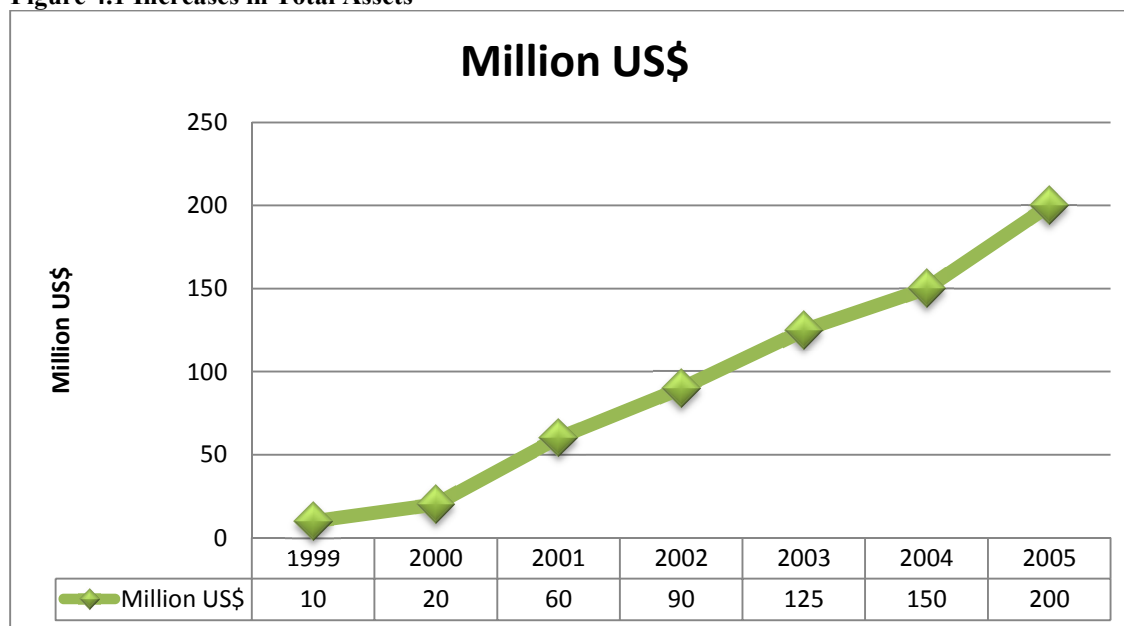
	Personnel				Branches			
	2004	2005	2006	2007	2004	2005	2006	2007
<b>MFBS</b>	1376	1932	2996	3899	80	108	226	295
<b>MFIs</b>	507	859	1675	2374	62	81	173	259
<b>RSPs</b>	883	1335	2489	3214	203	339	652	600
<b>Pakistan</b>	2913	4526	7342	9529	362	549	1073	1165
<b>Top 3</b>			4474	5901			785	778

**Source: PMN Annual Report.**

#### 4.8 Increases in the Investment of Microfinance Sector

In the period 1999 to 2005 there is a high increase in investment in the micro finance sector. The total investment in the microfinance sector is increased to \$400 million in these years. This will be possible with the support of the World Bank to Pakistan poverty alleviation fund, Asian Development Bank and government support which leads Khushali Bank and other five banks to be licensed under the ordinance 2001, and private organizations. The increase in the investments has resulted in the increase in the total number of assets available to retail microfinance provider shown in the Figure 4.1. In 1999, the total assets are \$20 million which is an increase to \$200 million in 2005.

**Figure 4.1 Increases in Total Assets**

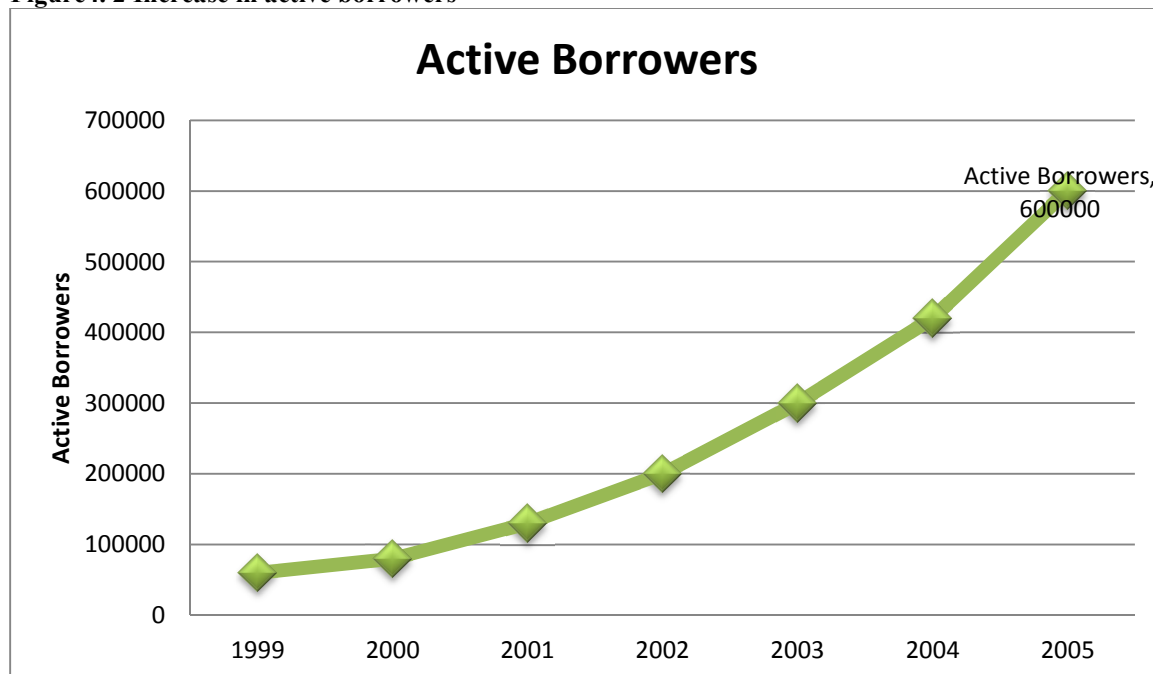


**Source: Microfinance Performance in Pakistan 1999-2005**

#### 4.9 Growth Rate of Active Borrowers

The growth rate of active borrowers is an important phenomenon to analyze the performance of micro credit in Pakistan. Increases in the number of microcredit borrowers will also show the performance of the micro finance sector in Pakistan. Figure 4.2 clearly shows the massive growth in the active borrower of micro credit in the recent years. In 1999 the active borrowers is 60,000 and it will reached to the 600,000 in 2005. This figure shows the high performance of microfinance in the recent years.

**Figure4. 2 Increase in active borrowers**



**Source: Microfinance performance in Pakistan 1999-2005**

## Conclusions and Policy Recommendations

### 5.1 Conclusions

Microfinance is the most important resource to provide loans and other basic financial services to increase the employment rate, productivity and earning capacity. It will impact the people's lives through removing poverty, improving living standards, such as health, education, food and other social impacts.

The microfinance sector is developed day by day in Pakistan. Most of the population of Pakistan is based on the rural area, where people live on the poverty line. The need for microcredit is higher in the rural area than urban area. The target market of the microfinance sector is estimated to be 25 to 30 million borrowers. The large numbers of microfinance borrowers show the market opportunity and need in Pakistan. In 2006 there were 600,000 borrowers of microfinance and the government of Pakistan set the outreach goals to 3 million borrowers in 2010 and further to 10 million in 2015.

We found that high interest rates on microcredit are one of the problems faced by the microfinance sector. The reason behind high interest rates is the cost of microcredit transactions. But poor people still favor and want microcredit because they don't have access to the commercial loans, which are collateralized loans. These poor people are very hard working and may have innovative ideas about business but they don't have opportunity. That is why they take micro loans on high interest rate and often they get success in their business and repayment of these loans.

As we discussed earlier there is huge market for microfinance and large numbers of people and businesses require micro loans. We found the impressive role of the government in Pakistan in the microfinance industry. The government of Pakistan realizes the importance and effectiveness of microfinance and takes the initiative to support the microfinance industry. Microfinance ordinance 2001 is the key step of government to the establishment of microfinance institutions for providing organizational, financial and infrastructural support to poor people. The creation and funded to the Khushhali Bank, which is the first microfinance bank in Pakistan also contribute the great role in the microfinance industry.

We observed that there are three main types of microfinance provider in Pakistan; Microfinance banks, Microfinance institutions, and Rural Support Programs. They all have further various organizations. In the past few years these organizations are very developed and provide the financial services to the people and business. We also investigated the role of the Pakistan microfinance network in microfinance sector. Their main objective is improvement of the coverage and sustainability in Pakistan.

Finally we investigated the performance of the microfinance sector in Pakistan. As we showed in the results chapter, the growth in the personnel raised from 2913 to 9529 and branches of microfinance increased from 362 to 1165 in the year 2004 to 2007. The investments reached \$400 million which resulted in an increase in the total assets of retail microfinance providers from \$20 million to \$200 million. This will lead the increase in the active potential borrowers of microcredit from 60,000 to 600,000.

These facts and figures clearly show the improvement in the performance of microfinance sector in Pakistan. But Pakistan still needs higher improvement in the microfinance sector to reach their goals of outreach microfinance to 10 million borrowers in 2015 and removing poverty.

## 5.2 Policy Recommendations

The study generates the idea from my study that microcredit is useful tool of poverty alleviation in Pakistan. The majority of Pakistan population is basically poor and lived in rural area. As we told earlier there is 30 million people need microcredit in Pakistan but currently microfinance institution provides services to 600,000 people. The statistical data shows improvement in microfinance sector but still they need very hard work to provide the micro loans to 30 million people. To get this desire achievements off course it will take some time, but we should do proper planning to arrange the funds and make sure that it will distribute to right person and business. The Government should encourage and providing flexible condition for foreign investment in microfinance sector such as investment by Asian Development Bank and World Bank. The Government should look at the security and political issues to attract the foreign investors.

We can also improve the microfinance sector by hiring highly educated and skillful employees. The industry needs professionals and skilled staff which have deeply knowledge about micro loans, and make new and creative programs in that sector. There must be providing training to current employees such as sales employ can be trained into credit assessment officers.

The commercial bank in the country should also providing the small loans to poor and small entrepreneurs to enhance the outreach of loans and more people will take opportunity. In Pakistan there is need of such type of policy which encourages the commercial banks to enter the microfinance sector.

The Government should take strict action against those who don't pay back the loans. Because there is default culture in Pakistan, people get the loans and not willing to pay back. So the Government makes strict laws to dealing with defaulters and make sure that this law is applicable to all whether it is poor or powerful politician.

The interest on microcredit is very high compare to the other loans. Still people willing to get the micro loans but if the interest is charge on these loans will reduced little its help the poor a lot in payback the money. There should also revise the minimum and maximum amount of loans in microcredit according to the need of peoples. Because some time small business need little more loan to arrange the resources for business and the interest rate will be also control by providing more. The interest is high because the transaction cost on the little amount and once the loan amount is increased the interest rate would also decrease.

It is suggested that in the future, the researcher must study the performance of microfinance providers separately in order to analyze the individual performance and contribution. The reason for this is that there might be some microfinance institutions which are going in lose and some profitable. They can apply the policies and procedure of successful institutions to other institutions which are losing.

Our second suggestion is to study the difficulties that face the borrower to get the loans and repayment of these loans. This area deserves future research to identify the problem and their solution to help the poor people.

Our third suggestion for future research is that researcher gets the primary data for performance evaluation of microfinance in Pakistan. The statistics of their own calculation may be present the different picture about the performance of microfinance sector in Pakistan.

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