Village Banking in Pakistan

PPAF Microfinance Innovation and Outreach Program (MIOP)

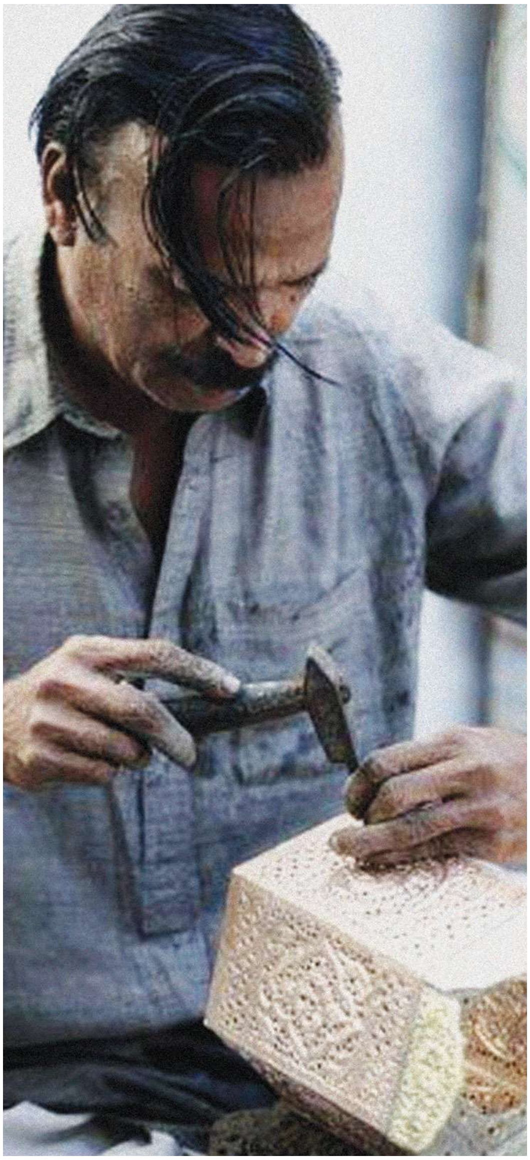
Pakistan Poverty Alleviation Fund

Financial Services Group

CONTENTS

Village Banking in Pakistan

Overview



Microfinance has enjoyed impressive growth in Pakistan over the last decade. The Government of Pakistan incorporated microfinance as a central tool of its poverty reduction strategy and, together with the State Bank of Pakistan, fostered the development of an enabling policy and regulatory environment that has since received global recognition.[1] Nonetheless, the industry continues to face a number of challenges and significant unmet demands. Large swathes of the rural poor remain beyond the reach of formal financial services. In this context, the Pakistan Poverty Alleviation Fund (PPAF), with support from the International Fund for Agricultural Development (IFAD), has been testing innovative products and initiatives to meet the financial needs of marginalized population. Village banking is one such initiative.

This note examines the current village banking program of a PPAF Partner Organization (PO) – Farmers' Friend Organization (FFO). While FFO is an emerging MFI, its experience with the development of ten village banks in the district of Sheikhupura in Punjab

1- Economist Intelligence Unit (EIU) of the Economist magazine ranked Pakistan as a global leader in microfinance regulations in its 2010 report.

province over the previous two years allows for the identification of a set of lessons learned and policy conclusions for supporting village banking in the country. The study seeks to inform donors, policymakers and other stakeholders about role of the village banking lending methodology in expanding access to formal financial services among the rural poor in Pakistan. Specifically, it aims to address whether village banking offers a cost-effective and financially sustainable alternative to conventional microcredit models in rural areas of the country and identify key success factors for the implementation of village banking programs. It suggests that flexibility in responding to local conditions and a core emphasis on institutional development through social mobilization and technical assistance are critical to the social and financial viability of any village bank.

Financial Inclusion in Pakistan

State of Microfinance Sector in Pakistan

Microfinance was formally initiated in Pakistan in 1980s but did not take off until the late 1990s. While the sector remains small in terms of overall financial penetration levels when analyzed at the global level, it experienced rapid expansion over the previous decade and holds significant promise. By the end of 2010, there were 2 million active borrowers in Pakistan, along with 3.2 million active savers and 3 million insurance policy holders.[2]

A number of policy efforts on the part of the Government of Pakistan (GoP) and State Bank of Pakistan (SBP) helped improve the microfinance infrastructure and enabling environment, and accelerated investment and growth in the sector. Those include the establishment of PPAF as an apex funding body, creation of the country's first specialized MFB – Khushhali Bank, issuance of the Microfinance Institutions Ordinance 2001 and development of a micro-finance unit within the SBP to regulate the industry. The ordinance opened the way for the commercialization of the sector. The central bank's 2007 national MF strategy - "Expanding Microfinance Outreach (EMO)" – and 2011 Strategic Framework provided further impetus to the industry.

Young but dynamic, the industry is undergoing a number of important shifts. First, the quantity of specialized microfinance providers (MFPs) has skyrocketed and today, the sector consists of a diverse range of players, including Rural Support Programs, development NGOs, Microfinance Institutions (MFIs), Microfinance Banks (MFBs) and commercial financial institutions. Among the approximately 60 organizations operating in the country, eight MFBs were established over the previous decade, including through the transformation of three leading MFIs.[3] To date, credit has

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2- PMN, MicroWATCH Issue 18 (January-December 2010)
3- State Bank of Pakistan, Strategic Framework for Sustainable Microfinance in Pakistan, January 2011

dominated the microfinance industry in Pakistan. However, MFPs are increasingly offering micro-savings, micro-insurance and remittances in addition to credit to diversify their product offerings and meet the needs of low-income population. Steps are also being taken to promote the entry of commercial players in the sector to mainstream microfinance into the formal banking system and enable the required expansion and sustainability of microfinance services in the long run. Finally, a great deal of technological and institutional innovation is underway to expand cost-efficient financial services to the unbanked population. The launch of branchless banking initiatives that make use of telcos, postal networks and mobile phone technology is a noteworthy example.

Unmet Demand for Financial Services

This growth and dynamism notwithstanding, the industry faces a number of funding and institutional capacity constraints, among others, that challenge its ability to achieve a major breakthrough and reach the scale and sustainability necessary for significant impact.[4] Rapid growth leveled off in 2008 and 2009 and has stagnated since, resulting in a tightened industry portfolio.

Existing data reveals a substantial unmet demand for financial services in the country and huge potential market for MFPs. Pakistan, in fact, has one of the lowest financial penetration levels in the world. Among the population of 180 to 200 million people, only 12% of adults have access to basic formal financial services.[5] The cumulative outreach of MFPs constitutes only 7% of the potential microfinance market, which is conservatively estimated at 27.4 million.[6]

Moreover, there is an unequal penetration of financial services across different segments of the population and regions. While some urban areas of Pakistan have achieved significant financial coverage, particularly the urban areas of Punjab and Sindh, large segments of the population remain underserved or completely untapped. Balochistan, KPK and FATA are largely marginalized from microfinance activity, with the number of branches actually declining in these provinces in 2010.[7]

4- See SBP Strategic Framework for detail on these challenges facing the sector
5- The SBP Strategic Framework reports that 88% of the population is unbanked, with 56% of the adult population financially excluded and another 32% informally served;
6- PMN MicroWatch 18 (December 2010)
7- Ibid.

Remote rural regions of the country have been especially excluded, due to the high transaction costs and risks perceived in serving these areas.[8] About two-third of the nation's population lives in rural areas and a dominant portion of this population is poor. [9] Nonetheless, rural clients face constraints in accessing credit due to their inability to comply with conventional loan collateral requirements, lack of credit history and high appraisal costs relative to the generally small loan size needed. A combination of these factors, plus characteristics of low population density, high dependence on agriculture and fewer economic opportunities within rural areas increases the credit risk manifold for any institution that wishes to serve poor, especially rural clients in Balochistan, KPK, FATA and other far-flung areas of the country.

As a result, the sector is experiencing an increasing trend among MFPs in Pakistan to extend outreach in urban areas at the expense of rural growth.[10] The rural poor of Pakistan in turn rely on informal sources, predominantly family, friends and moneylenders to meet their credit needs despite the costs and risks that the latter in particular

8- State of Microfinance in Pakistan, pg 25
9- World Bank, Pakistan, 2009
10- PMN MicroWatch 18 (December 2010)

entails. This segment of the population constitutes the largest underserved market for MFPs in Pakistan.

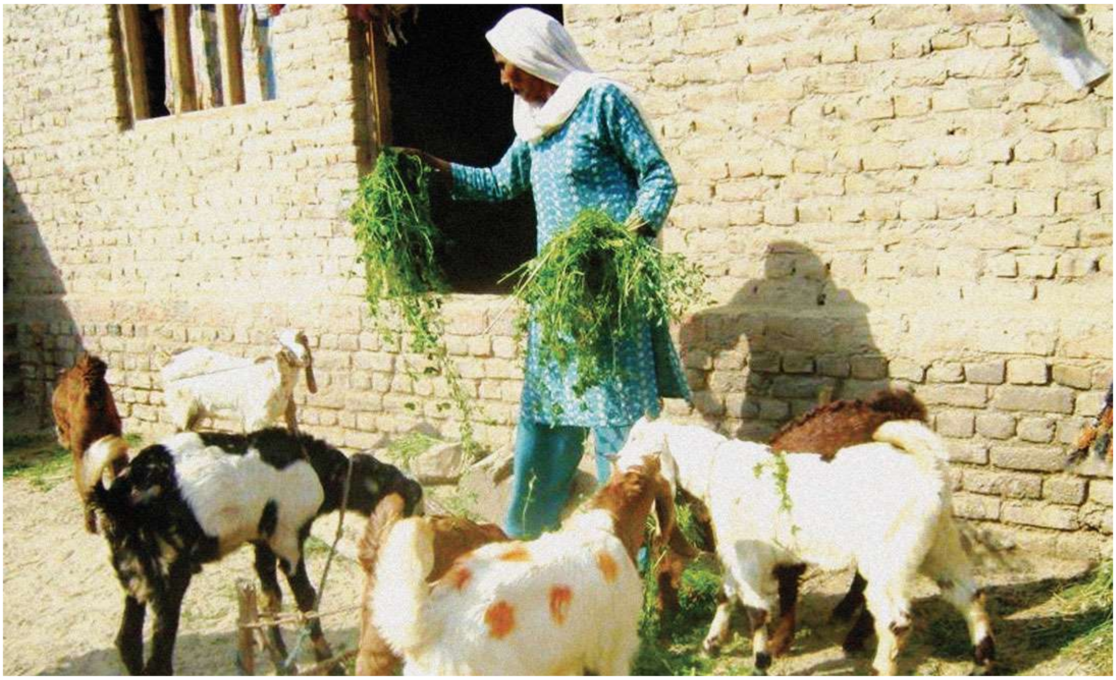
A PMN report on Pakistan's rural microfinance market speaks volumes for this urban-rural divide in access to formal financial services.[11] Surveys show strong demand among the rural poor for increased availability of credit and more diversified microfinance products that respond to their particular needs, both to cope with during times of emergency and take advantage of economic opportunities to generate household income. Lack of financing is cited as a major constraint to business development and the expansion of existing enterprises.

Alternative Channels for Reaching the Rural Poor

Innovative solutions for microfinance product delivery are required to address this supply–demand gap and accelerate sustainable growth in the sector. Despite strong institutional participation in the industry, there is little diversity in the lending methodology and products being offered. Microfinance in Pakistan is largely limited to the standard brick and mortar branches for the distribution of credit services. Approximately, 92% of the borrowers and 89% of the funds have been provided through group lending, with individual lending also utilized to a lesser extent.[12] The conventional model of microfinance in Pakistan is very human resource – intensive and entails high operating expenses.[13] There is need for increasing awareness for MFPs to consider adopting non-traditional and more cost-effective ways of improving outreach of financial services into new markets and introducing innovative products that are more suitable for the poor at the grassroots level.

The SBP has made it a strategic imperative for stakeholders to experiment with technological and methodological innovations that overcome cost barriers and mitigate risk. In 2011 Strategic Microfinance Framework, it calls for the development of scalable and financially sustainable alternative delivery channels for broadening and deepening the reach of financial services.[14] The main motivations for exploring alternative

11- PMN Rural Microfinance Report
12- State of MF in Pakistan, pg 20
13- The SBP reports the sector's operating cost to loans ratio at 22%.
14- State Bank of Pakistan, Strategic Framework for Sustainable Microfinance in Pakistan, Jan 2011



systems to the traditional model include the possibility of massive outreach to low-income population through penetration of new markets or servicing of hard-to-reach rural areas and dramatic cost reduction / improved operational efficiency. Branchless banking technologies and distribution channels, in particular, have been prioritized as means to reach the unbanked and underserved market segments and have already achieved noteworthy success in doing so. Continued emphasis is needed on the design of alternative systems that are more cost-effective and efficient in delivering financial services on a large scale.

Microfinance Innovation and Outreach Program through PPAF

A high degree of experimentation with innovative microfinance outreach initiatives is currently underway within the Pakistan Poverty Alleviation Fund (PPAF). Financial Services Group of PPAF is spearheading the effort to improve access to demand-driven and sustainable financial services in remote areas of Pakistan. In 2006, with support of the International Fund for Agricultural Development (IFAD), PPAF launched a Microfinance Innovation and Outreach Program (MIOP) to improve the access of poor rural women and men to a wide range of productive assets, skills, services and new technologies, and thereby enhances their livelihoods. The program places a particular emphasis on encouraging microfinance operators to implement pilot schemes to develop and test innovative financial products and market access initiatives. The partner MFPs in turn work with community organizations and their participating poor rural members who are the recipients of the newly developed financial products.

PPAF supported the development and testing of many types of microfinance products and approaches including Village Banking, Settlement Branches, Women Cooperatives, Livestock Farming and Social Safety Nets. Additionally, it experiments with approaches aimed at increasing outreach of existing partners to hitherto low microfinance access areas – remote and deprived areas of Balochistan, Sindh and KPK. In all, 20 innovative products and 5 approaches have so far been introduced in partnership with 26 partner organizations.[15]

In many respects, PPAF is ideally positioned to provide the space for this experimentation and innovation. PPAF served as a major catalyst for the growth of microfinance and now has the opportunity to further leverage its experience and resources to deepen the outreach of the sector. As the lead apex institution for community-driven development in the country and fully autonomous private sector organization with support from the GoP and a variety of donors, PPAF acts as a wholesaler of pro-poor funds to Pakistani civil society.

Its POs perform the actual retailing function of loaning funds and implementing projects on the ground. Over the last eleven years, PPAF has established itself as one of the main players in the development sector in Pakistan, extending lines of credit for microfinance and enterprise development services, grants for community infrastructure schemes, social sector development services, emergency response interventions and grants to strengthen the human and institutional capacity of both POs and local communities. From the initiation of its activities in 2000 to the end of December 2011, PPAF had successfully disbursed a cumulative total of Rs. 100.4 billion through 112 POs under these

[15]- PPAF Data

various funding windows. PPAF's coverage has included 90,100 villages/settlements spanning 120 districts across all provinces and regions in the country.[16]

This track record, geographic reach and network of POs give PPAF a unique ability to penetrate microcredit services in Pakistan's least–served districts.

Most importantly, at the core of the PPAF model is a commitment to building institutions and sustainable networks for service delivery at the meso and micro levels. The process of social mobilization provides the institutional foundation for the design and implementation of all PPAF-supported interventions. This emphasis on community empowerment and the development of local and self-help organizations ensures that projects are demand-driven, locally managed and sustainable over time. It is the bedrock of the methodology of PPAF-supported Village Banking Programs and other MIOP initiatives, the importance of which will be further explored below.

16- Ibid.

Role of Village Banking

A Brief Sketch of Pakistan's Village Banking Landscape

Village Banking is an initiative that PPAF and several of its POs have tested under MIOP to enhance the outreach of microfinance to the rural poor. Village banks are community-based financial services providers. Under the methodology, neighbors in a poor, usually rural community form a borrowing community or village organization to meet their financial needs on a sustainable basis. As grassroot level institutions, the village banks are initiated, owned and managed by the communities themselves and focus on penetration of hard-to-reach rural markets. Microfinance providers lend in bulk to these village organizations, which are in turn responsible for onward lending to members of the community using a system of cross-guarantees and social collateral to ensure timely repayment. The communities are independently responsible for all loan disbursements and recoveries. One of the key rationales often given for adopting village banking is that it reduces transaction costs, both for microfinance operators and borrowers, and is a means to extend savings, remittances and other financial and non-financial services to clients in addition to small business loans.

Village banking is not new to Pakistan. The product was introduced by AKRSP in 1989 and developed through the organization's network of village organizations. Despite these roots, however, village banking remains an upcoming methodology that is employed by few organizations and has yet to be deeply explored in Pakistan. Of the MFPs operating in Pakistan, only four were found to offer village banking loans, including three affiliates of the Pakistan Microfinance Network (PMN). These MFPs include National Rural Support Program (NRSP), Sarhad Rural Support Program (SRSP), Thardeep Rural Development Program (TRDP) and Farmers' Friend Organization (FFO).[17]

[17]- PMN Social Performance Report 2009

All are PPAF POs and multiproduct lenders, offering solidarity group and individual loans in addition to village banking. Being NGOs or Rural Support Programs, none are permitted to mobilize deposits and thus are leveraging village banking to extend savings services and target rural areas of the country that contain high concentrations of poor clients. All of the organizations currently offering village banking are driven by strong social agendas, with processes of social mobilization and community empowerment at the core of their strategy.

Text Box 1

Overview of Village Banking Programs of PPAF Partner Organizations

- NRSP — Rawalakot, AJK
- SRSP — Abbottabad, Peshawar and Kohat, KPK
- TRDP — Tharparkar, Sindh
- FFO — Sheikhupura, Punjab

Unique Characteristics of Village Banking – The Experience of FINCA

Village banking remains an emerging methodology in the Pakistani context and faces a number of challenges and constraints that will be further explored below. It has, however, achieved well-documented success and growth in different parts of the world over the previous two to three decades. The Foundation for International Community Assistance (FINCA) pioneered the village banking model of microcredit. What started off in Latin America in the 1980s has expanded worldwide. FINCA has proven that it is possible to leverage the village banking methodology to deliver financial services to the poorest borrowers across geographic contexts at a large scale and free of reliance on subsidies.

While donor funding was critical to enabling the development of FINCA village banking programs in their early years, FINCA affiliates enjoyed steady progress towards financial sustainability throughout the 1990s. In Latin America, these organizations "started out as NGOs specialized in credit delivery and gradually matured into financially self-sufficient MFIs with the capacity to cover their operational costs and deliver a broad range of services to their clients." In light of its successful track record, FINCA village banking programs, with the technical assistance of the International Fund for Agricultural Development (IFAD), have been pursuing commercial funding to enable them to grow and make financial services available to more rural poor people on a sustainable basis.[18]

FINCA has shown that with strict adherence to village banking principles but flexibility in adapting to local conditions, excellent repayments rates can be achieved through the model. More generally, the FINCA experience has shown that on average, village banking has a number of advantages when compared to conventional credit lending methodologies. The following unique characteristics make village banking preferred model in certain circumstances;[19]

- Achieves higher penetration of rural areas. On average, village

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18- Supporting innovation in the field: The role of IFAD's support in the sustainability and commercial transformation of FINCA's village banking programmes, 2006

19- The Inter-American Development Bank (IDB)/Consultative Group to Assist the Poor (CGAP) inventory of 176 MFIs, as cited by Glenn Westley in A Tale of Four Village Banking Programs. Best Practices in Latin America (Washington, DC: IDB, 2004).

banks are found to have greater outreach in rural areas when compared with conventional microcredit lending methodologies.

- Reaches the poorest. Social pressure substitutes for collateral in the case of village banking. Members may not get a new loan unless fellow members are up to date on their payments. Since village banks do not rely on collateral to guarantee loans, they can serve those lacking land or other assets. This higher outreach to poor clientele and micro-entrepreneurs is evidenced by the generally small average loan size.
- Facilitates product diversification and savings. Village banking allows clients to access a broader package of services, including savings. New loan sizes are often based on the previous loan size plus the amount saved in previous loan periods, encouraging deposits mobilization.
- Provides clients valuable non-financial services. Village banks provide members a forum for mutual support, technical assistance and empowerment as well as for delivering other formal non-financial services to meet development needs prioritized by the community (in education, health, infrastructure, etc). It fosters a democratic process and community ownership, by involving community members in all key decisions regarding the management and governance of the village bank.

Some experts have concluded that the real advantage of village banking compared with conventional solidarity group and individual lending methodologies are, in fact, the savings and non-financial services it can provide rather than greater cost-efficiency in credit delivery.[20]

20- Ibid.

A PPAF Supported Village Banking Program

The successful track record of village banking on a global level and the huge untapped potential of microfinance in Pakistan justify a deeper examination of the product and its performance to date under PPAF/MIOP. The Village Banking Program (VBP) of Farmers' Friend Organization (FFO), a PPAF PO, was selected for purposes of this study for several reasons. First, FFO is among the limited number of organizations currently offering village banking loans in Pakistan, but one that is prioritizing the methodology within its microfinance program moving forward, making it an ideal target. Second, it is carrying out its VBP in the rural areas of Sheikhupura district in central Punjab, one of the most promising areas for microfinance. Third, FFO is a relatively young organization that has achieved remarkably low loan delinquency rates and a degree of success with its VBP in a short period of time that should be highlighted. Finally, FFO confronts a number of challenges common to other PPAF POs that have the potential to constrain the success of its VBP if left unaddressed. The combination of these factors make FFO a unique case from which lessons learned may be extracted for diverse microfinance operators and areas of the country.

Farmers' Friend Organization

Farmers Friend Organization (FFO) is an emerging MFI that was established in 2003 to combat the incidence of poverty at the grass roots level in rural and low profile urban areas of Sheikhupura district in central Punjab. FFO's partnership with PPAF was established in October 2007. The organization is dedicated to fostering economic development through promotion of social mobilization and the provision of financial services in the targeted market. The goal of the FFO microfinance program is to empower poor households and micro entrepreneurs to become economically self-reliant by providing appropriate financial services in a sustainable manner. FFO is operational in 18 union councils of the district.

In addition to implementing retail level microcredit operations, FFO developed a village banking program in collaboration with PPAF to achieve greater rural penetration and growth. As described below, the characteristics of Sheikhupura's rural financial market made it a particularly hospitable environment for the introduction of the village banking methodology and offer substantial potential for FFO to expand its outreach in the target areas over the coming years.

Text Box 2

Demand for Financial Services in Rural Markets of Sheikhupura

Sheikhupura is a promising market for the expansion of microfinance. The district is characterized by a substantial informal sector and rich cottage industry. Despite the presence of numerous microfinance providers in the district, some since 2000-01, the cumulative outreach of all MFPs is 35,741 active borrowers with a gross loan portfolio of PKR 580,052,811: the district's potential market for microfinance services is estimated at 831,522 clients. [21] There is particularly low penetration in the rural areas of Sheikhupura. Recent market research conducted by FFO in rural areas targeted for village banking to assess the level of demand for financial services revealed the following;[22]

- Strong demand for credit to grow businesses and increase household income: The number of potential clients is estimated at least 22,000 and the estimated potential market size for microcredit services amounts to PKR 440 million. The cumulative market penetration of microfinance providers is as low as 4% of the total demand, with 96% of the surveyed micro-entrepreneurs having no access to formal financial services. Moreover, 87% of the interviewed micro-entrepreneurs are in need for credit, mainly for expanding their businesses (41%), purchasing business assets (22%), working capital (29%) and starting up new businesses (8%). The majority of businesses are in trading activities, as well as agriculture and livestock, with a lesser number in manufacturing, handicrafts and services
- Potential for significant savings mobilization: The demand for savings services, insurance, and other financial and non-financial services is also noteworthy. The majority of those surveyed expressed agreement with the concept of compulsory savings to access credit products

[21]- MicroWatch, Issue 18 December 2010 (PMN)
[22]- Farmers' Friend Organization, Microfinance Market Research Report

FFO started its village banking program in October 2009 with the financial and technical support of PPAF under the IFAD-MIOP. During a pilot phase, FFO established seven village banks (VB) in seven union councils of Sheikhupura district following a process of social mobilization and capacity building. After the successful completion of the pilot phase and keeping in view the absorption capacity of the PO, in October 2010 FFO launched a second phase of the VBP to establish three new village banks as well as support the development of the seven existing institutions. In addition to lines of credit, PPAF has provided capacity building grants to FFO in support of capital costs, operational costs and training of the office bearers of VBs. The aim is to strengthen and sustain the VBs established under the pilot phase to enable them to operate as local financial institutions capable of fulfilling the financial needs of the rural poor, as well as to extend village banking services to thousands of new households.

Current Performance

While the number of clients served through village banking does not yet exceed the number served through conventional microcredit lending, FFO has adopted village banking as the preferred model for rural areas moving forward based on the success experienced to date.

As of Sep 2011, FFO had disbursed Rs. 157.3 million to 9,724 clients in 18 union councils through the overall microfinance program. Through the ten village banks, FFO has disbursed a cumulative amount of Rs. 50.4 million to 3,125 clients. Of the total disbursements made under the auspices of the village bank program, approximately 93% of the clients are women, thus supporting PPAF's crosscutting strategic objective of gender empowerment. The village banks have collected a cumulative total of Rs. 5.2 million in community savings, with a current active balance of Rs. 4.32 million.

Table 1

Outreach of Village Banks in FFO Project Areas (as on Sep 30, 2011)

Village Bank/CO	Location	No.of Villages	No. of Groups	No. of Clients Households	No. of Female Clients	Savings Balance (Rs.)
Easy Approach Community Organization	Village Kujjar	5	70	301	291	1,246,617
Dosti Welfare Society	Basra Colony Muridke	8	115	482	445	553,739
Social Development Organization	Kharianwala	9	122	516	465	512,875
Roshnee Foundation Farooqbad	Islampura	16	77	329	321	289,579
Al-Mustafa Foundation	Wandala	4	84	362	357	412,081
Insani Khidmat Welfare Society	Khanpur	8	98	419	390	478,525
Al Quaid Development Foundation	Dera Shareenwala	5	31	147	147	186,400
Aman Welfare Society	Buraj Attari	4	37	170	150	149,754
Sawera Development Society	Chikhuke Malian	11	52	237	237	224,661
Creative Foundation	Village Kaloke	3	35	162	94	269,400
Total		73	721	3,125	2,897	4,323,631

During the last two years, FFO has succeeded in maintaining a 100% rate of recovery with 0% portfolio at risk under its village banking program. In all of the VBs, the total disbursements made thus far have been duly recovered along with the associated markup, as per the stipulated time frame. As of Sep 2011, the total outstanding portfolio of the VBs under FFO amounts to Rs. 25.96 million in the form of 3,125 loans. Of these outstanding loans, 93% have been disbursed to women. The detailed outlay and distribution of the active portfolio is summarized in the table below.

Table 2

Active Portfolio of FFO Village Banks (as on Sep 30, 2011)

Village Bank/CO	Loan Principal	Loan Service Charges
Easy Approach Community Organization	2,556,095	461,321
Dosti Welfare Society	4,297,364	774,819
Social Development Organization	3,795,154	691,890
Roshnee Foundation	2,056,641	374,057
Al-Mustafa Foundation	3,599,006	649,224
Insani Khidmat Welfare Society	3,697,140	667,323
Al Quaid Development Foundation	1,425,726	256,638
Aman Welfare Society	1,217,304	219,106
Sawera Development Society	2,118,712	382,027
Creative Foundation	1,193,521	217,520
TOTAL	25,956,663	4,693,925

FFO's Village Banking Model

FFO follows a basic methodology for implementing its village banking program. Social mobilization and organization, capacity development, provision of lines of credit and monitoring and evaluation represent the core program strategies. Under the program, FFO uses the forum of the Community Organization (CO) for disbursing small loans to individual members for productive purposes. While FFO cannot collect savings as a registered NGO, COs do not face the same legal bindings and can mobilize savings. Thus, through the VB, FFO is able to provide rural clients with a package of financial services beyond credit, including savings and remittances.

The following provides a description of the typical process and requirements for setting up and managing an FFO village bank;

Text Box 3

An Outline of FFO's Village Banking Methodology

FFO generally utilizes the following methodology for developing a village bank;

Stage 1 - Selection of a Village
After an initial assessment, FFO selects a village for the establishment of a village bank, in the form of a Community Organization (CO).

Stage 2 – Social Mobilization and Establishment of a CO
Through a process of social mobilization, a CO is established to work as a village bank, as well as carry out other development initiatives prioritized by the community.

Stage 3 – CO Capacity Development
FFO provides the CO technical support to develop the technical and managerial capabilities of the organization. A variety of capacity development interventions are carried out to evolve the structure of the VB, develop by-laws, acquire legal status through registration, and design procedures to work as a financial intermediary.

Each VB has a General Body (GB), composed of members of the VB. Each VB is generally comprised of between 15-25 members, each representing a village household. The GB elects officers of an Executive Council, usually a chairperson, vice-chairperson, treasurer and secretary. After electing officer bearers and establishing by-laws, the VB is required to get registered under any of the relevant laws. All new VB must get registered before signing an agreement with FFO for the operation of the VB.

As per the by-laws, the GB also elects a Credit Management Committee (CMC), which consists of at least 4 members and is responsible for client appraisals and management of the day-to-day operations of the VB. Each VB has one paid staff member, called the Village Bank Officer. FFO provides training and on-the-job capacity building to the members of the CMC and other office bearers, particularly in the area of loan and savings administration.

Stage 4 - Agreement between FFO and VB
After gaining maturity against different indicators, the CO works as a village bank to fulfill the financial needs of the poor and FFO enters into agreement with the VB to support its microfinance operations. The VB is evaluated on the basis of how vibrant and self-reliant it is in terms of community management. Indicators measure factors such as degree of internal democracy and active participation of members, inclusion, state of recordkeeping, regularity in savings, and capacity of VB office bearers.

Stage 5 - Accumulation of Funds from Community Savings
The VB first accumulates its own financial resources through membership fees, members' savings, and grants.

Stage 6 – FFO Provides VB Line of Credit for On-Lending
After a VB accumulates the required level of internally generated funds/savings as per the agreement, FFO provides the VB a one-year line of credit for onward disbursement as sub-loans to community members. This loan is utilized by the VB to finance its village-level credit operations. FFO makes

quarterly disbursements to the VB, conditional upon satisfactory performance of the previous disbursed funds. The rate of markup charged by FFO on the line of credit to the VB is 14% (flat) per annum; on every loan disbursed by VB.

Stage 7 - Selection of Borrowers by VB members

The VB selects its borrowers. The prime responsibility for identifying borrowers and appraising the character of the borrowers' lies with the village bank members; FFO does not conduct loan analysis. Before applying for a loan, community members form a group of 2-5 borrowers. The group relies on a system of cross-guarantees and social collateral to ensure clients remain up-to-date on repayments. FFO ensures that in each VB at least 40% of clients are women.

Stage 8 - Day-to-day Operations of the VB

The village bank's CMC is responsible for overall performance of banking activities, including guaranteeing loan repayment and keeping track of transactions, and carrying out all recordkeeping of disbursement and repayment. The VB ensures that lending to the ultimate beneficiaries is not below the commercial banks' prevailing lending rates for prime customers, using rates that, in the long run, fully cover its costs of operation. The following are some of the most important implementation modalities and aspects of FFO's VB policy:

- The rate of mark-up charged by the VB is no less than 18% (flat) per annum (FFO VBs recently reduced their markup from 20%).
- The VB provides small business loans of between Rs. 10,000 - 20,000, for a period of 12 months.
- Borrowers repay the disbursed loan on a monthly basis through the group leader.
- The minimum amount of compulsory savings is 10%-20% of the loan disbursed, which the borrower is required to deposit at the time of disbursement.
- Voluntary savings can be made and withdrawn at any time during the loan period.
- The VB Officer is responsible for the timely deposit of all savings and loan recoveries in a bank account opened in the name of the VB.

Stage 9 – Continued Technical Assistance and Monitoring by FFO

FFO's role in the whole process is of a supporting arm, not a service delivery organization. Therefore, in addition to providing lines of credit and capacity building grants, FFO acts as a facilitator on a continuous basis. FFO monitors the day-to-day work and performance of each VB through weekly field visits, and provides regular technical assistance and on-the-job coaching to build the capacity of VB office bearers. By the end of the second year of operation, FFO aims for the VB management to have a strong grip on both the basics of microfinance delivery, as well as the importance of savings and its internal mobilization.

Stage 10 – Role of PPAF

As wholesale lender and sector developer PPAF guarantees that the relationship between the VB and FFO is working effectively and any dispute arising is resolved amicably. Additionally, it frequently monitors the performance of the VBs selected randomly. Besides on-lending funds, PPAF is also providing financial support for technical assistance, exposure visits and training programs for the VBs.

Stage 11 – Registration of Village Banks

Both PPAF and FFO encourage VB to get registered with appropriate regulatory authorities and most of the VBs are register under various laws.

Village Banking in Pakistan

Cost Effective and Sustainable Outreach

The sustainability of FFO as an MFI is primarily linked to its outreach. To become a financially sustainable MFI, FFO is prioritizing the deepening of the existing VBs outreach during the course of its 2011-2014 business plan. Village banking has gained considerable success and acknowledgement within FFO due to its low cost involvement both for FFO and communities and 100% recovery of disbursed loans. Moreover, global best practices show that reaching tens of thousands of clients through village banking is entirely possible. FFO aims to extend financial services to 10,000 rural households in Sheikhupura through village banking over the coming years and build strong VBs capable of operating as local financial institutions and fulfilling the financial needs of the rural poor on a sustainable basis.

Instead of supporting the development of new VBs, FFO is currently placing an emphasis on building the capacity of the ten existing institutions and supporting them in expanding their client base.

FFO's experience shows that village banking can offer a remarkably cost-effective model for extending outreach in rural areas of the country where population density is low and transaction costs run high. Through a single village bank, FFO can reach hundreds of rural clients at significantly lower cost when compared with the standard process of operating through a brick and mortar branch. As described above, village banking has the advantage that it provides a single loan to many borrowers at once through the forum of a CO and relies on the VB members to screen out bad credit risks, set reasonable loan sizes, guarantee loan repayment, and keep track of all transactions. It relieves the MFI, in this case FFO, of the costly responsibility of collecting information on prospective clients and conducting appraisals.

Village banking does require the loan officer to conduct regular travel and monitoring activities, and considerable time is required to organize and build the capacity of the VBs. However, even when taking into account operating costs and costs of training and capacity building, village banking reduces the financial and human resources required. It costs FFO approximately Rs. 50,000/ month to set up a new microcredit branch (office rent, supplies, travel, salary, etc), whereas it costs only Rs. 16,000/month for a village bank, including salaries and operational costs. The VB officer is on the payroll, but that aside, all VB office bearers provide their services on a voluntary basis.

Through accumulated earnings and other incomes, FFO aims to make every village bank operationally and financially sustainable in a period of 2-3 years. The Operational Self-Sufficiency (OSS) ratio of a typical FFO VB at the end of the first year is projected at 64%, and 94% at the end of the second year. This calculation is based on the expected ratio of operating revenue to expenses of a VB. Having strong command of the methodology of microfinance delivery and with the availability of adequate funds for credit, VBs should enter their third year of operation with a strong level of self-sufficiency.

FFO aims for the VBs to generate enough income to be able to meet all of their operating costs and expand their operations to provide services to more borrowers through three predominant sources;

- Interest earned on loans to community members: Village bank loans are issued to borrowers at market rates, leaving a 4% margin in markup (FFO charges 14% flat, the VBs charge 18% flat)
- Loan processing fee of 3%
- Interest earned on savings, which is disbursed to borrowers – 10%

FFO projects that the VBs will reach their break-even point at an average active clientele of 500 borrowers, with an average loan size of Rs. 20,000, after which the VB would gradually build up its own pool of financing for on-lending to borrowers (over an estimated period of 5-7 yrs).

Broader Impact on Community Development

Beyond considerations of cost and access to needed financial services, what distinguishes FFO's village banking program from its conventional microcredit lending model are the contributions it makes to the empowerment of grassroots organizations and social development of these communities over the long term.

The formation of a VB through the forum of a CO ensures the democratic election of a management committee, decentralized governance, management and problem-solving and group guarantee mechanisms to substitute for collateral. VB members participate in the decision-making process, create their own bylaws and are given choices about their services. International experience shows that these factors foster community solidarity and builds the confidence and sense of ownership of community members over the long-term. LAC VB best practices because they have ownership of the VB and feel it belongs to them / provide tangible benefit, communities are encouraged to look after the development of the CO and promote its sustainability as an institution following the process of social mobilization.

Social mobilization means little if local communities lack the capacity and incentives to give permanence to the institutions created. The SM process, on the other hand, has tremendous potential to advance local development priorities over the long term if combined with the appropriate follow-on interventions. The VB is just one initiative of the COs. In addition to carrying out VB functions and depending on local need in each village, the CO may operate as a skill center or support projects in the areas of education, health, gender empowerment, or community infrastructure, for example. Whether village banking is the best way to promote the sustainability of community organizations requires further examination. However, the experience of FFO and other PPAF POs suggests that the linkage between a well managed VB and continuity of the CO, with its positive implications for participatory development at the local level in Pakistan appears powerful.

Challenges in Implementation of a Successful VBP

Achieving the desired levels of outreach and impact requires a well-managed village banking program. PPAF partner organizations offering village banking face challenges and constraints in this respect;

- Capacity and Sustainability of the VBs: Importance of having clear ownership and governance structures and the adequate capacity to perform the core functions of the VB independently of the PO. Vibrant COs have transformed into successful VBs, whereas less developed COs are faltering in their capacity and operational self-sufficiency

Key Success Factors for Supporting Village Banks in Pakistan

Taking into account these challenges and experience of FFO and other PPAF POs, we can identify a number of broad factors critical to the success of any village banking program in Pakistan. In the absence of these factors, the ability of village banks to achieve desired levels of outreach and sustainability will be limited;

- Flexibility in tailoring the VBP to diverse geographic areas and local needs: In order to achieve success any of the programs/ products requires flexibility to suit the local needs hence, the same applies for the VB program. A VB program must not be replicated on the same model as the typical microfinance branch structure. Rather, the program must have inherent flexibility to suit the local requirements in every aspect. Since the VBs are governed at local level, it is safe to assume that the program has inherent flexibility to suit local needs
- The primacy of social mobilization and institutional development: Quality institutional development goes hand in hand with sustainable growth. Importance of the strength of the institution (at apex, PO and VB levels) and the role that a robust social mobilization process and continued technical assistance play in generating this outcome. At the VB level, the core focus should be on building socially and financially viable institutions. If a strong institution is in place, then any project or initiative of the community organization, such as a VB, can be implemented successfully and be sustainable over time. Critical to link the scale of microfinance operations with the human and institutional capacity of the organization and expand outreach in a gradual manner

Village Banking in Pakistan

The Way Forward

Governments and donors looking to strengthen the outreach of microfinance in Pakistan should consider the role that village banking can play. This note sought to examine whether a rationale exists for advancing the village banking methodology in comparison with the conventional microcredit model in rural areas of the country where high operating costs constitute a barrier to entry for many MFPs. The experience of FFO and other PPAF POs testing the product under MIOP show that VB can facilitate cost-effective microcredit outreach into unbanked rural areas and a means of strengthening access to savings and non-financial services, if undertaken in an appropriate manner.

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