NGO/RSPS/Cooperatives- TRANSFORMATION GUIDELINES

Introduction

The NGO-MFIs & RSPS have been the major players in Pakistan's Microfinance Sector since 1980s. Though their outreach levels remained modest over the years, they played an important role in development of whatever form of microfinance sector the country had before enactment of MF framework in 2001. The framework acknowledges their contribution in the sector and encourages the NGO-MFIs/RSPs/Cooperatives having requisite capacity to transform into formal Microfinance Banks. The licensing criteria for establishing Microfinance Banks/Institutions allows NGOs/RSPs/Cooperatives/other programs having potential and capacity to contribute up to 50% of the required capital in the form of credit and other assets portfolio subject to review by a Chartered Accountancy Firm from amongst the SBP panel. Considering the peculiar nature of MFIs' credit portfolio, State Bank issued guidelines for reviewing credit portfolios of NGO-MFIs interested in transformation, to ensure a reliable assessment of the portfolio quality based on pre-defined parameters.

The Portfolio Review Guidelines however, focus on just one aspect of the NGO transformation and do not cover the whole transformation process. To cover this gap SBP has now developed detailed guidelines to help & facilitate the NGOs/RSPs/Cooperatives/other programs in their transformation process. The guidelines define and discuss various aspects of the transformation and prescribe minimum requirements to be completed for the transformation. The NGO-MFIs/RSPs/Cooperatives may apply additional processes to assess their capacity to transform and ensure a smooth transition from informal, non-profit and unregulated to a formal, for profit and regulated financial institution for the poor.

Why to Transform

Transformation from NGO-MFI/RSPs/Cooperatives/other programs to a formal MFI is a major shift from a non-profit, socially motivated and donor dependent institution to for-profit, self-reliant and regulated financial institution, which involves cultural, organizational, operational and financial transformation. Normally one or all of the following objectives leads to the transformation decision:

- **Access to commercial capital:** As NGO-MFIs/RSPs/Cooperatives/other programs grow and attain maturities the expectations and demand to expand outreach increase substantially, this requires greater and rapid access to different sources of loan able capital. Being in the informal & unregulated sector, NGOs/RSPs/Cooperatives/other programs across the world are not eligible to mobilize public savings to finance their operations, nor do they have adequate collaterals to obtain credit lines/wholesale funds from commercial banks, whereas the donors' support remain uncertain and not forthcoming in all the circumstances. Transformation into formal & regulated MFI enables them to raise commercial funds through deposit mobilization, borrowings from financial sector, issuance of bonds or other commercial papers and stock issues to finance their businesses and appropriately leverage their equity.

- **Expand outreach and grow portfolio:** - Access to limited and uncertain sources of funds inhibits NGOs/RSPs/Coopeatives/other programs to increase their capacity and outreach levels. The transformation into formal MFBs lends credibility to the MFIs and provides sustained access to multiple sources of capital giving them necessary comfort to plan and go for network expansion as well as increase outreach and scope of microfinance services. This will however be contingent on effectiveness and responsiveness of the policy, legal and regulatory framework under which the MFI would transform.

- **Product Diversification:** Microfinance experience from across the world shows that the poor do not need just credit but a package of financial services including savings, credit, payment transfer etc. The NGOs/RSPs/Cooperatives/other programs being in the informal sector can only offer micro credit leaving a huge unmet demand for other financial products. Transformation enables the MFIs to fill this gap and offer variety of financial products and services to the poor, which not only increase the access of the poor to a range of financial services and enhance their satisfaction and commitment with the institution but also helps the MFIs to diversify and increase their revenue streams besides creating a stable source of loan able funds.

The NGO-MFIs/RSPs/Cooperatives/other programs interested in transformation should carefully review its transformation objectives and make an objective assessment that whether under the given policy and regulatory environment, it has the capacity to achieve the desired objectives.

Transformation Cost & Transformation Continuum

Notwithstanding the benefits and attraction of the transformation, it involves substantial cost including pre-transformation cost, regulatory requirements, taxation cost, vulnerability to external shocks etc. and should be carefully and consciously evaluated viz. a viz. expected benefits while planning for transformation. Further successful transformations are normally a gradual progress along a continuum[1], major milestones of which include:

[1] Charitonenko, Stephphanie, "**Commercialization of Microfinance Philippines**", ADB, Manila, 2003

- Adequate experience as NGO-MFI/RSPs/Cooperatives/other programs & achieving reasonable operational size & scale in terms of credit portfolio and service delivery network, reliable accounting & information system, establishment of internal audit function, review of books of accounts by external auditors etc;

- Adoption of professional, business like approach to manage the NGO-MFI operations and offering demand driven products/services at cost recovery interest rates;

- Achieved full operational sustainability and satisfactory progress towards achieving financial self-sufficiency through increased cost recovery, efficiency and expanded outreach of services;

- Accessing market based and non-subsidized commercial funds and impact thereof on outreach, revenue streams and future outlook of the NGO-MFI/RSPs/Cooperatives.

- Prepare to operate as for-profit, formal financial institution subject to prudential regulation/supervision and able to attract private risk capital.

- Have acquired /developed critical minimum software to support the existing operations.

- Preferably have got itself rated from a reputed credit rating agency.

The NGO-MFIs/RSPs/Cooperatives/other programs willing/planning to transform into Microfinance Banks should assess their respective positions in the transformation continuum and accordingly decide to proceed further.

Independent Institutional Assessment

The NGO-MFIs/RSPs/Cooperatives/other programs satisfied with their progress along the transformation continuum and willing to go for transformation, shall arrange an independent institutional assessment of their capacity and advisability to transform in the given economic, political, cultural, legal and regulatory environment. The institutional assessment shall include assessment of NGO-MFIs'/RSPs/Cooperatives/other programs financial position, governance structure, human resources, control systems and accounting and information systems. The assessment shall be made by a team comprising a Chartered Accountancy Firm from amongst the panel maintained by State Bank of Pakistan for banks & financial institutions and Microfinance Specialist(s), domestic or foreign having adequate understanding of Pakistan Microfinance Sector and policy & regulatory environment.

Financial Position & Capacity

To assess the financial position, the consultants shall make a detailed review of assets and liabilities of the NGO-MFIs/RSPs/Cooperatives/other programs and make an objective assessment of their quality and real value. The credit portfolio like commercial banks and other financial institutions, is a major component of MFIs'/RSPs/Cooperatives/other programs assets portfolio, however its characteristics and nature is different from that of commercial banks and as such needs to be reviewed with a different approach and methodology. Keeping this in view, State Bank of Pakistan has issued detailed guidelines for reviewing credit portfolios of NGO-MFIs interested in the transformation. The guidelines are enclosed as Annexure-I and shall be used to assess the credit portfolio quality. The quality and value of investments and fixed other assets could however, be reviewed and assessed using the normal audit tests and procedures.

While reviewing the liability side, the auditors/consultants shall assess the real value of the obligations of the NGO-MFI/RSPs/Cooperatives/other programs, their respective maturities, possibility of transferring to the new entity and their impact, if any, on the transformation. The nature of capital & reserves of NGO-MFIs/RSPs/Cooperatives/other programs is also different from normal commercial entities having no ownership structure and mostly buildup through donations, grants and earnings of the MFI. The auditors/consultants shall assess the quality of the capital and opine that whether the capital is free from encumbrances or restrictions of any kind and that the NGO-MFI/RSPs/Cooperatives/other programs can contribute the same to the capital of the transformed entity.

Governance Structure

The auditors/consultants shall review the governance structure of the NGO-MFI/ RSPs/Cooperatives/other programs, the composition of its Board of Directors/Governing Body/Council, the criteria & eligibility for election/selection as member BOD etc, the capacity and understanding of the Board about MF dynamics, the members' commitment with the mission and objectives of the NGO-MFI/RSPs/Cooperatives/other programs and their willingness as well as capacity to contribute personal resources/funds to the new entity's capital. They shall also review the decision making process in NGO-MFI/RSPs/cooperatives/other programs and the role and effectiveness of the Board in developing professional and business like environment and culture in the MFI. Further keeping in view the nature of operations and mandate of the MFI after transformation, as well as the regulatory requirements, the auditors/consultants shall recommend changes, if any, required in the composition and skill mix of the Board.

Human Resources

The quality of human resources is critical for success of any organization and due to highly decentralized and personalized nature of operations of MFIs, its importance increases manifold. The auditors/consultants shall make an objective assessment of the qualification, experience, skill level, capacity to learn new and innovative techniques etc. of the senior management team and the field force and their commitment to the cause of the institution. They shall identify the skill gaps and developmental needs of the HR, if any required, in case of conversion into formal Microfinance Bank.

Control Systems & Environment

The quality of control environment in an MFI is reflective of the level of professionalism and business mindedness of the management. Normally the successful and prospering institutions have strong control systems and a control conscious environment. The auditors/consultants shall review the control systems keeping in view the peculiar nature of operations of MFIs and identify the specific control areas in which improvements would be required in case of transformation into MFB. The presence of Microfinance Specialist(s) in the review team should facilitate a realistic assessment of control systems, the governance structure as well as the human resources quality of MFI.

Accounting & Management Information System

The review and assessment of Accounting & Management Information system of NGO-MFIs/RSPs/Cooperatives/other programs have been covered in detail in the annexed portfolio review guidelines; the auditors/consultants shall review the systems using the tests & procedures given in the guidelines.

Recommendation to Transforms

The auditors/consultants shall, based on the findings of institutional assessment exercise an objective analysis of political & economic conditions in the country and policy, legal and regulatory environment for the Microfinance Sector and its future outlook, recommend that whether the NGO-MFI/RSPs/Cooperatives should go for transformation. They shall also recommend the future course of action in case of recommendation in favor of transformation. It is advisable that the same consulting team would undertake the feasibility study for conversion of the MFI into MFB as a number of areas like organizational background & capacity, review of policy environment etc of the study would already be covered in the institutional capacity assessment exercise.

Transformation Decision

The NGO-MFI/ RSPs/Cooperatives/other program's Board on receipt of the institutional assessment report by audit/consulting team, shall review the report and its recommendations and make a decision to go for transformation or otherwise. In case of decision in favor of transformation the Board shall authorize preparation of proposal and application for submission to State Bank of Pakistan for grant of license to operate as Microfinance Bank under MFIs ordinance 2001. The resolution of the Board shall also be submitted to SBP along with other documents. The criteria for grant of license for establishing Microfinance Banks specify the terms & conditions to be completed for grant of license and may be carefully reviewed along with these guidelines while preparing the proposal and application for grant of license. The criteria are annexed for ease of reference as Annexure- II.

Information/Documents to be submitted to SBP for Grant of License

The NGO-MFI/ RSPs/Cooperatives/other programs shall submit application for grant of license to SBP on prescribed forms, duly filled in and signed by NGO-MFI/ RSPs/Cooperatives Board's authorized person along with following documents, the forms are annexed as Annexure III:

- Institutional Assessment Report prepared and completed as per the guidelines discussed in above paragraphs;

- Board Resolution to go for transformation along with its objectives;

- Feasibility Report containing business plan & financial projections for 5 years specifying what the MFB plans to achieve and how to achieve these in the medium term

- Detailed CVs of the Proposed Board Members of the MFB and commitment letters to serve as the Board member and subscribe capital, if any.

- Draft Memorandum and Articles of Association & proposed name of the MFB;

- Detail of assets & liabilities to be transferred to the MFB- the transfer shall be admissible at value assessed/determined by the audit/consulting team during institutional assessment phase

- A pay order/bank draft valuing Rs.500, 000/- in favor of State Bank of Pakistan as application processing fee

Relationship between NGO & MFB

The NGO-MFI/RSPs/Cooperatives/other programs shall, in its proposal for transformation, describe in detail the nature of its relationship with the Microfinance Bank other than owner/major shareholder and the nature of activities/functions the NGO/RSPs/Cooperatives will continue to perform after transformation into/sponsoring the MFB and linkages if any, with the operations and functions of the MFB.

Approval in Principle

State Bank of Pakistan on receipt of application complete in all respect shall process the application and if satisfied with the overall quality of the proposal, shall grant approval in principle for establishing the Microfinance Bank under MFIs ordinance 2001within one month of receipt of the application. The State Bank shall also grant NOC for incorporation of the Microfinance Bank with Securities & Exchange Commission of Pakistan (SECP) as a public limited company.

Grant of License

The NGO-MFI/RSPs/Cooperatives/other programs granted approval in principle and NOC for incorporation, shall, after incorporation of the proposed microfinance bank, submit the incorporation certificate to SBP. The State Bank shall grant the license subject to receipt of clearance from security agencies and CBR etc.

Commencement of Business

The NGO-MFI/RSPs/Cooperatives/other programs after grant of license to establish the MFB shall complete the assets & liabilities transfer process, arrange subscription of capital, if any to be subscribed by persons other than the NGO/ RSPs/Cooperatives and obtain certificate of commencement of business from SECP. The licensed MFIs shall open branches/places of business under MFIs branch licensing policy. The process shall however be completed within six months of grant of license by the SBP.

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ANNEXURE-I

Guidelines for Reviewing Credit Portfolio of NGO-MFIs Interested in Transformation into MFBs

Introduction

The legal framework for MFIs was enacted in October 2001 with the objective to allow private sector entry into banking with the poor. The framework provides for and encourages NGOs-MFIs, which have demonstrated ability to manage the MFIs on sustainable basis and have capacity to mobilize local savings and expand outreach, to transform into regulated Microfinance Banks. The MFIs licensing policy and criteria prescribed by the Central Bank under legal framework allows NGOs to contribute up to 50% of required capital in the form of credit, investments and other assets portfolio (free of losses) subject to review by a Chartered Accountancy firm from amongst the panel of auditors maintained by SBP.

The peculiar nature of MFIs credit portfolios e.g. small tickets but large volumes, large number of small disbursements and recoveries, dispersion over wide geographic areas, non collateralized nature and practical difficulties in legal enforceability of claims on borrowers, necessitates a different approach and methodology and test procedures to review the portfolios. The objective of issuing the guidelines for reviewing NGO-MFIs' credit portfolios interested in transformation is to ensure a reliable assessment of the portfolio quality based on pre-defined parameters. The guidelines however, prescribe the minimum requirements/parameters to be completed during the review process, the auditors may apply additional procedures and tests to reach at a reliable assessment of the portfolio quality and adjustments required, if any.

Guidelines

Characteristics of MFIs Credit Portfolio

The major characteristics of microfinance lending, which makes the MFI 's portfolio risk different from that of conventional financial institutions are given hereunder; the auditors while planning a review of MFIs' credit portfolio and designing test procedures should take into consideration these characteristics:

- MFIs grant a large number of small loans, and so receive an even larger number of small repayments. Further the microfinance operations are often dispersed over a wide geographic area and to be efficient, MFIs need streamlined and decentralized operating structures. These issues make it harder to maintain effective portfolio information and management systems.

- Decentralization implies that relatively few staff members are involved in approving, disbursing, monitoring, and collecting the loans. This pattern can increase the opportunity for deviation from approved policies and for fraud.

Decentralization can also increase the risk of error or manipulation in transferring information from branches to headquarters.

- To handle small transactions efficiently, MFIs face great pressure to cut costs sometimes at the expense of adequate portfolio controls and information, as well as sufficient supervision of clients and loan officers.

- Many microfinance portfolios grow rapidly, which puts pressure on systems and can camouflage repayment problems. A rapidly growing portfolio has a higher percentage of loans that are in the early stages of repayment; the delinquency problems are more likely to appear at later stage.

- MFIs generally feel, not always correctly, that writing off loans from their books would send wrong signals both to the borrowers and credit officers that the MFI is no more interested in recovering the loan. Further most MFIs do not pay taxes and as such provisioning & write off doesn't produce any tax savings for them.

Review of Credit & Interest Accrual/Non-Accrual Policies

The Auditor shall review MFIs' credit policy/manual covering target market (s) characteristics, loans origination, appraisal, approval, disbursement, monitoring and recovery processes and procedures, loan classification and provisioning and policies for interest accrual/non-accrual to develop a detailed understanding of the policies as well as to test compliance thereof. He shall also interview the credit officers on sample basis to assess compliance with policies and obtain their feedback / opinion on the policies and systems. A brief description of main features of the policies and their impact on quality of the MFIs' loan portfolio shall be made part of the portfolio review report.

Review of Accounting and Information Systems

The accounting, loan tracking MIS and loan administration are the three important systems/areas, which affect the MFIs credit portfolio quality. The accounting system and loan tracking MIS produce information whereas the loan administration systems define policies and procedures, which govern the loan operations. The accounting system receives data about individual loans transactions to generate aggregate financial information whereas the loan tracking MIS focuses on individual loans information including client identity, amount disbursed, loan terms such as interest rate, loan period, repayment schedule, repayment history, aging of delinquency, outstanding balances etc. Ideally there should be seamless integration of loan tracking MIS with the accounting system; however, this is not the situation in most of the MFIs operating in different countries including Pakistan and generally the two systems are not fully integrated due to which there are issues of reconciliation of MIS data with the accounting system data.

The Auditor shall review the MFI's accounting and information systems and make an objective assessment about their capacity, reliability and effectiveness for generating portfolio related information and reports. The capacity refers to systems' ability to handle the transaction volumes; the MFI is generating, and the variety of reports and information including client payment history, loan delinquencies and their aging, branch/geographic area/sector/credit officer wise break-ups, details and trends, details of rescheduled loans etc. The accuracy and reliability means that the system correctly reflects loans disbursed, payments received and current repayment status of outstanding balances and that the system has built-in safety features, satisfactory external safety environment with access restricted only to the authorized users. For the purpose the auditor shall examine a statistically significant number of loans, segmented by branch office, chosen on the basis of materiality criteria or at random, compare the loan documents and transaction records with ledger accounts, planned repayment schedules, the MFI's credit policies and the delinquency reports generated by the loan tracking MIS. The auditor shall test amounts disbursed, amounts received, and dates of payments and current repayment status of the loans. He/she shall also check whether the institution accurately records the loan transactions on the dates they occur, whether the tracking system correctly distributes the payment among relevant accounts and whether the outstanding loan balances in the tracking system are in conformity with the institution's credit policies.

The Auditor shall test whether the loan tracking MIS data reconciles with accounting system data; due to large volume of transactions, inconsistencies in the data generated by the two systems are common in MFIs. However, if over time a large number of transactions hang in suspense accounts, there may be a material weakness in the loan administration system and should be looked into carefully by the auditors.

The capacity and reliability of the system wouldn't be of great value unless people at all levels of the organization are receiving timely reports in an intelligible form and using the data they contain; the auditor therefore, should also assess the effectiveness of the systems.

The overall assessment of the systems' capacity and reliability, level of integration and reconciliation issues and severity thereof shall be made part of the portfolio review report and shall form an important basis in deciding the depth of portfolio review and sample sizes for testing the portfolio.

Review of Internal Audit Function

The Auditor shall review whether the internal audit function is in place in the NGO-MFI and whether its size and capacity is compatible with the level of development and size of the MFI. He/She shall assess the scope, coverage and effectiveness of the audit particularly with respect to MFIs-loan portfolio, the quality of reports and enforcement thereof. The assessment of the internal audit function shall be described in the portfolio review report. The assessment shall among others form the basis of depth of portfolio review.

Portfolio-Related Fraud Controls

The auditor shall review whether the MFI have an effective operational audit function capable of detecting the types of fraud most common in MFIs loan operations. Such fraud often occurs "off the books" e.g. loan payments are stolen before they are registered leaving no paper trail for the auditor to follow other than an eventual delinquency report, loan officer creates fictitious groups or borrowers and makes disbursements etc. The Auditor while assessing MFI's operational safeguards and other internal controls shall make an assessment of controls devised by MFI to check such incidences.

Depth of the Portfolio Review

No single set of portfolio review procedures is appropriate for all MFIs. The Auditor shall, based on the review of credit and allied policies, accounting and information, systems and controls, internal audit functions of the MFI, and conducting interview from loan officers to ascertain their awareness and hurdles observed during implementation of policies and procedures, decide the depth of the portfolio review and tests etc. For MFIs having well defined credit policies with effective mechanism and culture to ensure compliance, reliable accounting and information systems and effective internal audit function, the testing could be limited to branches covering 25% of the outstanding portfolio; for rest of the portfolio, reliance could be made on internal assessment of the MFI. The MFIs having relatively larger instances of non-compliance with the policies, limited capacity information and accounting systems, weak control structures and ineffective internal audit function, the testing will have to be increased to the branches covering 35-50% of the outstanding portfolio or even ***more*** depending on the severity of weaknesses in the systems and control functions; for the remaining portfolio, the results of the reviewed branches will be extrapolated.

Review of Loan Files

The loan files shall be reviewed for completeness, adherence to the MFIs loan policies and procedures and assessing quality of the MFI claims appearing in its books of accounts. The loan file normally contain, original loan application, identity card and address of the borrower, nature of business, references/guarantors and collateral information (depending on MFI policy), signed loan document stipulating loan terms and conditions, the clients' credit history and documentation of follow-up steps in case of delinquent loans. The auditor shall review 10%-15% loan files of each branch selected for review or more depending on his/her assessment about the overall control environment at the branch, level of completeness of files reviewed etc. Major observations/findings of the files review process shall be made part of the portfolio review report.

Client Visits

Client visits is an important and integral part of MFIs portfolio review. The visits are made to verify that the clients exist and loan details provided in the files as well as the MFIs claims appearing in its books are valid. The sample size for the clients to be visited shall be 5% to 10% of the clients outstanding in the branch records as of portfolio review date depending upon the auditor's assessment about the overall control environment and experience gained during the initial visits i.e. the sample size would be increased beyond these limit in case materially large number of borrowers remains untraceable or deny having taken any loan from the NGO-MFI. The auditor may recommend provisions/adjustment based on review of loan files and the client visits. Major observations/findings of the client visits shall be reported in the portfolio review report.

Adjustment lending/Repeat Loans

Adjustment Lending/Repeat Loans is another very common feature of MFIs, particularly the MFIs having weak control structures and inefficient monitoring systems. It refers to the practice of adjusting/liquidating an existing loan with a fresh loan with the objective to present a rosy picture viz. good portfolio quality, recovery rate and fresh disbursements, to the stakeholders. The auditor shall apply tests to determine the level of adjustment lending in the reviewed branches and recommend adjustments/provisions against such loans.

Rescheduling

The auditor shall review the details of rescheduled cases and repayment patterns after the rescheduling. The rescheduled loans against which even a single installment is overdue shall attract 100% provision, whereas the rescheduled loans whose first installment after the rescheduling is not due by the finalization of audit shall attract 50% provision.

Loans Outstanding Whose Term Expired

The auditor shall test the loans appearing in the books of accounts as current (performing) but whose original term is expired, determine the amount of all such loans and provisions held, if any, examine the reasons for the same and recommend additional provisions, if any required based on the test results and the reasons identified.

Interest accrual

The auditor shall examine whether the MFI stops accrual of interest and reverses previously accrued but unpaid interest, on Non-Performing Loans. He/She shall test the accrued interest receivable balances in conjunction with the loan balances and determine whether the MFI stops accruing further interest, and reverses previously accrued but unpaid interest, on Non Performing Loans. He/She shall also assess whether the accrued interest is shown in the books separately as other assets or made part of the loans outstanding. In case it is clubbed with the principal loan amounts, the auditor shall determine its level and compute the portfolio net of interest accrued besides recommending reversal of interest accrued on NPLs.

Interest Income Testing Through Yield Gap Analysis

The Yield Gap Analysis is an important analytical tool to review the loan portfolio as well as the interest accrued by the MFI. It compares actual interest income with an independent expectation of what the portfolio should be yielding, based on the loan terms and the average portfolio over the period and investigates material mismatch, if any. It is advisable that the auditor should test/evaluate the results achieved through substantive testing through analytical tools such as yield gap analysis.

Loan Loss Provisions Using Aging Criterion

The auditor shall, based on the reviews and tests applied, determine the level of adjustments/provisions required against the MFI's credit portfolio. In addition to the provisions determined through various tests as discussed above, the portfolio shall be grouped into following categories using the aging criterion and provisions be determined as per the rates given against each category:

Sr. No.	Category	Criteria	Provision Required
1.	***Current***	*All loans with no payment of principal or interest (mark up) are over due by 30 days or more.*	0%
2.	***OAEM***	*All or part of principal or interest (mark up) is over due by 30 days or more but less than 90 days.*	0%
3.	***Substandard***	*All or part of principal or interest (mark up) is over due by 90 days or more but less than 180 days.*	20% of outstanding principal *net of cash collaterals / liquid securities**
4.	***Doubtful***	*All or part of principal or interest (mark up) is over due by 180 days or more but less than 365 days.*	50% of outstanding principal *net of cash collaterals / liquid securities**
5.	***Loss***	*All or part of principal or interest (mark up) is over due by 365 days or more*	100% of outstanding principal *net of cash collaterals / liquid securities**

***** *Liquid securities which are easily encashable without recourse to law.*

General Provisions

In addition to the provisions determined/identified during the course of review, a General Provision equivalent to 2% of the net outstanding portfolio (net of specific and other provisions identified during the review) should be determined.

Annexure-II

ESTABLISHING MICROFINANCE BANKS

Category of Microfinance Banks

The MFIs' legal framework allows establishment of three categories of formal microfinance banks in the country viz:

- Nation wide MFBs - minimum paid-up capital of Rs.500 million
- Province wide MFBs - minimum paid-up capital of Rs.250 million and
- District wide MFBs - minimum paid-up capital of Rs.100 million

The Licensing, Regulatory & Supervisory Agency

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

Who Can Apply for a License for Establishing Microfinance Banks

Any person or group of persons, Pakistan or Foreign national, having requisite financial and managerial capacity and exposure to and understanding of dynamics of the MF Sector as well as established integrity levels may apply for a license under the MFIs Ordinance.

Ineligibility to Become Sponsors/Directors

Any person (s) having any of the following disqualification shall not be eligible to be a Director on the Board of MFB:

a) has been convicted by a court of law in Pakistan or abroad for a criminal offence;
b) has been associated with any illegal activity especially contravention of banking and corporate laws.
c) has failed to meet his/her obligations to banks and other financial institutions. The Sponsors/Directors shall furnish names of the banks/DFIs and their branches with which they have had dealings along with the reports from such Banks/DFIs.
d) has defaulted in payment of taxes- each director and sponsor shall indicate his/her National Tax Numbers.
e) is or has been associated as Director/Chief Executive with the Corporate Bodies whose corporate and tax record including customs duties, central

excise and sales tax has been unsatisfactory. They shall name the corporate bodies, their bankers and disclose their tax numbers and dividend record. Those not so associated with Corporate Bodies would be required to indicate their occupation/profession/trade and highlight their achievements.

f) is member/office bearer of any political party or member of Senate, National/Provincial assembly/assemblies
g) In the opinion of the sanctioning authority maintains adverse reputation regarding integrity and performance.

Minimum Capital Requirement

No MFB shall commence business as microfinance bank unless it has a capital of Rs.500 million, Rs.250 million and Rs.100 million respectively for countrywide, specific province-wide and specific District-wide microfinance banks.

The NGOs/Projects already providing micro credit and allied services to the poor, may apply for a license under the MFIs Ordinance. They may contribute up to 50 percent of the required capital in the form of their existing portfolio of micro-credit and other assets (net of losses) after due diligence by a reputed Chartered Accountancy firm on the SBP's panel of auditors. The remaining 50% will however, be contributed in the form of cash or Government securities.

Minimum Contribution by Sponsors

The promoters or sponsor members shall subscribe at least 51% of the minimum capital and the shares subscribed to by the sponsors shall remain in the custody of State Bank and shall not be transferable nor shall encumbrance of any kind be created thereon without prior permission in writing from SBP.

Net worth of Sponsor Directors

The declared personal Net worth Sponsor Directors shall not be less than the amount to be subscribed by them personally. The Net Worth shall be indicated and supported by a duly authenticated copy of the latest Wealth Statement filed with the taxation Department. In case sponsor Directors residing in countries where filing of Wealth Statement is not a requirement of law, a certificate of Personal Net Worth and General Reputation issued by an international bank of repute would be acceptable. This facility would also be available to applicants who would have returned to Pakistan within six months of submission of application for grant of license.

The institutional sponsors shall submit a resolution of their respective Boards/Governing Bodies for i) sponsoring the MFB/MFIs either individually or in collaboration with other persons ii) the amount to be subscribed and iii) the nomination of Directors representing the institution on the MFB/ MFI Board. They shall also submit latest audited financial statements along with the auditors' opinion on the financial repute and capacity of the institution to make the proposed investment in the MFB/MFI.

Public Floatation of Share Capital

In case the sponsors are interested in raising some capital through public floatation of the share capital, firm commitment from '**A**' rated underwriting firms to underwrite the public floatation shall be submitted along with the application for grant of license.

Foreign Investment

Foreign investment shall be allowed in accordance with the Govt. Foreign Investment Policy. While dividends may be repatriated with SBP approval, the repatriation of capital will be allowed at inter-bank exchange rate in case of sale of shareholding to sponsors acceptable to SBP.

Structure of the MFB Board

The MFB Board shall have at least seven members and not more than 25% of the members shall be from the same family.

No person shall be on the Board of more than one Microfinance Banks/Institutions. Similarly, no group shall be granted license for establishing more than one Microfinance Banks/ Institutions.

President/ Chief Executive

The President/Chief Executive shall be a professional with sufficient experience as Microfinance Specialist or Senior Banker with no adverse information regarding his/her integrity and performance and his/her appointment, as President/Chief Executive shall be subject to SBP clearance.

Commitment Letters by Sponsors/Directors/President

The Sponsors/Directors, Chief Executive and Members of senior Management team shall submit commitment letters to subscribe the committed capital and serve in their respective positions.

Application Forms

Application forms have been placed on SBP website and can be accessed by clicking the link www.sbp.org.pk/about/micro/index.htm or obtained directly from Director Banking Supervision Department.

Information/Documents to be submitted with the Application

The sponsors in addition to the information required in above paragraphs, shall submit following information/documents with the application:

- The draft Memorandum and Articles of Association of the MFB and the proposed name
- Feasibility Study for setting up the MFB in the specified area i.e. the specific district, province or the whole country;
- The organization structure along with proposed job descriptions and detailed CVs of the Chief Executive and the Senior Management team;
- The microfinance model(s), which the proposed MFB would be implementing for extending MF Services, and
- Short term and long term business plans

Application Processing Fee

The applicant shall deposit a pay order or demand draft of Rs.500,000/- (Rupees five hundred thousand) favoring State Bank of Pakistan along with the application as processing fee. The fee so deposited shall be non-refundable.

NOC for Incorporation with SECP

The sponsors shall submit the application complete in all respect including the processing fee to the Director Banking Supervision Department State Bank of Pakistan Karachi for grant of license to operate as MFB. The State Bank shall process the application and if satisfied with the capacity of the sponsors and senior management team to manage and operate the MFB, the quality of the proposal (feasibility report and business plans etc) and contents of the draft memorandum and article of association of the proposed MFB, shall issue NOC to the sponsors for incorporation of the proposed bank as a public limited company. In case of weaknesses in the proposal, concerns on capacity of the sponsors and senior management team and or incomplete information, the sponsors will be given an opportunity to improve the proposal or take steps to address the concerns raised by SBP. NOC will be issued if proposal etc. is improved to the satisfaction of SBP; the application will be declined otherwise.

Grant of License

The sponsors granted NOC for incorporation of the proposed bank with SECP as public limited company, shall, after incorporation of the company, submit the incorporation certificate to SBP. The State Bank shall grant the license subject to receipt of clearance from security agencies and CBR etc.

Commencement of Business

The MFB shall commence operation within six months of the grant of license by the SBP. After grant of license the sponsors shall subscribe the committed capital and obtain certificate of commencement of business from SECP. The licensed MFB shall then apply to SBP for grant of licenses for opening branches/places of business under MFIs branch licensing policy.

Compliance with Legal Framework & Prudential Regulations for MFBs

The company granted license to operate as MFB shall comply with the provisions of Microfinance Institution Ordinance 2001, Rules/Prudential Regulations framed under it and SBP directives issued/to be issued from time to time. The Prudential Regulations for MFBs can be accessed by clicking the link www.sbp.org.pk/about/micro/index.htm or obtained directly from Banking Supervision Department.

x…x…x

ANNEXURE-III

APPLICATION FOR ESTABLISHING MICROFINANCE BANK/INSTITUTION UNDER MFIs ORDINANCE 2001
(TO BE SUBMITTED BY SPONSORS / DIRECTORS)

1. Name of the proposed Microfinance Bank / Institution ______________________________

2. Category of License- Applied for ______________________________
(Country, Province or District based) (Also Give the name of Province / District if Provincial / District bank)

3. Contact person's name, address, phone & Fax numbers ______________________________

4. Proposed place of operational Head Office (Indicate places in order of preference for Country / Province –wide bank) ______________________________

5. Proposed paid-up capital ______________________________

6. Subscription by the Sponsor Directors and their personal Net Worth.

*Name with Both Parent's / Spouse's Name & Address	Relationship with other sponsor Directors	Occupation / Profession / Trade	**Subscription in thousand Rupees.	Subscription as % of Total paid up capital	***Personal Net Worth in thousand Rupees.	National Tax Number	National Identity Card Number & Passport #
1.	2.	3.	4.	5.	6.	7.	8.

1.
2.

Total __________ __________ __________

__________ __________ __________

Total Subscription by Sponsor Directors as a % age of the total Paid - up Capital __________

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* Nominee Directors shall also give name & address of the institution to which they would represent
** Nominee Directors to give amount subscribed by their institution
*** Certified Wealth Statement / Auditor's certificate to be attached by individual / institutional sponsors along with audited annual accounts

7. Name of the proposed Chief Executive/President- Pl. attach his/her detailed CV along with references

8. Whether the commitment letters of Sponsor Directors and CEO to serve in their respective positions are attached? Yes/ No

9. Whether any of the Sponsor Directors and Chief Executive or their spouses has been associated with any illegal activity specially contravention of banking and corporate laws? Yes/ No
(If yes please provide details)

10. (a) Exposure / Financial obligations of Sponsor Directors or their spouses or their firms to banks and other financial institutions along with due dates and maturity.

(b) Please provide list of companies / firms and their bankers in which sponsor directors and their family members viz. spouses, children and parents serve(d) as Directors, Chief Executive, Partner, Proprietor, or major shareholders holding 5% or more shares:

Name of the Sponsor Director and his/her family members	Occupation / Profession / Trade	Present position	National Tax Numbers	N.I.C. & Passport Numbers	Name of Associated Company / Firm & % age of share-holding	Name of the financial institution along with the name of the branch with which sponsor Directors, their family members and firms/companies has had dealings	*Account Number
1.	2.	3.	4.	5.	6.	7.	8.

***** Pl. attach report (Certificate) of each bank with which the sponsors etc. have had dealings.

11. (a) Has any of the Sponsor Directors or their spouses or firms defaulted in payment of taxes? Yes/No

If Yes, please attach details.

12. Information regarding Companies/Firms with which the Sponsor Directors and their spouses have been associated as Director, Partner, Chief Executive or major shareholder holding 5% or more shares.

Names of Sponsor	Names of Corporate Bodies	Position held & Shareholding in %	National Tax number of the Corporate Bodies	Nature of Business	Asset Base as reflected in the latest Audited Accounts of the Corporate Bodies	Dividend declared in the immediately preceding three years
1.	2.	3.	4.	5.	6.	7.

13. Please submit the following documents along with the application: -

    i. Feasibility Study of setting up the Microfinance Bank/Institution in the specified area i.e. the specific district, province or the whole country;
    ii. Detailed business plan- specifying what and how the MFB would achieve in the medium term
    iii. The organization structure along with job description and detailed CVs of the senior management team;

14. Please attach pay order or bank draft for Rs.500, 000/- favouring State Bank of Pakistan as application processing fee (non-refundable)

<u>NOTE:</u>

i) Minimum subscription by Sponsor Directors – 51% of the total paid up capital.
ii) Prescribed personal Net Worth of each individual / institution – Not less than the subscribed amount of each person.
iii) Attach copy of the Wealth Statement or certificate of Net Worth and reputation.
iv) Not more than 25% of the Sponsor Directors from the same family.

Name(s) & Signature(s) of the Applicant::______________________________