



The World Bank

Pakistan Financial Inclusion and Infrastructure Project
(P159428)

Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Appraisal Stage | Date Prepared/Updated: January 30-2017 | Report No: 112343



BASIC INFORMATION

A. Basic Project Data

Country Pakistan	Project ID P159428	Project Name Pakistan Financial Inclusion and Infrastructure Project	Parent Project ID (if any)
Region SOUTH ASIA	Estimated Appraisal Date 23-Jan-2017	Estimated Board Date 14-Mar-2017	Practice Area (Lead) Finance & Markets
Lending Instrument Investment Project Financing	Borrower(s) Economic Affairs Division, Government of Pakistan	Implementing Agency Development Finance Group, State Bank of Pakistan	

Proposed Development Objective(s)

The proposed development objective is to contribute to increasing access to financial services for households and businesses in Pakistan. This will be done by: (i) improving market infrastructure and institutional capacity, (ii) supporting the uptake and usage of Digital Payments and Financial Services and by (iii) improving access to financial services for microenterprises and SMEs (MSMEs).The project will seek to substantially increase access and usage of financial services by women and support women-owned MSMEs.

Components	
Financing (in USD Million)	Amount
Financing Source	
International Bank for Reconstruction and Development	23.00
International Development Association (IDA)	107.00
Total Project Cost	130.00

Environmental Assessment Category

FI-2-Financial Intermediary

Concept Review Decision

Have the oversight and clearance functions been transferred to the Practice Manager? (Will not be disclosed)

No

Decision

The Concept Note review authorized the preparation to continue.



B. Introduction and Context

Country Context

A mild growth recovery is underway in Pakistan, and external account pressures have subsided. Pakistan's economy posted GDP growth of 4.2 percent in FY2014/15, up marginally from 4 percent the previous year. Government consumption posted strong growth, and private consumption was supported by record high remittances of some USD 18.7 billion in FY2014/15. Moderately higher economic growth is forecast for FY 16-19 (5 percent in FY2017 and 5.4 percent in FY 2018), driven by investment and productivity gains in services and manufacturing. In the near term, investments under the China Pakistan Economic Corridor (CPEC) and low international oil prices will also support growth. Increasing reserves have contributed to stability in foreign exchange markets and low inflation. Modest growth, however, will not be sufficient to create jobs for the large number of youth joining the workforce every year and make a significant contribution to poverty reduction.

Financial markets in Pakistan are shallow and narrow. In 2015 financial sector assets stood at about 68.5 percent of GDP, below that of other relevant emerging markets. Private sector credit to GDP, which declined significantly from 2008-2015, was just 15.4 percent, significantly below the regional average of 47.6 percent. Stable, deep, diversified, efficient and inclusive financial systems are essential for poverty reduction and economic growth.

Sectoral and Institutional Context

In the last 25 years, Pakistan's financial sector has gone from one dominated by underperforming state-owned banks to a modern and sound financial sector dominated by private banks. The banking sector accounts for 75 percent of financial sector assets, with the balance in the National Savings Scheme (NSS)¹ (16.5 percent), insurance companies (5 percent), non-bank financial institutions (4.0 percent), and microfinance institutions (0.5 percent). The microfinance sector is small in terms of assets, but is significant in terms of financial access. Financial soundness indicators indicate that the banking sector is generally sound, liquid and profitable. Islamic finance is growing rapidly, and currently accounts for 11 percent of sector assets.

Pakistan has taken measures to improve financial inclusion for over a decade, and has led the way in South Asia in digital payments and branchless banking². A proactive regulator (SBP) and widespread computerized national identity cards (NADRA) have contributed to significant growth in digital transaction accounts (DTA)³. The government has digitized some of its own payments, including its main social safety net program, the Benazir Income Support Program (BISP). Banks and MFBs are actively involved in branchless banking, in partnership with mobile network operators (MNOs).⁴ As a result, Pakistan has the highest penetration of mobile money⁵ accounts in South Asia at 5.8 percent of the adult population, compared to the South Asian average of 1.9 percent. The gender gap on mobile accounts is much narrower than the overall gap for accounts.

Despite these achievements, financial access remains low. According to World Bank Global Financial Inclusion Database (FINDEX), only 13 percent of adults had access to a formal account in 2014, far behind Sri Lanka at 83 percent, India at 53 percent and Bangladesh at 31 percent.⁶ Use of formal financial services is also limited. Individuals often make payments or borrow informally (about 43 percent of unbanked adults made or received payments informally and half of the Pakistani population reported borrowing through informal methods).⁷ Some market segments are significantly excluded from the formal financial sector:

- a. There is a significant untapped market for microfinance, which is suffering from funding constraints. The microfinance sector serves only 3.1 million borrowers, just 11.5 percent of the estimated potential market.⁸ In order to fund future growth and reach 10 million active borrowers by 2020, the industry needs additional funding of PKR 300 billion (USD 3 billion).
- b. Despite constituting about 25 percent of the labor force, only 4.8 percent of women are included in the formal financial sector, compared to the South Asian average of 37.4 percent. Loans to women account for less than 3 percent of total bank loan volume.

¹ NSS deposits are equal to 30 percent of total banking deposits and account for 24 percent of the Government of Pakistan (GOP)'s domestic debt.

² In Pakistan, this term refers to using agent based models linked to a specific type of bank accounts.

³ In Pakistan, this refers to accounts that are designed to be accessed through digital channels and for making digital payments.

⁴ There are 8-9 significant Digital Financial Services (DFS) businesses (2 of which have been providing DFS for the past 6-7 years and many are startups innovators) led by all four major MNOs and some of the biggest banks. The three largest MNOs each own a microfinance bank.

⁵ In the context of Pakistan, these are also branchless banking accounts that are designed for access through mobile phones.

⁶ About 26 percent of unbanked adults cited that financial services were too far to access.

⁷ 23 percent of adults cited that financial services are too expensive to use.

⁸ PMN, Microfinance Growth Strategy 2020.



- c. Similarly, even though SMEs constitute 90 percent of enterprises in Pakistan, as of June 2015, banks were lending to just 4.7 percent of the estimated total SMEs in the country (3.2 million). Banks have limited appetite to serve the SME sector due to perceived risks, and have favored alternative investment options, notably government securities.⁹ As a result, SMEs use their own sources for 89 percent of working capital and 75 percent of investment needs.

The development of branchless banking has the potential to significantly enhance financial inclusion, but several issues need to be addressed to expand access to DTAs:

- a. Gaps in the National Payments System (NPS) that hamper financial inclusion and broader financial sector development need to be addressed. These include weaknesses in the legal framework, the payments infrastructure, fair and transparent access to settlement systems, and the overall oversight framework for the NPS. Significant investment is needed to upgrade payments, settlements and information technology systems.
- b. While Digital Payments have been growing, most transactions are done over the counter (OTC) instead of through customer accounts (80 per cent OTC). This implies high transaction costs and limited scope for product development. At the same time, merchant acceptance of electronic payments is not widespread. A recent study by the World Bank Group estimated that, out of approximately USD13 billion retail sales by micro, small and medium retailers in 2015, more than USD10.8 billion is paid for by cash.¹⁰ Cash is also the preferred payment method by micro, small and medium retailers in Pakistan for supplier and wage payments.¹¹
- c. Expanding access to DTAs and reaching scale and viability can be achieved through digitization of bulk payments such as government payments.¹² For example, according to FINDEX, roughly 2.5 million adults are receiving government payments in cash (and are unbanked).

More diverse, sustainable and efficient access points are also critical for financial inclusion. Various networks can be leveraged for access such as the Central Directorate of National Savings (CDNS), or the Pakistan Post, which has 12,000 branches. End-to-end automation and modernization of the existing manual systems will be needed. Modernization will allow more avenues for delivery of financial transactions and services.

In May 2015 Pakistan launched its National Financial Inclusion Strategy (NFIS) to achieve its vision i.e. ‘individuals and firms can access and use a range of quality payments, savings, credit and insurance services which meet their needs with dignity and fairness’.¹³ The proposed project supports the authorities’ efforts to move towards universal financial access.

The project will factor in lessons learnt from financial sector work in Pakistan and in peer countries. Underlying analytical and operational work include the NFIS,¹⁴ the FISF technical assistance supporting NFIS implementation, the DFID funded Private Sector Development Trust Fund, and the recently completed Financial Sector Assessment Program (FSAP). The project is action and outcome oriented, and is complemented by Bank-financed policy credits that unlock constraints in the financial sector.¹⁵ It will coordinate with activities of IFC¹⁶ and other development partners engaged in financial inclusion efforts, such as Gates, CGAP and DFID.

⁹ Commercial banks hold about PKR. 6.5 trillion of government domestic debt as of June 2016 (about 42 percent of total assets) and investments in government securities constitute approximately 92 percent of total banking system investments (which has largely explained the robustness of the banking sector, Pakistan Economic Update, 2016). The situation is starting to reverse with the easing of interest rates and efforts in fiscal consolidation.

¹⁰ World Bank Group (2016). *Cash vs. Electronic Payments in Small Retailing: Estimating the Global Size*. Washington, DC: World Bank. <http://pubdocs.worldbank.org/en/219031465585757849/WBG-Electronic-Payments-Small-Retailing.pdf>

¹¹ Recent data by the Global Payment Systems Survey (GPSS) of the World Bank also confirms this: the number of cashless transactions per capita in Pakistan in 2015 was 0.4 compared to the low and middle income countries’ average of 22.4 cashless transactions per capita in 2015. Cashless transactions per capita per year was around 274 in high-income countries according to GPSS. For further information, see World Bank Group (2016) “Global Payment Systems Survey: Universal Financial Access – Accounts & Access Module” at <http://pubdocs.worldbank.org/en/504871475847684346/GPSS-UFA-Note-October2016.pdf>

¹² Digitization of government payments can also be linked to fiscal savings for the government, including from reduced administration costs of paying benefits and public sector wages in cash, and lower levels of ‘leakage’ as a result of recipients being paid directly into accounts.

¹³ Pakistan’s goal is to expand financial access to at least 50 percent of adults, and to increase the percentage of SME loans in bank lending to 15 percent by 2020. In addition, other headlines targets of the NFIS include by 2020 an increase in the percentage of adults living within 5 kilometers of an access point, 25 percent of women with a transaction account and 10 percent of adults saving at a formal financial institution in the past year.

¹⁴ Such as MSME finance, Digital Transaction Accounts, Payment systems technical notes, NFIS Action plan and so forth

¹⁵ Including the upcoming Development Policy Credit on Finance for Growth, which includes for e.g. the launch of a new DTA scheme concept in its prior action among others.

¹⁶ More particularly in the SME finance sector and gender finance.



The Government of Pakistan (GOP) has requested the project which will support a holistic NFIS approach. It will focus on the development of market infrastructure and the ecosystem that will facilitate access and usage of digital payments and financial services. Access to credit for MSMEs will be supported by a line of credit that will catalyze private sector financing and focused interventions including technical assistance in line with the NFIS.

C. Proposed Development Objective(s)

Development Objective(s) (From PAD)

The proposed development objective is to contribute to increasing access to financial services for households and businesses in Pakistan. This will be done by: (i) improving market infrastructure and institutional capacity, (ii) supporting the uptake and usage of Digital Payments and Financial Services and by (iii) improving access to financial services for microenterprises and SMEs (MSMEs). The project will seek to substantially increase access and usage of financial services by women and support women-owned MSMEs.

Key Results

The success of the project in reaching the PDO¹⁷ will be measured by the following indicators: (i) Improved levels of development of the large value and retail payments system; (ii) Electronic payments per capita; (iii) Number of digital transaction accounts; and (iv); Number of e beneficiaries (borrowers) reached¹⁸. Additional intermediate indicators which will help achieve the PDO targets are described in section VII of the Project Appraisal Document.

D. Project Description

This project aims to contribute to financial inclusion (i) at the individual level by improving access and usage of digital payments and financial services. This will be done through investments, pilots, capacity building and analyses aimed at improving the financial infrastructure and the ecosystem for DTAs and the National Savings Schemes (components 1 and 2) and (ii) at the firm level by improving access to financial services for MSMEs (component 3).

Component 1: Direct Support to the NFIS Implementation (USD 4.5 million)

This component will provide direct support to implementation of the NFIS in line with the priorities laid out in the NFIS action plan

Component 1a. Improving financial and market infrastructure to facilitate the uptake of DTAs (USD 22.5 million)

This sub-component will support the significant investment needed to upgrade payments and settlements systems and the associated information technology (IT) systems. These systems are critical to (i) support the safety, efficiency and reliability of the National Payments System (NPS), (ii) provide settlement services to the various retail payment systems and foster competition and interoperability and (iii) enable the shift of Government payments to electronic means.

- a. Improvement of the payment infrastructure. This will include (i) Upgrade/replacement of the existing SBP-operated payment system by a payment system with dual Real Time Gross Settlement (RTGS) and Automated Clearing House (ACH) capabilities; (ii) Implementation of a National Payment Gateway (NPG) for interoperability among alternative delivery channels, including the branchless banking network, conventional payment service providers, and other payments platforms. The NPG will be operated by SBP.¹⁹
- b. Improvement of market infrastructure. To complete the upgrades in the financial infrastructure described above, this sub-component will support investments in corresponding technical systems/platforms centralized in SBP such as IT systems, risk management systems, and interfaces linking government systems and capital/commodity markets. The NFIS identified financial, payment and ICT infrastructure as key enablers of financial inclusion. This critical market infrastructure supports both financial stability and inclusion.

For sustainable financial development it is key that financial stability is preserved as financial systems are deepened, access is expanded, and new risks emerge. To this end, this sub-component will also support legal and regulatory reforms and capacity building for oversight of the NPS; onsite

¹⁷ Indicators are consistent with IDG A2F Revised Methodology for Corporate Score Card Reporting.

¹⁸ Beneficiaries include micro-entrepreneurs that receive loans under the line of credit detailed in component 3a.

¹⁹ The Gates foundation plans to support the creation of a micropayment platform. As indicated above, the NPG will allow the plug-in of various platforms including the future micropayment platform.



inspections of licensed payment system operators and payment service providers; IT and operational risk management, internal risk management mechanisms at SBP and SBP general oversight and supervision capabilities.

Component 1b. Improving access and usage of Digital Payments and Digital Financial Services (DFS) (USD 18 million)

This sub-component will support the GOP in establishing a national framework for the promotion and use of Digital Payments and DFS. Digital transaction accounts represent an initial entry point for low-income and financially excluded households, which can over time provide access to a broad set of financial services that go beyond payments to include savings, credit, and insurance. The scheme will facilitate a shift in financial behavior from cash to digital payments, through the definition of business rules, the establishment of a shared acceptance network, and connection to the national payment infrastructure. The scheme will offer a national platform to standardize digital payment transactions, in order to achieve scale and increase the use of digital payments, in particular for the disbursement of government payments and the collection of government receivables. The analytics that will inform the design of the scheme will be supported by the Bank's FISF program, complementary analytical work may also be funded under the project (details to be included in the operations manual). The private sector will be actively engaged in the definition and implementation phases of the scheme. This component will also finance the payment system components needed to support the scheme; and the promotion and marketing of the scheme, including for underserved segments such as women. A key objective of the project is to bring significantly more women (9 million) into the financial system through DTAs. Particular emphasis will be placed on the conversion of OTC retail payments to DFS transactions, on scaling national acceptance networks, and on awareness campaigns on the benefits and usage of DFS. Challenge funds will be supported to foster innovation on payment products and DFS, including support to pilot products that have the potential to become sustainable businesses.

Component 1c. Enhancing Secretariat Capacity and Project management and Monitoring (USD 4.5 million)

The NFIS Secretariat is providing an effective national coordination structure for the NFIS, which is key for the implementation and monitoring of the NFIS action plan. This component will support the Secretariat's capacity in undertaking its roles and responsibilities in implementing the NFIS, including policy and advocacy work. Support is envisaged in the form of dedicated technical experts, monitoring & evaluation, and support to technical committees under the NFIS.

Management of project implementation will be assumed by a small team in each responsible agency and a project coordination unit. The sub-component will include costs for project management, monitoring and evaluation (M&E) and capacity building.

Component 2. Supporting Expansion of Access points for Financial Services (USD 15 million)

This component will support investments and analyses that will drive financial access points. Focus will be on integrating more diverse, sustainable and efficient access points across Pakistan, notably through the Central Directorate of National Savings (CDNS) which runs the National Savings Schemes (NSS) through 375 branches. Through the NSS, CDNS is a key contributor to financial inclusion, with an investor base of around 7 million and a portfolio of over PKR 3300 billion, equivalent to 33 percent of bank deposits. Most of its products are designed for low-income segments of the society, however due to lack of automation and operational constraints, NSS has not been able to extend its financial services across the country, especially to the rural areas. The most important reform needed to bring potential access points into the formal financial sector's outreach and facilitate the expansion of DTAs are the end-to-end automation and modernization of existing systems. The current NSS systems are based on manual records, processing, and reconciliation with single entry cash-based accounting principles. This component will support the automation and modernization of CDNS, which is in-line with the recommendations of the 2016 Pakistan FSAP.

This component will also aim to reach scale through bulk payments, including social transfers, government to person payments (G2P), and corporate payments. Expanding access to DTAs and reaching scale and viability through digitization of bulk as well as retail payments is a key driver of Pakistan's financial inclusion strategy. The project will support the formulation of a roadmap for digitizing all government payments with a plan that connects the dots with what already exists (e.g. NADRA, retail payments systems) while also identifying gaps that need to be filled (e.g. connecting people's identities to accounts). A detailed mapping of government payments at both the federal and provincial levels will be the first step.²⁰

Component 3: Improving Access to Microfinance and to Financial Services for Micro, Small and Medium Enterprises (USD 70 million)

Component 3a. Improving Access to Microfinance and to Financial Services for Micro Enterprises (USD 50 million)

²⁰ The project will coordinate with the World Bank Public Financial Management PforR project: "Improving Accountability for Service Delivery" under preparation and the past and upcoming Bank projects supporting the Benazir Income Support Program (BISP).



This subcomponent will provide a line of credit (LOC) to Participating Financial Institutions (PFIs) to refinance eligible loans to microfinance borrowers including microentrepreneurs. The LOC will be channeled through Pakistan Poverty Alleviation Fund (PPAF) for onlending to Pakistan Microfinance Investment Company (PMIC), to then on-lend to microfinance institution (MFIs) and microfinance banks (MFBs). The LOC is expected to ease the liquidity constraint that the microfinance sector currently faces by crowding in private investment in the microfinance sector as well as by facilitating PMIC's access to market funding.

PFIs will be selected based on transparent and clearly defined eligibility criteria around their financial health, institutional capacity to on-lend, governance, and operational processes. Covenants and performance measures to promote good practices including on consumer protection, corporate governance, internal controls and transparency will also form part of the eligibility criteria. This is to ensure sustainable development and growth of the microfinance sector. The component will also focus on: i) developing products tailored to client needs,²¹ ii) encouraging loans to first time borrowers and iii) promoting availability of financial services for microentrepreneurs and in particular women microentrepreneurs²². The component has a strong gender dimension with a target of allocating 50% of loans to women-owned microenterprises.

Component 3b. Improving Access to Financial Services for Small and Medium Enterprises (USD 20 million)

In line with the NFIS action plan, this subcomponent will support access to finance for SMEs with the following activities:

- Risk Sharing Facility (USD 10 Million). The governing body of the Credit Guarantee scheme for Small and Rural Enterprises (CGS), operated by SBP and funded by the GoP and DFID, has decided to undertake an analysis of alternatives to the current CGS, including an independent public-private Credit Guarantee Fund for SMEs. DFID will fund this study under its Financial Inclusion Program (FIP). USD 10 Million will be allocated to endow the modified Scheme or Fund through capitalization from the GoP. To be eligible for this funding, the proposed fund would need to meet the Bank's requirements in terms of additionality, leverage and sustainability, and broadly meet the Principles for Public Guarantee Scheme for SMEs 2015.²³
- Technical Assistance, awareness, and Innovation in SME Banking (USD 10 million). This activity will provide a range of analytical work, challenge funds, and TA to both financial institutions and SMEs to support increased access to finance to SMEs, with focused interventions to support increased access to women entrepreneurs.

E. Implementation

Institutional and Implementation Arrangements

Islamic Republic of Pakistan is the borrower, and the project's activities will be executed by the State Bank of Pakistan, the CDNS (Ministry of Finance) and PMIC.

There will be an overall Project Coordination Unit (PCU) at SBP, and small project units at each agency that will be responsible for the execution of project's activities under that agency's purview, notably with respect to financial management, procurement and safeguards. SBP will have overall responsibility for project Monitoring and Evaluation.

The State Bank of Pakistan, which hosts the NFIS secretariat, will be responsible for Components 1, and 3b. SBP will have a PCU with requisite capacity on project management, financial management, procurement and environmental and social safeguards. Dedicated project managers will be responsible for some aspects, with the support of technical teams. The PCU will be headed by a Project Director at the executive director rank. The PCU will be in charge of overall project coordination at SBP as well as overseeing FM, procurement, reporting, M&E, audit, public information and related functions.

The CDNS (MOF) will be responsible for Component 2. CDNS will establish a small team with adequate capacity on project management, financial management, and procurement. For component 3a, MOF will channel funds through PPAF. Project focal points with expertise in fiduciary and safeguards will be appointed. Since most PMIC staff are from PPAF, institutional knowledge of project implementation will transition from PPAF to PMIC. The responsible agencies will hire part-time technical specialists as required. To facilitate project implementation, a detailed Operations Manual (OM) will be prepared by SBP, PMIC and CDNS (MOF).

²¹ LOC will take into account product development and loans using innovative financing mechanisms and delivery channels

²² LOC will seek to support the transition of MFB from lending to individuals to lending to microenterprises and small businesses and promote microloans to women.

²³ 2015, First Initiative and World Bank Group.



ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT

F. Project location and salient physical characteristics relevant to the E&S risk management analysis (if known)

This project is an overall financial sector project, which consists of two main types of activities:

- (a) Components 1, 2, and 3(b)-Activity 2 involve analytical studies, capacity building, upgrading digital payment systems/ software etc. and are not expected to have E&S risks and impacts. No civil works or renovations of any building or rooms, or generation/treatment/disposal of wastes is expected for these project components. Additionally, analytical studies will not lead to the identification/development of the physical activities which would cause environmental and social impacts. Thus no safeguard policies are triggered. In terms of locations, all these components will be implemented nation-wide in currently undefined locations. Many of the elements, such as IT systems, and digital payment systems, will not have physical locations in traditional sense ("cyberspace"). Similarly, policy and regulatory reforms are not location specific.
- (b) Components involving commercial lending instruments (Financial Intermediation), i.e. the Line of Credit (LoC) for financing microfinance enterprises (component 3(a)) and Risk Sharing Facility (RSF) that would provide support to private sector financial institutions in the form of a partial credit guarantee of their loans to private sector SMEs (Component 3(b)-Activity 1). These components will channel financing to Micro, Small and Medium Enterprises (MSMEs) across Pakistan in an inclusive manner to expand access to finance to previously unbanked population, thus supporting sustainable growth of the national economy. The project will support loans for the purpose of working capital, capital expenditure and other business needs and it is expected that most of MSMEs will be in industrial estates/zones and areas designated for commercial activities. The main focus of the lending components of the project is on the following financial products and sectors (which are the key salient characteristics for determining the degree and level of exposure to E&S risks in MSME finance in the financial sector):
 - (1) **Microfinance:** Supporting small-scale business activities conducted by microfinance borrowers, implemented through Pakistan Microfinance Investment Company (PMIC) that will on-lend to Participating Financial Institutions (PFIs) that will, in turn, provide loans to end micro-borrowers that are private sector entities or individuals. The majority of these micro-enterprises are expected to be in the trade and service sector firms/ borrowers (such food and beverages, small transport services, communication, restaurants). It must be noted that some sectors with perceived higher potential E&S risks and impacts in the country context (namely property/real estate development, commercial construction, tanneries, timber and logging, mining, hunting, and informal cross-border trade) will be excluded from financing as a matter of project design.²⁴ The project will support working capital loans and other loans such as those for equipment purchases. In the case of micro-enterprises, the loan size is expected to be very small, USD 200-1,500, as determined from up-to-date nationally representative survey data. As the degree of financial exposure is one of the key determinants of risks in the financial sector, this is a contributing factor to assessment of E&S risks and impacts associated with these small loans to be relatively low.
 - (2) **SME finance:** This project component envisions designing and rolling out of a Risk Sharing Facility expected to be implemented through the State Bank of Pakistan (SBP) or another institution, which will be decided at later stage (at the beginning of project implementation) based on the study funded by DFID. This study will undertake an analysis of alternatives to the existing credit guarantee scheme, including an option of creating an independent public-private Credit Guarantee Fund for SME lending. Therefore, the SME-focused part of the project is not yet defined in terms of loan size, sectors, and associated financial products, or institutional arrangements. The specific locations of SMEs are also not known at present and would be determined later at implementation stage. It is currently envisioned that SMEs in the manufacturing and services sector will be the primary beneficiaries of the project.

Rationale for classification as Category FI-1, FI-2, or FI-3:

OP/BP 4.03 (World Bank Performance Standards for Private Sector Activities) will be applicable to the project, and more specifically to Line

²⁴ It should be noted that excluding certain legitimate productive sectors is a project-specific decision that is based on the perceived challenges of managing certain E&S issues vis-a-vis project circumstances and risk appetite.



of Credit for financing microfinance enterprises (component 3(a)) and Risk Sharing Facility for financing SMEs (Component 3(b)-Activity 1), in lieu of the World Bank’s Safeguard policies. OP/BP4.03 is better suited for these given that all sub-projects are expected to constitute private sector activities implemented by private sector entities (MSMEs) and are financed through PFIs, which are commercial private sector financial institutions.

The project is categorized as **FI-2** in accordance with OP4.03. This categorization is based on the review of the prospective PMIC portfolio of business activities financed (micro-enterprises, and in case the risk sharing facility component is implemented, SMEs across manufacturing and service sectors with relatively limited associated E&S risks and impacts) and an expectation that, in accordance with BP4.03 paragraph 21, potential adverse environmental and social risks or impacts of these MSMEs will be few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures.

Application of OP/BP4.03 provides a substantial advantage for this project, as OP/BP4.03 offer significantly more clarity, guidance, and flexibility for FI projects in these circumstances than the safeguards policies, thus enabling more comprehensive and uniform implementation. In addition, IFC is also active in Pakistan’s financial sector, hence application of OP/BP4.03 will ensure a more harmonized approach, making it easier for the client to follow only one set of requirements.

G Environmental and Social Specialists on the Team

1. Salma Omar
2. Ahmad Imran Aslam
3. Ekaterina Grigoryeva

POLICIES THAT APPLY

E&S Policies	Triggered?	Explanation (Optional)
OP4.01 – Environmental Assessment	NO	Components 1, 2, and 3(b)-Activity 2 involve analytical studies, capacity building, upgrading digital payment systems/ software etc. and are not expected to have E&S risks and impacts, thus no safeguard policies are triggered.
OP/BP 4.03 – World Bank Performance Standards for Private Sector Activities	YES	<p>OP/BP 4.03, and more specifically, provisions related to private sector activities implemented by private entities (MSMEs) and financed through Financial Intermediaries (FIs), will be applied to the Line of Credit for financing microfinance enterprises (component 3(a)) and Risk Sharing Facility for financing SMEs (Component 3(b)-Activity 1) in lieu of WB safeguards policies. Accordingly, the following E&S provisions will be applied to this project (to be included in the project Financing Agreement):</p> <p>Financial intermediaries are required to develop, formally adopt, and maintain a functioning Environmental and Social Management System (ESMS), acceptable to the Bank, which will enable them to identify, assess and manage E&S risks and impacts under their Bank-supported portfolio of private sector business activities. The ESMS will ensure that all end borrowers (i.e. MSMEs) comply with the following applicable E&S requirements:</p>



1. Applicable environmental and social national and local laws and regulations of Pakistan
2. List of Excluded Activities
3. Business/ private sector activities that present moderate to high environmental and social risks should be operated in a manner consistent with the WB Performance Standards 1 through 8^{25,26}. This will also include WBG Environment, Health, and Safety (EHS) Guidelines. As the size, nature, and specific circumstances of SMEs are not known at this time, any of the Performance Standards may potentially apply based on the outcomes of the process of identification of risks and impacts hence none need to or can be triggered upfront.

The ESMS for the project should incorporate, as appropriate for the project circumstances, key elements of the ESMS described in Performance Standard 1 on Assessment and Management of Environmental and Social Risks and Impacts (as required by OP/BP4.03).

Additionally, all PFIs will manage the working conditions of their own workforce in accordance with relevant aspects of Performance Standard 2 on Labor and Working Conditions, as required by OP/BP 4.03.

Projects on International Waterways OP/BP 7.50	NO	As part of screening for E&S risks and impacts, issues covered by these policies will be considered. If such issues are identified in activities to be financed under LoC or RSF, which is unlikely, such activities will be excluded. Components 1, 2, and 3(b)-Activity 2 are not expected to have such impacts.
Projects in Disputed Areas OP/BP 7.60	NO	As above

KEY E&S ISSUES AND THEIR MANAGEMENT

A Summary of Key E&S Issues

1. Describe any E&S issues and impacts associated with the proposed project. Identify and describe any potential large scale, significant and/or irreversible impacts:

Components 1, 2, and 3(b)-Activity 2 involve analytical studies, capacity building, upgrading digital payment systems/ software etc. and are not expected to have E&S risks and impacts. No civil works or renovations of any building or rooms, or generation/treatment/disposal of wastes is expected for these project components. Additionally, analytical studies will not lead to the identification/development of the physical activities which would cause environmental and social impacts.

Components involving commercial lending instruments using Financial Intermediation process, i.e. the Line of Credit (LoC) for financing microfinance enterprises (component 3(a)) and Risk Sharing Facility (RSF) that would provide support to private sector financial institutions in the form of a partial credit guarantee of their loans to private sector SMEs (Component 3(b)-Activity 1) are the components that are expected to have E&S risks and impacts. As the project’s core model for LoC and RSF focuses on lending to PFIs for on-lending to MSMEs in various sectors, financial institutions can potentially be exposed to an array of E&S

²⁵ WB Performance Standard would be applied as commensurate with the outcomes of the environmental and social screening procedures and based on the nature and magnitude of risks and impacts of private sector activities. Application of WB Performance Standards will not be required for microfinance borrowers and is expected to be limited for SME borrowers.

²⁶ “World Bank Performance Standards” are, in effect, IFC Performance Standards on Environmental and Social Sustainability adopted as the “World Bank Performance Standards” in 2013 pursuant WB Operational Policy 4.03. IFC Performance Standards were first introduced in 2006 and updated in 2012. IFC Performance Standards can be found here:

http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+sustainability/our+approach/risk+management/performance+standards/environmental+and+social+performance+standards+and+guidance+notes



risks through these lending operations. The nature of E&S risk exposure in the financial sector is indirect (through business activities of borrowers), which means that E&S risks can contribute to (i) credit (e.g. higher rate of default resulting from inability of a borrower to effectively operate their business due to, for example, government fines for pollution), (ii) legal (e.g. deteriorating quality of collateral, if such collateral is part of the lending model), or (iii) reputational (e.g. public attention associated with pollution or negative impacts on communities) risks.

Business activities of MSMEs can potentially generate impacts – albeit relatively small - on the environment, present hazards to human health, or negatively affect local communities as a result of improper planning or low capacity for enterprise management. The extent of E&S risks in the MSME sector depends primarily on sectors, geographic context, and enterprise size. While E&S risks associated with individual MSMEs may be generally limited, aggregated across MSMEs they can be considerable. E&S concerns for SMEs are typically associated with production processes or other activities that generate emissions and byproducts that are potentially harmful to the environment, employees and communities (e.g. issues around labor standards, inappropriate disposal of waste, or unhealthy or hazardous working conditions). Therefore, proper mitigation measures should start with individual MSMEs, as practical given their size and commensurate with capacity to manage E&S issues. Given the overall project goal of poverty alleviation through inclusive access to finance, affordability of undertaking E&S risks management measures should also be taken into consideration when developing a mitigation plan for individual MSMEs. No large-scale, significant and/or irreversible impacts are expected at the level of microfinance and SME borrowers.

2. Describe any potential indirect and/or long term impacts due to anticipated future activities in the project area:
No negative indirect and/or long-term impacts are expected for this project.

3. Describe any project alternatives (if relevant) considered to help avoid or minimize adverse impacts:
The project's core approach to mitigation of E&S risks and impacts will be founded on the principles of gradual capacity strengthening of financial institutions and will consist of a combination of (i) applying clearly defined E&S requirements to identifying and managing specific risks and impacts and (ii) excluding certain activities representing negative E&S risks and impacts from financing based on a well-defined List of Excluded Activities. There will be dedicated capacity building budget resources to help SBP, PMIC, and PFIs to build the required capacity. Therefore, the key alternative to help minimize E&S risks and impacts is that the project will have an adequate screening system for not financing certain activities where E&S risks have been determined to be unacceptable.

4. Describe measures taken by the borrower to address E&S policy issues. Provide an assessment of borrower capacity to plan and implement the measures described:
Assessment of the existing institutional capacity for core implementing agencies / FIs with regard to their ability to meet applicable E&S requirements for the project included a review of the capability of these institutions at different levels, and their ability to manage and monitor the process of E&S due diligence at implementation. Initial assessment indicates that SBP and PMIC have varying degree of expertise and capacity and will be required to enhance these aspects, as described below.

To assist with enhancing current capacity of the project counterparts, a systems and capacity assessment for the project has been carried out, including detailed recommendations, suggested guidance and tools for enhancing such systems and capacity during project implementation. A summary of the assessment is presented below.

State Bank of Pakistan

SBP will be responsible for components 1 and 3(b), with the latter to be determined based on DFID study. For component 1, it will play a role of an implementing entity, and for component 3(b)-Activity 1, a wholesale financial intermediary for RSF (if the RSF is supported under the project). Component 1 will not have E&S risks and impacts, as mentioned above and does not trigger safeguards policies.

Should SBP be involved in RSF in the capacity of a wholesale FI (to be determined based on DFID study mentioned above), SBP will strengthen E&S systems and requisite internal capacity. SBP has prior experience in implementing a World Bank project on banking sector reforms, however prior activities were not associated with E&S risks and impacts. The previous Bank-financed TABS project (implemented by SBP) focused on payment system upgrade etc. and was category C. Nevertheless, SBP has developed some institutional capacity to implement E&S risk management arrangements, as well as awareness on E&S issues among SBP staff. SBP has Financial Inclusion initiatives Division which is responsible for GRM and public awareness campaigns. Additionally, SBP has a specialized set of departments within Development Finance Group (DFG) that aims to enhance financial inclusion through provision of credit to priority sectors. SME financing is dealt with by SME Finance Division, Refinance Division



as well as by Green Banking Unit. In order to ensure that E&S management system for the SME finance component of the project is operationalized, SBP will develop an organizational support structure as appropriate based on the design of this component of the project.

Given that the project component to be implemented by SBP (or another institution) is not yet designed, the ESMS that will govern its implementation will be developed based on the outcomes of the study to be conducted with support of DFID. Therefore, the provisions described above are indicative only. The timing for the RSF component is not known at this stage either. E&S system and capacity will be designed and developed at the time when these parameters become known, as commensurate with and adapted for the actual design of this project component. An important activity will be to conduct focused training and capacity building which would substantially enhance practical implementation of E&S requirements.

In the case where SBP would not become the wholesale FI for Component 3 (b) activity 1 and another FI is selected as the wholesale FI for the Risk Sharing Facility, then the review of ESMS of such wholesale FI will be carried out to ascertain ESMS's appropriateness to identify and manage the risks/impacts of the SMEs activities to be supported by this sub-component.

Pakistan Microfinance Investment Company

PMIC is expected to have good institutional capacity at the start of the project. As an institution that has taken over the microfinance activities of Pakistan Poverty Alleviation Fund (PPAF), which already has significant capacity to address environmental and social issues, PMIC will benefit from PPAF's current E&S systems and expertise.

In particular, PPAF has developed a comprehensive Environmental and Social Management Framework²⁷ document covering all of its investment activities, including microfinance. This framework underwent a number of revisions and each revision was meant to incorporate challenges faced and lessons learnt during the implementation. The procedures are well documented and to the best of our understanding are being implemented properly. There are no budget or staff constraints. This framework already supports all key elements of an Environmental and Social Management System that PMIC can build on by adopting, strengthening and internalizing its microfinance-relevant provisions, which will be adjusted to reflect and incorporate WB applicable E&S requirements under OP4.03, as stated in the ISDS. Specifically, the following key elements of an ESMS are present in PPAF ESMF (in line with para. 22 of BP4.03):

- a. **Policy approach:** Description of E&S policy and due diligence/ assessment requirements (to be adjusted in line with WB requirements for the project), including minimum E&S criteria to be met by microfinance borrowers;
- b. **Procedures for screening and risk assessment:** Review and screening approach for microfinance interventions is described in detail, including specifics for certain sectors; this includes proposed mitigation measures and the process of compliance confirmation by borrowers;
- c. **Organizational capacity and responsibilities:** PPAF staff with requisite E&S expertise and in charge of overseeing E&S risk management issues at PPAF and capacity will be transferred to PMIC and take on the responsibility for implementing the E&S due diligence processes and interacting with PFIs on the same;
- d. **Procedures for monitoring E&S performance:** Specific provisions and process for regular internal monitoring, as well for outsourcing specific monitoring activities, as necessary;
- e. **Reporting.**

To strengthen institutional arrangements at PMIC, the following is essential for the effective implementation of E&S risk management measures: (1) tailoring the above-mentioned PPAF policy and procedures (in their part that is relevant for microfinance) to fit the scope and nature of PMIC's lending activities under the project, as well as ensure WB applicable E&S requirements for the project (and subsequent adoption by PMIC as their own); (2) establishment of Environment and Social Management Unit (ESMU) within PMIC, and (3) appointing E&S Focal Persons in PFIs responsible for incorporating applicable E&S requirements in the microfinance scheme proposals, ensuring that agreed E&S mitigation measures are presented in the proposal have been consistently implemented, conducting periodic E&S monitoring, and submitting the monitoring reports to ESMU.

Training / Capacity Building Program

²⁷ <http://www.pfaf.org.pk/db/Latest%20ESMF%20Document%20for%20POs.pdf>



To ensure effective implementation of E&S risk management measures, formal training will be provided to SBP, ESMU and PFIs employees²⁸ and potentially a selected group of microfinance borrowers to develop comprehensive understanding of environmental and social issues and the associated risks. The key areas of training to the relevant staff members of SBP and PMIC include Environmental and Social Management Systems (E&S Policy and principles, screening and monitoring processes, reporting) and National Environmental Laws. A training plan with associated budget has been developed and included in the Project Appraisal Document.

Role of the World Bank

The Bank will assist PMIC and SBP (and another institution if one is engaged in the SME finance component) in fulfilling their oversight and monitoring role, and in particular: (i) assist and advise on improving and enhancing Environmental and Social Management System during project implementation, including capacity building activities; (ii) review annual consolidated E&S Performance Report submitted by SBP (or another institution) and PMIC (as required by BP4.03 paragraph 26); (iii) conduct supervision activities at the World Bank's discretion, as commensurate with ongoing needs of the project.

5. Identify the key stakeholders and describe the mechanisms for consultation and disclosure, with an emphasis on potentially affected people:

Stakeholder's consultations have been conducted to ensure the smooth implementation of E&S risk management measures by incorporating the concerns of the stakeholders and ensuring that the procedures are in line with their existing practices. Four consultation meetings were carried out with SBP and PMIC; first three meetings were planned at SBP in Karachi and one at PMIC in Islamabad. First meeting with SBP was carried out in the presence of World Bank representatives that entailed details regarding the scope of E&S requirements for the project, second consultation meeting was carried out with Additional Director, SBP. This meeting was regarding the existing financing procedures and SBP's futuristic approach regarding the proposed project. The third meeting was organized at SBP in which various banks financing SMEs and their representatives were invited to record their recommendations, grievances and concerns. Another meeting with PMIC was carried out in Islamabad to address their concerns. In this meeting the existing financial procedures, lending mechanisms and monitoring plans were discussed. The meeting was attended by microfinance institutions.

²⁸ This will primarily include Relationship Managers and relevant credit staff.



B. Disclosure Requirements (N.B. The sections below appear only if corresponding policy is triggered)

Environmental Assessment/Audit/Management Plan/Other

Date of receipt by the Bank	Date of submission to InfoShop	For category A projects, date of distributing the Executive Summary of the EA to the Executive Directors
N/A	N/A	

"In country" Disclosure

Comments

As no E&S risks and impacts are associated with Components 1, 2, and 3(b)-Activity 2, no safeguards policies are triggered and no safeguards instruments need to be prepared and disclosed.

For Line of Credit for financing microfinance enterprises (component 3(a)) and Risk Sharing Facility for financing SMEs (Component 3(b)-Activity 1), no E&S framework is required under OP/BP4.03 for projects involving Financial Intermediaries. As per OP/BP4.03, FIs that participate in the project are required to develop and operate an ESMS (which is a system owned and internalized by the FIs as part of their lending process) that is commensurate with the level of E&S risks in its portfolio and prospective business activities. The Bank reviews the FIs' ESMS and determines its adequacy based on the project's risk profile. In addition, the Bank assesses systems or procedures for training. Based on this assessment, strengthening of current systems may be recommended and should follow the principle of continuous improvement to ensure that ESMS enables FIs to meet applicable E&S requirements for the project. For FIIP, such assessment and recommended improvements are included in this ISDS, as well as the Project Appraisal Document (PAD). Once the key recommended improvements are completed, the Bank would approve the ESMS in a memorandum, following which these will be disclosed as per OP/BP4.03 provisions stated below. In line with the overall design of this project, such approval is expected to be as follows: (1) For PMIC under the microfinance lending component, this is expected to be completed before negotiations; (2) for the SME finance lending component, this will be completed once the wholesale FIs is identified during project implementation. This approach allows the client the opportunity to enhance E&S systems and capacity using the specific project budget allocated for E&S training and capacity building. This will ensure effective implementation and tangible outcomes for E&S risk management (especially given the fact that the SME lending component is not yet defined and there is no clarity on which institution will implement it).

In accordance with BP4.03, disclosure requirements for projects involving FIs are as follows:

The FI to disclose through the FI's website, if a website exists, and to permit, in writing, the Bank to disclose at the Bank's InfoShop and local PIC, the following elements of the FI's ESMS:

- (a) The FI's policy statement which describes specific objectives, metrics, and aspirations that the FI has set with regard to its environmental and social performance;
- (b) The FI's procedures for screening and assessing risks and impacts of subprojects or individual transactions; and
- (c) After Bank review, the summary of the environmental and social assessment that is required for any subproject considered high risk in accordance with the ESMS (not expected for this project)

C. Compliance Monitoring Indicators at the Corporate Level (to be filled in when the ISDS is finalized by the project decision meeting) (N.B. The sections below appear only if corresponding safeguard policy is triggered)

OP/BP 4.03 - WB Performance Standards for Private Sector Activities

Does the project require a stand-alone EA (including EMP) report?

No

If yes, then did the Regional Environment Unit or Practice Manager (PM) review and approve the EA report?

N/A



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Are the cost and the accountabilities for the EMP incorporated in the credit/loan?

N/A

The World Bank Policy on Disclosure of Information

Have relevant E&S policies documents been sent to the World Bank's Infoshop?

Yes

Have relevant documents been disclosed in-country in a public place in a form and language that are understandable and accessible to project-affected groups and local NGOs?

Yes

All E&S Policies

Have satisfactory calendar, budget and clear institutional responsibilities been prepared for the implementation of measures related to E&S policies?

Yes

Have costs related to E&S policy measures been included in the project cost?

Yes

Does the Monitoring and Evaluation system of the project include the monitoring of E&S impacts and measures related to E&S policies?

Yes

Have satisfactory implementation arrangements been agreed with the borrower and the same been adequately reflected in the project legal documents?

Yes

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APPROVAL

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