Mid-Term Assessment of EAGR Programme

Final report

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Disclaimer:

This report has been prepared in connection with the signed Fixed Price Contract dated 15th January 2021 (the "Contract"), between Karandaaz Pakistan ("Karandaaz") and Alvarez & Marsal Financial Industry Advisory Services Limited ("A&M"), to conduct a mid-term assessment of Karandaaz' Enterprise & Assets Growth Programme ("EAGR"), herein referred to as the "Project". This report has been prepared by A&M for Karandaaz, and the delivery and use of this document is as per the Contract. In preparing this report, A&M has performed analysis based on information provided up to and including 8th April 2021.

Except to the extent otherwise stated in this report, our work has been carried out on the basis that any information supplied (whether or not in writing and by management or otherwise) to A&M and on which our work is based was complete, accurate and not misleading.

A&M has not performed anything in the nature of an audit nor, except where otherwise stated, have we subjected the financial or other information contained in this report to checking or verification procedures. Because A&M's services are limited in nature and scope, A&M cannot be relied upon to discover all documents and other information or provide all analyses that may be of importance in this matter. There is no assurance that all matters of significance will be disclosed by A&M's work.

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1. Glossary of terms

A&M	Alvarez & Marsal Financial Industry Advisory Services LLP, UK
BAFL	Bank Alfalah Limited
BMGF	Bill and Melinda Gates Foundation
BoD	Board of Directors
CE	Communication Events
CIC	Corporate Investment and Credit
CGAP	Consultative Group to Assist the Poor
CGS	Credit Guarantee Scheme
EAGR	Enterprise and Assets Growth
E-PMO	Enterprise Project Management Office
DFI	Development Financial Institution
DFS	Digital Financial Services
FAW	FAW Group, a transport sector beneficiary
FCDO	Foreign, Commonwealth & Development Office
FGD	Focus Group Discussion
FI	Financial Institution
FIP	Financial Inclusion Programme
FS	Financial Services
FSD	Financial Sector Deepening (an FCDO programme)
FSDP	Financial Sector Development Programme (an FCDO programme)
GoP	Government of Pakistan
HoldCo	Holding Company
ICF	Innovation Challenge Fund
IFC	International Finance Corporation
IZP	InfraZamin Pakistan
JSBL	JS Bank Limited
KRN	Karandaaz Pakistan
KfW	Kreditanstalt für Wiederaufbau (German Development Bank)
KIIs	Key Informant Interviews
KM	Knowledge Management
KM&C	Knowledge Management & Communications
LF	Logframe: Measurement approach for EAGR objectives
Market Failures	Inability of the market to serve an inherent need
MBL	Meezan Bank Limited
MFB	Microfinance Bank
MFI	Microfinance Institution
MFP	Microfinance Partner (i.e. MFB or MFI availing financing from PMIC)
MF+	Microfinance Plus
MIB	MCB Islamic Bank
MoU	Memorandum of Understanding
ME	Medium Enterprise
MSME	Micro, Small and Medium-sized Enterprise
MTA	Mid-term Assessment

MTN	Medium Term Note
NADRA	National Database & Registration Authority
NBFC	Non-Banking Finance Company
NBFI	Non-Banking Financial Institution (same as NBFC)
NPL	Non-Performing Loan
PCGC	Pakistan Credit Guarantee Company
PEPZ	Private Enterprise Programme Zambia (an FCDO programme)
PMIC	Pakistan Microfinance Investment Company
PMN	Pakistan Microfinance Network
PMO	Project Management Office
PPAF	Pakistan Poverty Alleviation Fund
Programme	EAGR
QPR	Quarterly Progress Report
Results Framework	Frameworks through which programmes are assessed
RMA	Results Measurement Approach
RPA	Risk Participation Agreement
SBP	State Bank of Pakistan
SE	Small Enterprise
SECP	Securities and Exchange Commission of Pakistan
SEED	Sustainable Energy and Economic Development
SGB	Small Growing Business
SME	Small and Medium-sized Enterprise
SMEDA	Small and Medium Enterprise Development Authority
SoW	Scope of Work
SPV	Special Purpose Vehicle
SRQ	Steward Redqueen Model
SSF	SAFCO Support Foundation
STR	Secured Transactions Registry
TA	Technical Assistance
TFC	Term Finance Certificate
TMF	Thardeep Microfinance Foundation
ToC	Theory of Change
VfM	Value for Money
VP	Visibility Products
WEP	Women Entrepreneurship Programme
WV	Women Ventures

2. Introduction and mid-term assessment objectives

a. Executive Summary

Background: Approved in March 2014, Enterprise and Assets Growth (EAGR) is a 10-year £187 mn, two-phased programme, funded by FCDO through Karandaaz (KRN). Its ambition is to catalyse Micro, Small and Medium-sized Enterprises (MSMEs) to drive growth, employment and trade, therein also addressing the needs of women and young people, as entrepreneurs and job seekers.

As conceived, EAGR's objective is to allocate a large majority of the funding to financial institutions (FIs), who would utilise it in the form of recyclable capital, to Small and Medium-sized Enterprises (SMEs). The remaining funding was allocated for the following:

- Capacity building of financial and non-financial service providers, for improved delivery of business support services and financial solutions to SMEs;
- Improving business investment climate, through research and demonstration effect, in reduced regulatory, legal and institutional barriers to exports and investment;
- Provide challenge funds, enabling commercial and financial intermediaries to develop innovative products, services and delivery channels for greater financial inclusion of the poor, women and youth, and small business;
- Develop robust monitoring, evaluation, impact assessment, research and knowledge management capabilities.

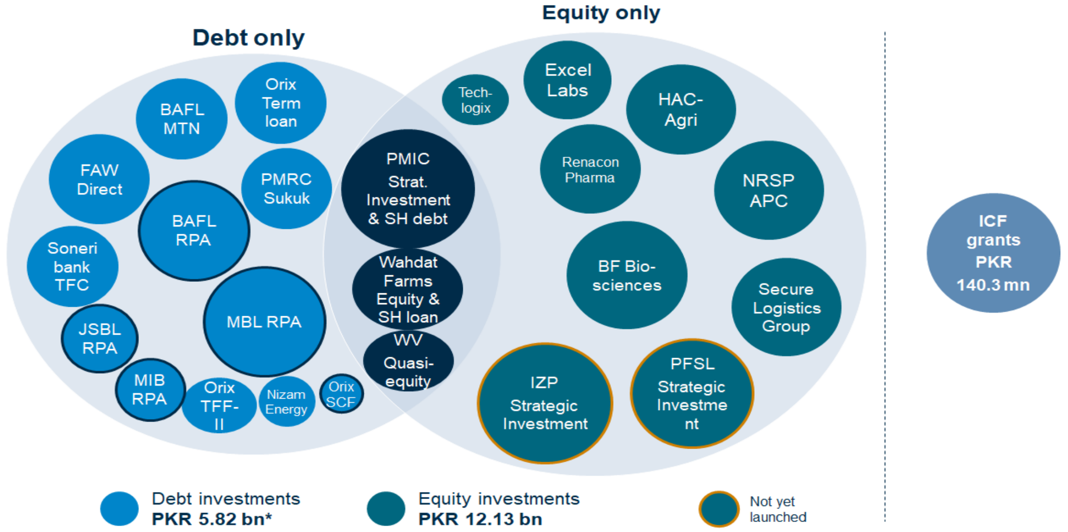
EAGR initiatives: EAGR's objectives are met through numerous initiatives, varying in size and scope, often delivered through collaborative partnerships. They all seek to sustainably address significant, clearly identified gaps in the Financial Services (FS) landscape affecting financially excluded populations, especially MSMEs. Initiatives funded by EAGR include:

- Wholesale (debt) investments
- Equity investments
- Pakistan Microfinance Investment Company (PMIC)
- InfraZamin Pakistan (IZP)
- Innovation Challenge Fund (ICF)
- Women Ventures (WV)
- International Finance Corporation (IFC) Technical Assistance

In addition, there are some initiatives which are funded by FCDO outside EAGR, but compliment EAGR objectives. Notable ones include:

- Pakistan Credit Guarantee Company (PCGC): funded by FCDO under the Financial Inclusion Programme (FIP)
- Secured Transactions Registry (STR): funded by FIP
- Pakistan Microfinance Network (PMN) digitalisation: funded by FIP
- Sustainable Energy and Economic Development (SEED) programme: funded by FCDO

Diagram 2.1: Assessment of KRN initiatives under EAGR, as of Mar '21



**includes WV quasi-equity*

Table 2.2: KRN debt investments under EAGR

No.	Institution name	Instrument type	KRN share (PKR)[1]
1	ORIX-SCF	Risk Participation Agreement	1,867,479
2	Wahdat Shareholders Loan	Shareholder's loan	50,000,000
3	Nizam Energy	Direct Lending	163,853,241
4	Orix TFF-II	Direct Lending to NBFC	200,000,000
5	MIB	Risk Participation Agreement	226,461,724
6	Soneri	TFC- Capital Investment	500,000,000
7	FAW	Direct Lending via Apex Corporate Partner	500,000,000
8	BAFL - MTN	TFC- Capital Investment	500,000,000
9	PMRC	Sukuk - Capital Investment	500,000,000
10	JSBL	Risk Participation Agreement	503,712,522
11	Orix Term Loan	Direct Lending to NBFC	525,000,000
12	MBL	Risk Participation Agreement	666,809,741
13	BAFL	Risk Participation Agreement	1,114,277,980
14	WV portfolio	Convertible debt / Quasi-equity (initially structured as debt)	367,100,000
Debt only total (including convertible debt of WV)			**5,819,082,687**

Table 2.3: KRN equity investments under EAGR

No.	Institution name	Instrument type	KRN share (PKR)
1	HAC Agri	SME Equity	410,000,000
2	Wahdat Farms	SME Equity	500,000,000
3	NRSP APC	SME Equity	600,000,000
4	Excel Labs	SME Equity	350,000,000
5	Techlogix	SME Equity	156,900,000
6	Secure Logistics Group	SME Equity	600,000,000
7	BF Biosciences	SME Equity	835,000,000
8	Renacon Pharma	SME Equity	505,000,000
9	PMIC	Strategic Equity & Shareholder Debt	5,024,243,000
10	IZP	Strategic Equity	1,650,000,000
11	PFSL	Strategic Equity	1,500,000,000
Equity only total			**12,131,143,000**

[1] KRN, 2020, *QPR Jan – Mar 2021*

Mid-Term Assessment Objectives and Approach: EAGR has reached the mid-term of the programme cycle in terms of both, time and spend. As of 31st December 2020[2], FCDO disbursed £90 mn (PKR 18.92 bn)[3] to KRN for the EAGR programme, and over £21 mn (PKR 4.50 bn) has been deployed in the quarter ending March 21 additionally[4], bringing the cumulative total to over £111 mn (PKR 23.42 bn). This document constitutes the mid-term assessment (MTA) of EAGR with respect to its alignment with its intended strategic objectives, as well as providing recommendations to both, FCDO and KRN, on significant issues while assessing accountability, impact, learning & course corrections, within the following thematic areas:

- **Programme impact:** Results Measurement Approach (RMA), first level direct impact, second level distributional impact, and Value for Money (VfM)
- **Market development:** Demonstration effect, innovations, risk appetite, addressing market failures through strategic investments, sustainability of KRN's partnerships, KRNs Knowledge Management & Communications (KM&C) division, and KRN initiatives such as Innovation Challenge Fund (ICF), and Women Ventures (WV)
- **Institutional assessment:** Governance, operating and financing structure, and sustainability

Information and data was sourced and gathered through secondary research, Key Informant Interviews (KIIs) and a Focus Group Discussion (FGD), which was then analyzed, both qualitatively and quantitatively. Sources of information included KRN's Logframe (LF), progress reports, document archives, and existing literature.

Our assessment and analysis: we have split up our assessment and analysis, based on the three thematic areas listed above along with accountability:

Accountability: Table 2.3a illustrates EAGR's progress with respect to end-of-programme targets. The assessment uses 50% as the assessment benchmark; however, information obtained through consultations related to EAGR's progress is also accounted for and documented throughout this report, to expand on some of these outputs. We have just shown progress against outputs, as outcome impact will be shared in the programme impact thematic area, and also in the body of this report. Output 2 is related to Digital Financial Services (DFS), and targets are to be populated after the first use-case of the Micro-Payment Gateway is rolled out by April 2021, hence, they have not been added to this assessment.

Table 2.3a: Assessment of EAGR's progress as at Mar '21 against end of programme targets (Mar '24)

On-Track	**'24: ≥ 50%**	**In the right direction**	**50 < '24 ≥ 40%**	**At risk**	**'24: < 40%**

[2] FCDO 2020, *Annual Report 2020*
[3] SBP, 2021, GBP to PKR ER of 210.27 [Online] Available here
[4] FCDO 2021, Quarterly Progress Report, January – March 2021

Output 1: PMIC			
Output indicators	Targets (Mar ‘24, set in ‘21)	Achieved (Mar ’21)	Prog. on Mar ‘24 targets
1.1 Outstanding loan portfolio of PMIC (PKR bn)	57.70	23.10	40.03%
1.2 Percentage of outstanding portfolio under Microfinance Plus (MF+) initiatives	15.50%	5.50%	35.48%
1.3 Leverage factor i.e. all funding raised by PMIC other than KRN divided by total KRN financing to PMIC	7.20	4.03	55.97%
Output 3: SMEs			
Output indicators	Targets (Mar ‘24, set in ‘21)	Achieved (Mar ’21)	Prog. on Mar ‘24 targets
3.1 Size of outstanding SME Financing (debt &/or equity) portfolio leveraged via KRN supported facilities (PKR bn)	51.90	30.20	58.19%
3.2 Investment Return (Annual)	8.40%	6.30%	75.00%
3.3 Size of outstanding portfolio leveraged via non-bank financial channels (PKR bn)	27.20	11.60	42.65%
3.4 Percentage of KRN credit portfolio at risk *Over 90 days	<15%	0.40%	100.00%
Output 4: SME Finance Products			
Output indicators	Targets (Mar ‘24, set in ‘21)	Achieved (Mar ’21)	Prog. on Mar ‘24 targets
4.2 Cumulative number of SME finance knowledge products for informing KRN investments	40	23	57.50%
4.3 Cumulative number of ICF rounds - contracts with partners in place	10	7	70.00%
4.4 Size of Women Entrepreneurship outstanding portfolio (debt and/or equity) (PKR mn)	600	367	61.17%
Output 5: Sustainable Special Purpose Vehicle (SPV)			
Output indicators	Targets (Mar ‘24, set in ‘21)	Achieved (Mar ’21)	Prog. on Mar ‘24 targets
5.1 Percentage of operating cost that can be supported from own source revenue	100%	83.00%	83.00%
5.4 Cumulative number of Communication Events (CE) and Visibility Products (VP)	129 CE	99 CE	76.74%
	265 VP	200 VP	75.47%

Programme impact: we have measured programme impact based on the following four methods:

- EAGRs direct impact: the first and second level impact on microfinance, SMEs, and digital finance
- Spill-over impact: the indirect on areas such as access to finance, women empowerment, financial literacy etc.
- Programme comparison: comparison of SME financing and microfinance, two major segments of EAGR
- KRN investment: total outstanding loan portfolio and incremental revenue supported by KRN financing

Diagram 2.4: EAGR first & second level impact, Mar '21

Microfinance	SMEs	Digital Finance	
824,707 Total beneficiaries	**1,973** Total beneficiaries	**7,041,512** Total utilization	**First Level Impact**
PKR 83 bn Incremental Revenue	**PKR 67.1 bn** Incremental Revenue	**33.6 mn** Branchless Banking Transactions (number)	
819,566 Jobs Supported	**52,857** Jobs Supported	**PKR 61.3 bn** Branchless Banking Transactions (value)	
557,980 Jobs Supported for Women	**425,266** Jobs Supported for Youth		**Second Level Impact**

Diagram 2.5: EAGR spill-over impact

Increased access to finance
Through enhanced geographical outreach of FIs

Women empowerment
Through increased access to finance, trainings & resultant financial literacy

Promoting business-women
Through women ventures programme and mentorship

Improved financial literacy
Through KRN's MF Plus segment and trainings

Improved technical skills through IFC
13,000 SME individuals trained

New lending products
For transport and agricultural value chain

Table 2.6: EAGR investment impact, Mar '21

Microfinance	SMEs
1-rupee ot total outstanding loan has generated 3.53 rupees in incremental revenue	1-rupee ot total outstanding SME investment has generated 3.06 rupees in incremental revenue
PKR 28,674 financing supported 1 job	PKR 414,325 financing supported 1 job

Important considerations

- KRN calculates the achievements of SMEs and microfinance with two separate methods. Therefore, an apple to apple comparison is not possible.
- Performance of both segments got negatively impacted by Covid due to loan deferments
- SMEs' contribution to the economy is much higher than that of microfinance through value addition, trade and taxation.
- The jobs supported by SMEs are of higher quality and are more sustainable than microfinance. Therefore, requires bigger investment
- SMEs generate more incremental revenue from financing than microfinance but this anomaly may be due to the difference in measuring methods and require further analysis

Table 2.7: EAGR programme comparison, Mar ’21 (exclusive of IZP & PFSL, as they are not operationalised at this stage)

Indicator	Microfinance	SME (debt + equity)
Total investment by KRN (%)	28.5%	53.5%
Total investment by KRN	PKR 5.03 bn	PKR 9.40 bn
Total outstanding portfolio	PKR 23.10 bn	PKR 21.90 bn
Incremental revenue supported by KRN financing	PKR 83.00 bn	PKR 67.10 bn
Jobs supported by KRN financing	819,344	52,857

Market development: The initiatives within EAGR are at various stages of their evolution and lifecycle, and they operate at different levels of scale. Several initiatives are designed to have wholesale or institutional level impact. For example: PMIC has performed well as the apex funding entity within microfinance, while playing an active and supportive role in boosting its institutional borrowers' capabilities and corporate culture; risk-sharing partnerships with banks and Non-Banking Financial Institution (NBFIs) have also provided impact at scale, while simultaneously generating deeper insights for KRN into lender and borrower behaviour; these institutional partnerships have also cross-fertilised KRN's innovation challenges from time-to-time, which have shown promising and potentially transformative results; WV, an initiative spun off from innovation challenges, is emerging gradually.

Sector-specific investments have also seen generally positive outcomes, albeit still at an early stage, in key areas such as logistics, agriculture and healthcare. IZP, PFSL and PCGC were also assessed, all of which are presently in the pre-launch stage of commercial operations, and all of which have the potential to be catalysts for wide-ranging changes in the financial services arena. They are designed to operate through direct, institution-level delivery of services that address key market gaps. They show promise of not only closing these gaps but also driving significant demonstration effects for the broader financial sector through multi-product, multi-tenor appetite for SME risk. Last but not least, the PMN digitalisation and the STR projects with the Securities & Exchange Commission of Pakistan (SECP): being relatively recently activated (the former in pilot phase), both show tremendous potential to deliver deep, lasting benefits to the MSME sector by elevating the quality of the infrastructure in their respective domains - microfinance and collateral registration.

Institutional assessment: KRN's governance structure follows global best practices in terms of structure and function. They have a nine-member board of which eight are independent. FCDO and BMGF act as observers. Board committees have been set up in accordance with SECP's Code of Corporate Governance. Advisory committees have been set up to augment the knowledge and skills of Board members by inviting technical experts to participate. Management committees have been delegated authority to approve smaller transactions. This is in line with best practices, as it removes the Board as a bottleneck.

Since inception, KRN has been committed to the goal of achieving sustainability. There is some way to go before KRN can be fully sustainable without donor assistance, especially given the nascent stage of most initiatives. Although they may be able to sustain themselves operationally, due consideration needs to be taken on whether they can be as successful without donor aid and donor oversight. There are a number of risks which need to be mitigated prior to FCDO exit, which include succession planning, revenue, and operational risk, among others.

Quarter ending March 2021: Toward the end of the MTA, KRN published its Quarterly Progress Report (QPR) for January – March 2021, key aspects of which are noted here. Most importantly, virtually across all metrics, KRN has maintained positive momentum built up over the prior periods, reflecting a strong overall grasp of the challenging operating environment without losing sight of the major development objectives of the organization. Thus, healthy growth was witnessed in SME financing, both directly and through partner financial institutions; significant debt and equity-based investments were made in three high potential SMEs, and KRN continued to be a leading catalyst for economic participation by under-represented individuals, groups and sectors in Pakistan.

KRN's focus on the development of Pakistan's financial infrastructure also continued at a healthy pace. Its dedicated SME financing subsidiary PFSL was granted a licence by SECP; IZP, its infrastructure guarantee subsidiary also progressed toward its commercial launch; and KRN invested in an innovative Shariah-compliant bond issue by Pakistan Mortgage Refinance Company (PMRC), an apex funding agency promoting housing finance in the country.

Another landmark was crossed in the digital financial services arena, as Pakistan's National Payment Infrastructure (branded as RAAST) was launched, which is a truly transformational event in the country's journey toward financial literacy and an inclusive digital economy.

Overall, at its mid-point, EAGR is assessed to have achieved many of its key objectives. Of those initiatives that are relatively mature operationally, the overall conclusion from the assessment is that KRN has "moved the needle" in terms of beneficial outcomes for the intended constituencies, and earlier-stage initiatives have generally been well designed and tend to incorporate market expertise and best practices.

Recommendations: A number of recommendations have emerged from the significant progress achieved in the first half of the EAGR programme. The recommendations need to be contextualised based on two key insights:

- KRN is taking a direct approach in areas where there is a dearth of willing partners. Within these areas, KRN's ambition is to create a demonstration effect, crowd in market players and development capital, and then gradually exit;
- KRN is positioning itself as a platform in specialised areas, where access to finance requires a more structured approach - e.g., green finance. They intend to utilise the same approach of incubating, crowding in capital, spinning off, and exiting. This is aligned with FCDO and other donor ambitions for their Pakistan interventions.

Given the less-than-expected performance of some initiatives, KRN has shifted from a market-centric approach (which focused on engaging partners – e.g., RPAs through partner FIs) to a more direct approach through strategic investments (e.g., PFSL, PCGC and IZP), where they can have more direct influence on the MSME financing market. **This is a significant and material change, for which KRN should consider developing a revised overall strategy for the EAGR programme, to address the major directional change.**

As part of KRNs transition from a market-centric approach to a focus on a more direct approach, the recommendations are broken down into iterative steps:

- The ToC needs to be redesigned to take into account this change in approach, along with suggestions made on programme risks and assumptions. The ToC shall set the revised programme strategy for FCDO to monitor, and KRN to implement;
- The LF needs to be tailored to effectively incorporate the revised ToC. New strategic investments need to be initially incorporated into the LF, with the assigned weightage

representative of their role in achieving EAGR objectives based on this new approach. Initiative-specific LF can be conducted thereafter;

- Demonstration effects can be defined and measured on the basis of this new approach, specifically for the new strategic initiatives which shall lead this more direct approach;
- At an institutional level, KRN should setup an Enterprise Project Management Office (E-PMO) to manage implementing this transition and the various new initiatives for KRN. Even though recommendations shall be implemented by pertinent functions, the E-PMO shall be responsible for seeing the recommendations through.

Some high priority recommendations as per MTA thematic areas are as follows:

- **Overall:** Similar to PMIC, separate output level thematic areas can be framed for strategic investments, connecting them to pertinent outcome indicators;
- **Programme impact:** (1) Follow a PKR denominated SME definition and, preferably, adopt the unified PKR denominated SME definition which regulators will release soon; (2) Regarding results measurement, continue using the SRQ model simultaneously with JIM, until the modelled estimations from the JIM model are found to be more robust; (3) Regarding results measurement, assess and incorporate the effects of Covid-19 and the economy slowdown in the LF targets, including the possibility of high NPLs;
- **Market development:** Regarding the demonstration effect, existing partner banks should be split into different categories, keeping in view the relative responsiveness to the overall objectives of EAGR; RPAs should be retained and relationships deepened with responsive partner banks, while RPAs with trailing banks should be gradually phased down;
- **Institutional assessment:** Pipeline maintenance needs to be administered for the General Body, Board and management team.

b. About this report

The following particular three sections of this report need contextualisation:

- **Section six:** This section details the initiatives which were either directly funded by EAGR, or were complimentary to EAGR. This includes initiatives such as the ICF, which comes under the Innovation division but is an initiative in its own right. Initiative overviews, performance, findings and analysis have been provided from the programme impact and market development perspective. Their governance and implementation arrangements in the broader KRN context have also been highlighted;
- **Section seven:** This section details those areas of the SoW which have not been covered in section six. This includes certain divisions such as Knowledge Management & Communications (KM&C), along with more overarching programme analysis on impact & accountability. KM&C in particular has been detailed in both, section 7g (KM&C sub-section) and section 7i (Operations sub-section, where the KM&C workstream has been analysed);
- **Section eight:** This section contextualises the recommendations as per the SoW, and provides one overarching multi-pronged recommendation, which should be the catalyst for course corrections needed by EAGR to reach its true potential by the end of the programme.

It is strongly recommended that the annexures are read in addition to the report. They provide further contextualisation of EAGR and the MTA for a first-time reader, and also provide additional findings and analysis which the reader may find insightful and helpful in understanding such a diverse programme.

The objectives for this report are to address the following key questions:

Programme impact	
ToC	• Is the ToC in the original business case still relevant to KRN or does it need to evolve? • Does the KRN LF adequately capture the ToC? • Is KRN on the path to achieving projected results? • How much will the current and evolving economic environment impact the ToC?
RMA	• Are the RMAs used by KRN adequate? • How do the RMAs used by KRN compare with each other? • How should the RMA change to capture future needs of KRN?
Impact/ Outcomes	• What is the first level impact of KRN investments on employment and growth of enterprises? • What is the second level distributional impact on poverty, gender, youth and quality of jobs? • Does the performance to date give confidence about achieving the end results?
VfM	• Is the programme delivering VfM? • How can the VfM be realistically improved?

Market development	
Demonstration Effect	• Is KRN on the pathway to create a demonstration effect in the market on sustainable business models of SME finance?
Innovation	• Is KRN innovative in its approach? • Is it focusing on the right areas of innovation? • How scalable are its innovations?
Risk Appetite	• Is KRN's risk appetite appropriate for the role it is expected to play in the market and to achieve its own institutional ambition?
Strategic Investments	• Has KRN's investment in PMIC added value to the microfinance sector? • Are strategic investments addressing market failures, providing missing pieces of institutional architecture and strengthening the financial sector architecture?
KRN partnerships	• Is KRN's partnership structure sustainable? • Is it delivering intended results? • Has KRN developed the capabilities to create the right partnerships? • Should it consider international partnerships and what value would that bring?
Knowledge Management (KM)	• How well positioned is the KM function with regard to: (a) supporting KRN investment decisions; (b) addressing information gaps and catalyzing market players; and (c) transferring and creating domain knowledge?
ICF	• Are challenge funds appropriately targeting market failures and creating a demonstration effect to promote financial inclusion?
Women Entrepreneurship programme (WEP)	• Is KRN's support to women-led businesses successfully creating a demonstration effect? • Is the design aligned with ambition and market need?

Institutional assessment	
Governance structure	• Is the KRN governance structure appropriate and aligned with its operations, existing and planned developments? • Is it structured to protect the mission and assets when FCDO exits?
Operating structure	• Does KRN have the right systems in place to become a commercially sustainable/ viable entity? • Is it on the path to strengthen them in line with growing needs and the size of the organisation?
Sustainability	• Is KRN on the path of sustainability post-FCDO exit? • What are the key considerations that should be resolved prior to FCDO exit?
Financing	• Has KRN been able to leverage its own balance sheet and those at subsidiary level to crowd in capital from commercial and private sources? • What is KRN's long term view on growth of its own balance sheet?

3. EAGR objectives and performance to date

a. EAGR objectives, status, and timelines

Approved in March 2014, EAGR is a 10-year £187 mn, two-phased programme, funded by FCDO and managed by KRN. EAGR aims to improve access to finance for MSMEs.

The core objectives of EAGR are to deliver business and economic growth, generate higher and sustainable incomes, and increase employment and trade opportunities. Broadly, EAGR aims to achieve these objectives by improving the overall investment and business climate in Pakistan, increasing capacity of financial institutions (FIs), and addressing employment challenges of women and youth, as well as poor and marginalised groups of Pakistan.

EAGR has reached the mid-term of the programme cycle in terms of both, time and spend. As of 31st December 2020, FCDO disbursed £90 mn (PKR 18.92 bn) to KRN for the EAGR programme, and over £21 mn (PKR 4.50 bn) has been deployed in the quarter ending March 21 additionally, bringing the cumulative total to over £111 mn (PKR 23.42 bn).

b. KRN key functions

KRN executes EAGR objectives through four key functions, with supporting and control functions as per the functional structure shared in the annexures. The four key divisions are:

1. **KRN Capital - Corporate Investment and Credit (CIC):** the CIC division focuses on deepening access to and providing growth capital to SMEs through debt and equity investments. In addition to generating financial returns for the company, the development aspect of the investments aim at creating additionality, and demonstrating to the market the benefits and success of SME financing. Debt and equity investments by KRN Capital are categorised as:

    - Strategic investments
    - Direct equity investments
    - Wholesale debt investments

2. **KRN Digital Financial Services (DFS):** The Bill and Melinda Gates Foundation (BMGF) is the main donor of the DFS division. As BMGF has similar objectives of financial inclusion, the partnership with FCDO led to BMGF providing funding for financial inclusion through digitalisation and technology for initiatives through the DFS function. FCDO has recently also funded two digitalisation projects led by the DFS function, which have been covered in this report as part of the EAGR programme.

3. **KRN Innovation (ICF & WV):** The innovation function runs two programmes:

    - Theme-based ICF rounds that provide risk capital and grants to generate innovative solutions through its challenge rounds, that address issues in the financial inclusion and the financial architecture space of Pakistan;
    - A WV portfolio, solely focusing on women-led businesses, providing business development services, mentorship, and growth funding;

4. **KM&C:** The KM&C function houses the two sub-streams of Knowledge Management (KM) and Communications:

    - KM is a research function for KRN, to bridge knowledge gaps in the financial inclusion space. It develops and disseminates evidence-based insights and solutions for the industry as a whole, and also performs research and landscaping for KRN initiatives;
    - The Communications sub-stream creates awareness, and runs campaigns of KRN's initiatives, creates impact videos, and works on improving the organisations brand image, via managing its social media presence.

4. Approach and methodology for MTA

MTA objectives: This MTA of KRN's EAGR programme primarily focuses on alignment of the KRN service delivery to strategic objectives of EAGR. However, the Scope of Work (SoW) is wider than the design objectives of EAGR, as the MTA is also expected to make recommendations to both, FCDO and KRN, on strategically significant issues which may not be part of the EAGR results framework. The MTA will emphasise on:

- **Accountability:** provide a holistic and evidence-based assessment of KRN performance on the results framework
- **Impact:** evidence-based assessment of the impact of results delivered, both planned and its spill-over effects
- **Learning & course correction:** measures that need to be taken in the second half of the EAGR term to improve efficiency and effectiveness

Secondary research: This has been conducted to understand and benchmark KRN's performance measurement approach with global best practices

Key Informant Interviews (KIIs): Over 60 KIIs were conducted with relevant stakeholders (as listed in the annexures). Key findings from these have been used to compliment secondary literature, wherever necessary. This has especially been the case for low performing indicators, key learnings and course corrections

Focus Group Discussion (FGD): A FGD was held on 25th February 2021 with KRN's Management Committee and FCDO members. This was an invaluable exercise which brought together key stakeholders. The ToC and LF, key MTA sections, were discussed, and findings have been incorporated throughout this report

Study limitations & revisions: Given the onset of Covid, the KIIs and FGDs were conducted remotely, which didn't allow us to develop the more nuanced and detailed understandings of programmes and stakeholders, which would naturally result through in-person consultations. However, given the tight timelines, remote consultations were an effective avenue for us to cover the universe of stakeholders. We would have ideally liked to conduct in-person consultations with SME beneficiaries in particular, however, their lack of availability, and their natural aversion to providing details about their financing remotely were barriers which needed to be accepted.

5. Benchmarking

In order for EAGR to incorporate best practices from programmes and entities which focus on MSME financing, a benchmarking exercise was conducted. The benchmarking entities are a mix of FCDO programmes globally and an FCDO-funded entity which invests in the MSME segment. Secondary research has been conducted through reviews of FCDO documentation and other online material. Insights in relation to programme impact, market development, and institutional assessment have been provided, where pertinent.

Financial Sector Deepening (FSD) Africa:

Programme overview: FSD Africa is a non-profit organisation, registered and based in Nairobi, Kenya[5], and funded solely by FCDO. Previously named the "Skills and Innovation for Micro Banking in Africa (SIMBA) programme" which began in 2012, the business case was updated in 2017 to incorporate the greater mandate of FSD Africa, which encapsulates the MSME segment. This highlights the changed approach FCDO has taken in Africa from focusing on the micro segment, to the greater MSME segment. This is a 15-year programme, which started in March 2017. The project spend to date is £81.93 mn (17.82%) against the project budget of £459.65 mn.

Relevance to EAGR: FCDO Africa has a similar objective to that of EAGR - i.e., strengthening the financial services sector through better regulation, management, and credit services extension to the MSME segment. Just like EAGR, they utilise both, grants and investment capital.

Programme performance: As of 2020, FSD Africa has reached around 30 countries, supported 27,000 full-time equivalent jobs (50% female), and reached 5.5 mn individuals (40% female) with financial services. It has also contributed to 3.2 mn MSMEs accessing financial services. It has directly mobilised £5.1 mn into their investments and grant-funded initiatives, and mobilised over £1.1 bn of green finance and other types of long-term capital.

Programme impact insights: FSD Africa constantly reviews its ToC to assess relevance and potential improvements. They have consulted Consultative Group to Assist the Poor (CGAP) and CDC to refresh their financial sector impact approach. In relation to the LF, a recommendation was provided that whilst tracking output targets, qualitative indicators should be captured at the project level, to better assess impact. Another pertinent recommendation was to disaggregate LF data by age, to better understand the impact on youth.

Private Enterprise Programme Zambia (PEPZ):

Programme overview: The programme ran from 2014-2020, closing on 30th November 2020. The budget for PEPZ was £21.10 mn, with 99.78% of the total budget spent.

Relevance to KRN: PEPZ's objective is to strengthen the competitiveness of the Zambian private sector to catalyze job creation, build SME skills and capacity, increase the accessibility of investment finance, and connect these SMEs with large companies and multinationals[6]. This is aligned with EAGR.

Programme performance: As per the 2019 annual review, PEPZ made an indirect investment in nine SMEs which resulted in 176 direct and 1,034 indirect jobs, through enabling business growth. PEPZ has worked with at least 326 SMEs in the agriculture, mining and tourism sectors, creating 3,447 direct and 9,960 indirect jobs.

Programme impact insights: One of the recommendations in FCDO's annual review was to track inclusiveness of people with disabilities, a key segment of the equity indicators in FCDO's VfM.

[5] FCDO, FSD Africa, *Annual review, October 2020*
[6] FCDO, PEPZ, *Annual review, June 2020*

Furthermore, the ToC has also evolved to document additional barriers faced by marginalised groups which were not effectively incorporated in the original business base and ToC. These changes have been tailored into the design, implementation and evaluation of these interventions. The programme terminated several grant agreements which were not serving development outcomes and showing little penchant for commercial viability. Spill-over effects of improved sanitation and reduced deforestation were also put to consideration for measurement. It was also suggested to include the amount of media coverage generated in the LF, as this can be a good practice to strengthen the market demonstration effect.

Market development insights: PEPZ runs a Business Linkages Programme, with the objective of connecting SMEs with large firms. This helps in capacity building of SMEs, along with improving the quality of information that larger firms have on them. The sectors are selected based on potential for SMEs to substitute the large firm's inhouse activities or their imports. For market development purposes, PEPZ has setup a Steering Committee, where government, mines, chambers of commerce and SMEs discuss how the use of local goods and services can be increased in mining, which is one of the focus sectors.

Financial Sector Development Programme (FSDP) Nigeria:

Programme overview: The programme started in 2006 and concluded in December 2020. The project spend was £33.15 mn, 85.65% out of the total £38.70 mn budget. ~ £30 mn was allocated to Enhancing Financial Innovation & Access (EFInA) with the rest to the Technical Assistance (TA) initiative.

Relevance to KRN: The programme objective is to increase access to financial services and job creation. Similar to Pakistan, Nigeria's banking system does not cater effectively to SMEs, but the fintech sector is growing. Nigeria and Pakistan also have similar socio-economic profiles. FSDP provides funding to EFInA, a Nigerian non-profit, established by FCDO in 2007. EFInA's objective is to promote financial inclusion and inclusive financial reforms through innovation grants to financial service providers, and the delivery of relevant research and evidence, capacity building, workshops and advocacy. This is a similar mandate to that of KRN. FSDP also supports TA provided by IMF and World Bank to regulatory institutions. The IMF TA strengthens the capacity of financial regulators to implement sound banking supervision. The World Bank TA supports the Central Bank of Nigeria on credit reporting and movable asset collateral systems, and also supports the Development Bank of Nigeria to develop, pilot and launch credit guarantees to increase commercial bank lending. This is also a similar mandate to the technical assistance under EAGR.

Programme performance: As per the January 2021 annual review, though the overall programme rating was "A", there was more of a focus on achieving outputs rather than ToC and linking outputs with the outcomes and impact. Even though financial inclusion in Nigeria increased from 47% in 2008 to 63% in 2018, target groups such as women and youth still have high exclusion rates. The programme has been impacted by external conditions, such as the 2016 recession which has slowed recovery.

Programme impact insights: An access-to-finance survey has been conducted to get a more holistic picture of key macro factors, such as economic climate, policy instability on financial inclusion, and the effects of recessions. EFInA also focused on the role of advocacy by incorporating it in the ToC and identifying the personalities who can drive the change.

Institutional assessment insights: A sustainability strategy was designed to highlight viable options for future funding and operating models, whilst not succumbing to mission drift. EFInA went through organisational restructuring in 2015, where organogram gaps were filled and new senior management was hired. The memorandum and articles were revised and new Board members were appointed.

CDC:

About CDC: CDC is a UK-based Development Financial Institution (DFI) with more than seven decades of investing experience in emerging markets, such as South Asia and Africa. CDC has the dual objective of supporting growth and jobs that lift people out of poverty, and to make a financial return, which is then invested in more businesses. CDC therefore recycles its capital to help create jobs and economic stability, leading to poverty reduction[7].

Investment approach: CDC invests from its own balance sheet, which allows a more flexible and long-term approach. It has a range of structured financial products, and invests in a range of different entities, including Financial Institutions (FIs) and investment funds. CDC uses its own internal metrics to measure the required financial return on investments. However, this has to be balanced with development returns, which are measured through the Steward Redqueen Model (SRQ), which is detailed later in this report.

CDC Pakistan: As per consultations, CDC has invested in Pakistan through Catalyst Microfinance (CMI), which is managed by Catalyst Microfinance Investment Management Company (CMIMC). CMIMC invests to establish and grow greenfield microfinance operations across Africa and Asia. CDC has also invested in Advans Pakistan through Advans, S.A., which is managed by Horus Development Finance. Advans Pakistan is a Microfinance Institution (MFI) providing financial products to MSMEs in Pakistan.

Potential role for KRN in CDC Pakistan: Based on consultations and corroborated by secondary research, KRN investments could be of interest to CDC, post FCDO-exit. There are a number of factors which play into this:

- **Alignment of FCDO under CDC & KRN:** FCDO is CDC's only sponsor, and one of KRN's two sponsors. Their ambition, strategy and best practices have been embedded into both entities, creating a natural alignment of culture and objectives
- **Alignment of impact measurement approach:** both entities currently use the SRQ model, and therefore historically had an alignment on the objectives of MSME financing, revenue growth, job creation, with a focus on gender, youth and job quality
- **Regional emphasis:** India, by far, has CDC's largest country portfolio. Given CDC's focus on South Asia and Africa, due to the poverty density, Pakistan fits in well as a target market
- **Alignment of segments and sectors:** CDC and KRN have both invested in the microfinance sector in Pakistan. As per consultations, CDC's sectoral emphasis is also aligned with KRN's, under EAGR
- **Focus on FIs:** CDC Plus, CDC's TA facility funded by FCDO, is looking to launch a TA facility for FIs. This will be through: assisting FIs design, pilot and scale new products; expand products to new markets; and help FIs enhance their processes and systems. Given EAGR's focus as per the current ToC on a FI-centric approach, and the continual role FIs play in developing an enabling environment for MSME financing, CDC will look favourably upon the level of engagement KRN has had with FIs under EAGR

[7] CDC Group, 2020, TA Facility [Online] TA Facility

- **Continuation of FCDO investment:** given EAGR is a FCDO facility, which operates through grants and TA, and is used to create a demonstration effect for commercial viability of MSME financing, it seems like a natural progression to transition EAGR investments to CDC. EAGR investments, developed through FCDO donor funding, can now get FCDO private sector funding. This will create continuity for FCDO's investment, whilst pushing EAGR investments into a more mature private-sector investor lens.

Key considerations for KRN:

- Consider disaggregating LF data by age, to better understand the impact on youth
- Consider tracking in the LF the inclusiveness of people with disabilities, a key segment of the equity indicators in FCDO's VfM
- Consider including the amount of media coverage generated in the LF, as this can be a good practice to strengthen the market demonstration effect
- Consider designing a sustainability strategy to highlight viable options for future funding and operating models, whilst not succumbing to mission drift
- Conduct a landscaping exercise to see whether other global FCDO programmes have consequently been invested in by CDC or other such DFIs, and what were the programme and organisational maturity requirements for that transition to be successful
- Begin engaging with CDC Pakistan in order to better understand their investment requirements, and how they are aligned with EAGR objectives. Consider focusing on those activities within the EAGR mandate, which create a direct trajectory towards CDC investment

6. EAGR Initiatives – analysis

a. Wholesale credit investments

Overview of wholesale credit investments

KRN defines wholesale investments as those debt investments where SME debt financing is provided to partner FIs for on-lending, as well as direct lending by KRN to corporate entities through an apex partner. The EAGR wholesale investment portfolio breakdown is as per graph 6.1

Graph 6.1: KRN & EAGR partner FIs breakup of total wholesale investment portfolio of PKR 12.17 bn, 31st Mar 2021

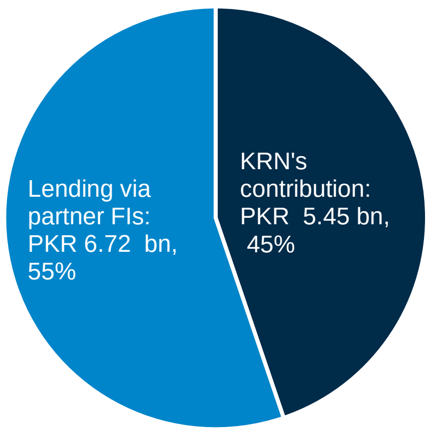


Table 6.2:KRN achievements on outcome indicators pertinent to wholesale investments, as at 31st Mar '21, against LF targets, as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
1. Cumulative number of SME beneficiaries accessing KRN supported financial services	1,973	1,683	117%
2. Cumulative incremental contribution to revenue/output of SMEs (PKR)	67.1 bn	63.1 bn	106%
3. Cumulative total number of jobs supported by SMEs	52,857	48,184	100%
4.1 Cumulative total number of jobs supported for women	557,980	582,717	96%
4.2 Cumulative total number of jobs supported for youth	425,266	449,984	95%
5. Cumulative number of partners that institutionalise SME finance innovations and/or non-partners that copy or adapt partner innovations	2 out of 6 partner banks institutionalised innovation; 1 non-partner FI adopted innovation	1/3 of existing partners institutionalise innovations; 1 non-partner FI adopt innovation	100% on partners and non-partner FIs

Performance measurement of wholesale credit investments

As per table 6.2, in relation to performance against outcome indicators for March 2021, KRN has performed very strongly, exceeding targets for most outcomes. KRN has exceeded its targets on partner FIs, and has met targets in terms of non-partner FIs. As a caveat, targets and achievements on jobs supported for women and youth are not currently bifurcated for wholesale and equity investments, due to the limitations in the result measuring model; therefore, the contribution of SMEs investments cannot be validated through these figures.

As per the table 6.3, in relation to performance against output indicators for March 2021, KRN has performed very strongly on their annual return-on-investment, credit portfolio-at-risk and SME financing (leveraged via non-bank channels) targets. They have met their annual target for NBFC leveraged portfolio size.

Table 6.3: KRN achievements on output indicators pertinent to wholesale investments, as at 31st Mar '21, against set LF targets, as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
3.1 Size of outstanding SME Financing (debt and/or equity) portfolio leveraged via KRN supported facilities (PKR)	30.2 bn	27.3 bn	110.62%
3.2 Investment Return (annual)	6.3%	5.7%	110.53%
3.3 Size of outstanding portfolio leveraged via non-bank financial channels (PKR) * For example, strategic investments for SMEs, lease financing, direct to corporate, cluster financing, etc.)	11.6 bn	11.6 bn	100.00%
3.4 Percentage of KRN credit portfolio at risk *Over 90 days	0.4%	<15%	100.00%

Findings and analysis for wholesale credit investments

<u>Programme impact</u>

Partner FIs (Banks & NBFIs): While some partner FIs made a genuine effort to improve access to finance for SMEs, the intermediary market model (which focused on achieving EAGR objectives through partner FIs rather than through more direct interventions) did not achieve its desired results, outcomes and impact. KRN was able to leverage participation of FIs in RPAs, but had limited control over lending preferences of partner FIs. Majority of partner FIs' SME portfolios consist of higher-end medium-sized enterprises, most of them already availing multiple lines of credit from other FIs. However, KRN made a significant effort in bringing FIs on-board for EAGR. Although the end objective (i.e., to increase the percentage of SME financing by partner FIs) was not achieved, with the share of private credit to SMEs remaining between 6-7%[8], there are many positives. **Based on the stakeholder consultations and LF results, debt financing through the intermediary market achieved the following: (1) Provided added stimulus to FIs for SME financing; (2) A focused effort to change the perception of banks towards the SME market; (3) Added to the revenues of SME end-beneficiaries; (4) Supported job creation.**

[8] SBP, 2020, *SBP's annual report*

Direct to Corporate (D2C): This investment type has made positive strides in increasing access to finance and developed a lending model for: (1) A largely informal and unbanked transport sector; (2) Agricultural value chain with a focus on eliminating the role of middlemen.

ToC: The assumption made in the ToC that "financial intermediaries will invest in SMEs" did not hold, especially for small enterprises. Banks find small enterprises high-risk and costly. The ToC implicitly assumed that banks would be more interested in better understanding the risks in SME lending and, hence, gravitate towards them for higher yields. However, FIs continue to prefer and focus their main lending activity to the government, which is less risky and leaves little incentive for them to invest in SMEs. For this reason, response of the banks towards SME lending will, at best, remain conservative.

Market development

Demonstration Effect: Lending under Risk Participation Agreements (RPAs) is planned to gradually end after the launch of Parwaaz Financial Services Limited (PFSL). The exact plan and timeline for winding down RPA-based co-financing has not yet been decided.

Considering the gradual planned ramp-up of PFSL, it would seem prudent to maintain RPA portfolios for a couple of years, irrespective of performance being less than targeted. Banks offer distribution and balance sheet capacity far greater than that of PSFL, particularly in its early years of launch.

Catalysing market development through innovation: KRN's CIC function is working with Meezan Bank Limited (MBL) and Pak Suzuki to introduce new financing options to its vendor ecosystem, including discounting of long-term receivables.

Risk appetite: Given that **programme portfolio impairments of partner banks under the risk sharing programme are much lower than their respective non-programme SME portfolios' impairments, there is broad agreement that not enough risk is being taken on SMEs to promote financial inclusion.**

During consultations, various banks' SME clients have self-reported as being multi-banked and were not previously "excluded"; several are at the high end of the "medium" customer category; and several have reflected a high degree of sophistication and awareness of financial services / service providers, which could explain the high credit quality and low NPLs in the portfolios. It is not known how prevalent these customer types are across RPA portfolios. Moreover, while the business environment and credit cycles have been positive from the time RPAs were launched, it is not clear if this is sustainable, especially with the expected downturn from the pandemic. As relief packages, deferrals and moratoriums come to an end, global projections and opinions indicate likelihood of a high percentage of NPLs in the SME segment. While this concern was not evident in any consultations, KRN should be in proactive discussions with partner banks for portfolio reviews and prepare for loan restructuring, which could mean extending RPA periods, as well as expect potential NPLs that could lead to loan losses.

Risk management: FAW, a direct client, had earlier undertaken a very risky foreign currency / local currency mismatch-based supplier / buyer credit scheme, which caused significant financial losses (~PKR 1.5 bn) to the company. This happened at the time of its onboarding as a KRN partner. A more robust credit due diligence process may have identified and partially mitigated the adverse effect of the currency devaluation on KRN's partner company.

Governance and implementation arrangements

Governance: RPAs are largely governed by the origination, credit underwriting and risk management procedures implemented by the partner banks. KRN helps the banks build and launch the product but otherwise remains passive on the process followed by partner banks. In accordance with RPA agreements, partners share quarterly portfolio position reports with KRN, and reporting progress against deployment targets. Banks also share half-yearly financial and impact reports, providing copies of semi-annual financial statements and details of consolidated performance indicators and returns for all disbursed SME financings[9].

KRN's investment committee and the Board receive regular updates on wholesale portfolio performance, which includes total outstanding loans, portfolio sectoral allocation of portfolio information and maturity profiles under each RPA. Any deferment of principal payments or expected delays in interest payments are also reported to the KRN Board.

KRN also engages a third-party consultant on a semi-annual basis to independently assess the EAGR programme's impact and outcomes achieved under each RPA, as well as the progress made by partners against finance deployment targets. For direct debt lending, KRN outsources the full legal, financial, and business due diligence to a third party, prior to offering the funding.

Credit due diligence is conducted in-house. Reporting and monitoring terms are agreed but typically consist of monthly funds deployment reporting and quarterly impact reporting from the beneficiary.

Investment committee approvals are required for debt facilities up to PKR 500 mn, with Board approval required for debt facilities greater than PKR 500 mn. In line with KRN's reporting procedures, the Board receives regular reports on the wholesale lending portfolio performance.

Operating structure: There is little or no reliance on KRN's operations with respect to wholesale lending. RPAs are managed by partner banks, including origination, credit due diligence and portfolio management.

Sustainability: With the roll-out of strategic initiatives, particularly PFSL, the future for RPAs is to be determined.

[9] KRN, 2020, *RPA Financing Agreements for Bank Al Falah, JS Bank*

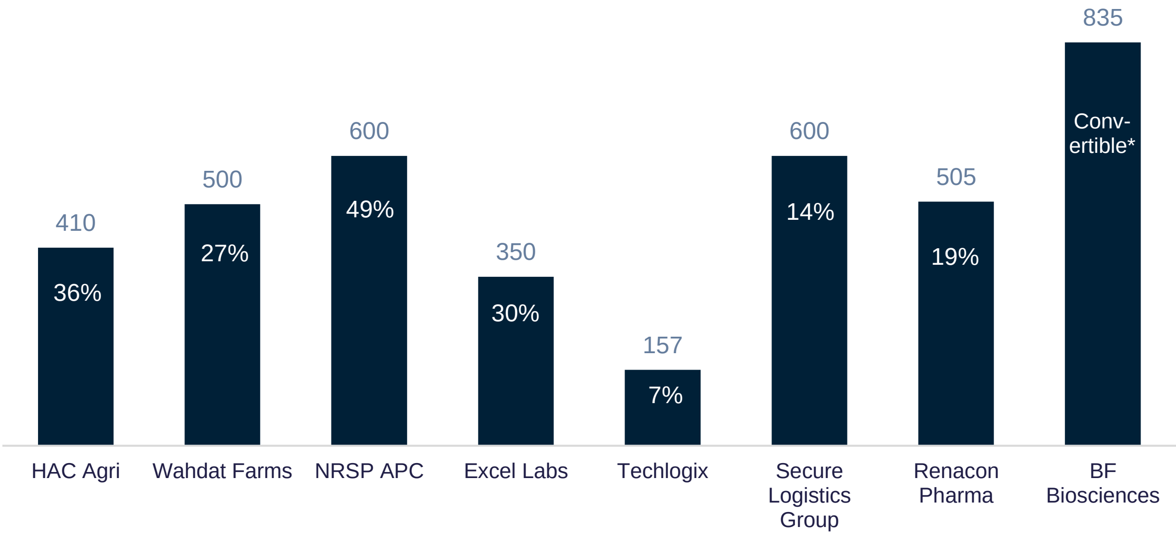
b. Equity investments

Overview of equity investments

KRN has invested in eight SMEs in the form of private equity investment, as shown in graph 6.4, for a total SME portfolio investment of PKR ~3.96 bn. KRN has specified the investment criteria as per table 6.5.

The minimum target return is ~10% per annum. KRN's Board Investment Committee (BIC) sets the portfolio limits for investments. The BIC for direct investments monitors limits on exposure in a single company, sectoral exposure, and limits on greenfield growth capital investments. A reallocation of up to 10% of assets in the said investment bucket (direct, wholesale etc.) is allowed to be taken by the Chief Investment Officer (CIO) upon approval from the CEO.

Graph 6.4: KRN's direct SME equity investment amounts and shareholding, as per Mar '21 QPR



Out of the eight equity investments, HAC-Agri and NRSP-APC were greenfield investments and the investment in Secure Logistics Group (SLG) was for a new project. All the direct equity investments have made progress showing potential for growth, but the investment in HAC-Agri, due to significant potential operational risks is being exited from. As a condition for equity investments, KRN holds a minimum of one Board seat in the investee SME and negotiates for a veto vote on business planning and decision-making. In addition to providing equity capital, KRN also provides TA and capacity building services to its equity investees for their institutional maturity, working to improve governance and reporting, creating business plans and financial forecasts.

Table 6.5: Investment criteria for direct SME equity investment

Investment criteria for direct SME equity investment	
Company size	• Revenue up to $15 mn; Assets up to $15 mn; Employees up to 300
Ticket size	• Up to GBP 5 mn; larger with co-investors
Ownership stake	• Not more than 50%; significant minority, opportunistic control
Investment type	• Growth capital; Common equity, preferred equity, convertible debt, structured credit
Geography	• Pakistan as principal place of assets and jobs creation

Sector focus	• Includes education, healthcare, agri, logistics, construction, retail & wholesale
Target holding period	• Up to 7 years
Economic impact	• Employment support (especially women and youth) and revenue growth

Findings and analysis for equity investments

Programme impact:

KRN has made eight equity investments in high potential SMEs that needed growth capital. KRN's equity investments provided necessary capital for SMEs, which resulted in higher revenues, profits and job creation as per LF results, corroborated by consultations. KRN's equity investment not only provided investees capital to grow, but also helped SMEs develop a corporate governance structure. **Key highlights of the SME equity investees include: (1) Addition of a Covid testing facility and developing partnerships with airlines; (2) Increasing capacity of a logistics group from a long-haul trucking company, to end-to-end logistics solutions; (3) NRSP APC to export and register as the first accredited warehouse as well as issue the first Electronic Warehouse Receipt (EWR) in Pakistan.**

Impact of SME investments: Since the LF provides aggregate results achieved from all SME investments, it is difficult to assign quantitative outputs specifically for the equity investments. However, the following information was received from interviewing beneficiary SMEs: (1) Improvement in the governance structures; (2) Improved infrastructural capabilities; (3) Higher profitability; (4) Creation of jobs. It is still early to suggest whether these investments have crowded in more investments, as most of KRN's equity investments are at a nascent stage and need more time to mature. However, there are signs of added financial interests of other entities in KRN's equity investments. For example: a Saudi group has become a co-investor in Secure Logistics Group (SLG); HAC Agri was able to raise additional financing from banks because of KRN's investments.

Spill-over effect of investment in HAC Agri and NRSP APC: HAC Agri and NRSP APC are developing a state of the art warehouse in Pakistan, with KRN financing. These warehouses will significantly increase annual capacity by almost 7,000 metric tonnes and will result in better prices for farmer produce, as farmers can maintain their produce for longer periods and sell at better prices. **Its spillover benefits will include, but will not be limited to: greater control and planning of harvest and transport; better shipping rates; and, pricing flexibility**.

Covid impact on KRN equity investments and its result measurement: While Covid had an initial negative financial impact on SMEs, its impact to date has been less than expected, as SMEs appear to have recovered post-lockdown. The effects of Covid will not subside entirely, for two reasons: (1) Lack of quick availability of vaccines; and, (2) Low uptake of Covid vaccines being expected due to socio-cultural perceptions (only 3.75% of the people aged 60+ have registered to be vaccinated so far)[10]. **While the impact of Covid on businesses is less than expected so far, its related and expected risks should be thoroughly reviewed to rationalise and align EAGR's LF targets for next year**.

Market development

Demonstration effect: KRN's equity investments have done well by enabling growth and creating jobs. Key learnings have emerged during the process, both in terms of underlying legal / regulatory processes of equity investment, and about the nature of collaboration and the balancing of various competing

[10] Al-Jazeera, 2021, *Pakistan Kicks off COVID Vaccination Drive for Senior Citizens*, March

priorities of investor and investee. **Ultimately, the potential for concrete and replicable interventions has been realised.**

Governance and implementation arrangements

Governance: All equity investments require KRN Board approval, which is a good governance practice. KRN has at least one seat on the Board of each equity investee company, which enables KRN to directly influence strategy and performance of the company, and also ensures that KRN's interests are protected. KRN's nominee Board members are proactive members of the portfolio company Boards, taking action and stepping in when required. For example, an additional Board nominee from KRN was appointed to the Board of Excel Labs when it was identified that they were not meeting their performance targets, providing additional oversight and steer. Portfolio companies are required to report on financial performance on a monthly, quarterly, and annual basis. The CIC team does not audit the accounts; and the Finance team consolidates the information of KRN's investee companies. The reports from portfolio companies includes[11]: (1) Management accounts of financial performance against budget and prior year; (2) Management accounts of year-to-date (YTD) financial performance against the budget and prior year; and (3) Forecast performance for the full year against budget and prior year.

Operating structure: Post-investment, KRN works with their equity portfolio companies to implement best corporate practices, which includes helping develop organisation structures, policies, procedures and implement a fit-for-purpose governance framework. Assisting companies reach a higher level of maturity and sophistication will enable them to source capital from other investors, and an eventual IPO. In exceptional circumstances, KRN's management will step in to serve as interim managers for equity companies, which is a common practice in private equity transactions. As an example, KRN's Director of Operations stepped in to fill in a vacant senior HR position at an investee company (Excel Labs) for a short period. As part of this role, she helped improve the maturity of the company's HR function with new and improved processes and procedures.

Sustainability: KRN aims to expand its equity portfolio of companies and might consider spinning it off into an independent investment platform, after which the sustainability of equity investments will largely depend on that platform's governance, due diligence, risk management procedures and KRN's oversight.

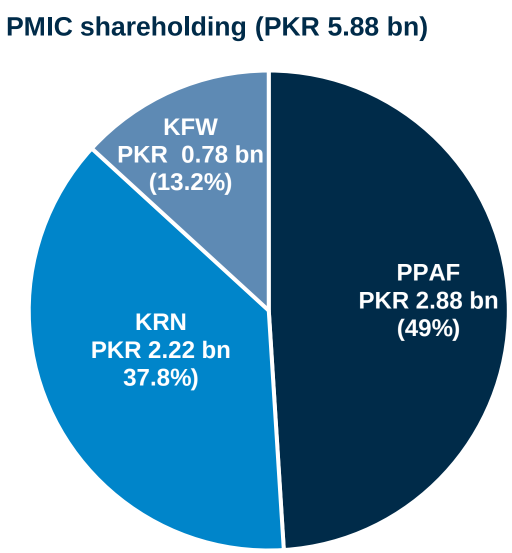
[11] KRN, 2020 *KRN Investment Policy, page 48*

c. Pakistan Microfinance Investment Company (PMIC)

Overview of PMIC

Being a national apex-level financier for Microfinance Providers (MFPs), PMIC was established as an important pillar of the National Financial Inclusion Strategy formulated by the Government of Pakistan in May 2015. It was incorporated under the Companies Ordinance 1984 as a non-banking finance company (NBFC), set up jointly by the Pakistan Poverty Alleviation Fund (PPAF), KRN, and KfW, with total share capital of PKR 5.88 bn. PMIC provides financial services to microfinance providers (MFPs) which, as of March 2021, includes three microfinance banks (MFBs) and 21 non-banking microfinance institutions (MFIs)[12] through wholesale funding, grants, subordinated debt, and technical assistance (TA).

Graph 6.6: Distribution of PMIC shareholding



Performance measurement of PMIC

PMIC witnessed low growth in FY 2019, due to a stagnant economy. This led to its outcome and output targets for FY 2021 being revised downwards in FY 2020. As per table 6.7, in relation to performance against **outcome** indicators, through its partner MFPs, PMIC provided loans to 824,707 end-beneficiaries, which resulted in cumulative incremental contribution of PKR 83 bn to their enterprise revenues. Even though there have been target adjustments and adverse economic conditions, PMIC is very close to most of its year-end targets, which shows they are on track. As per table 6.8, in relation to performance against **output** indicators, KRN is close to its targets after target revisions as well. Percentage of outstanding portfolio under MF+ Initiatives is the only indicator which needs a boost.

[12] Stakeholder consultation

Table 6.7: Description of KRN's achievements on outcome indicators as at Mar '21, against set LF targets, as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
Cumulative number of beneficiaries accessing microfinance from PMIC	824,707	825,831	99.86%
Cumulative incremental contribution to revenue/output of enterprises due to PMIC (PKR bn)	83 bn	83.9	98.93%
Cumulative total number of jobs supported by PMIC * 95% contribution to the total jobs supported under EAGR	819,566	871,800	94.01%
Cumulative total number of jobs supported for women * Almost 95% contribution from PMIC	557,980	582,717	95.75%
Cumulative total number of jobs supported for youth * Almost 95% contribution from PMIC	425,266	449,984	94.51%

Table 6.8: Description of KRN's achievements on output indicators as at Mar '21, against set LF targets, as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
1.1 Outstanding loan portfolio of PMIC	23.1	24.4	94.67%
1.2 Percentage of outstanding portfolio under MF+ Initiatives	5.5%	7.6%	72.37%
1.3 Leverage factor i.e. all funding raised by PMIC other than KRN divided by total KRN financing to PMIC	4.03	4.3	92.72%

Findings and analysis for PMIC

Programme impact

Spill-over impact, beyond first & second level impact: The LF captures PMIC's performance on financial indicators and job creation, but not on potential social spill-over impact. **Literature suggests, as corroborated through consultations, that PMIC has contributed towards spill-over benefits which include poverty reduction, women empowerment, environmental sustainability, and financial literacy**[13] [14] [15]. Wherever quantitative data is difficult to obtain, qualitative case studies are used as a best practice to align on-ground output and impact, with programme / institutional objectives[16] [17]. PMIC's partner MFPs do not have a unified strategy to measure beneficiary-level social spill-over impact and are following varying methodologies (e.g., some partner MFPs are using poverty scorecards while others are using case studies). A unified strategy will provide KRN robust qualitative input on the social spill-over effects of its investment in PMIC. It will also support KRN's communications function to exhibit its social impact, whilst developing a repository of qualitative evidence to be shared with donors and independent third parties. Since social spill-over effects are not part of the LF, KRN can use case studies to collect and record the effects of social spill-overs. KRN's Monitoring, Evaluation and Learning

[13] UMEA School of Business, Economics and Statistics, 2020, *Accessing Microfinance through Financial Literacy*
[14] Researchgate, 2018, *Microfinance and poverty nexus: leverage spillover*
[15] International Journal of Customer Relationship Marketing and Management, 2018, *The Role of Microfinance to Empower Women: The Case of Developing Countries*
[16] World Bank, *Case Study Evaluations*
[17] Ahmad et al., 2012, *A Case Study on Measuring Process Quality: Lessons Learnt*

(MEL) function should consider requesting case studies from each partner MFP via PMIC, with a reasonable and manageable frequency of the case studies to be mutually agreed with the partner MFPs. The case studies will provide higher value if aligned with KRN focus areas: financial inclusion, use of digital infrastructure, women empowerment, and enhanced capacity through PMIC funded trainings.

Underperforming MF+: The MF+ continues to miss targets, which is critical for the success of KRN's microfinance portfolio as it creates impact (jobs) by definition. PMIC should tailor a proper policy to grow its MF+ portfolio and distinguish itself from MFBs with which it is competing.

Second level distributional impact on gender: As per consultations and literature review, a significant portion of women borrowers are not the actual end-beneficiaries of loans. This finding is endorsed by a World Bank study, which highlights that 50-70% of microfinance loans to women are passed on to a male relative[18]. Consumer protection and exploitative practices is an existential issue in the microfinance and development finance sectors, This should, therefore, be incorporated in the programme risks in the ToC and efforts should be made by PMIC to deal with it to avoid business reputational risk.

Market development

KRN's strategic investment in PMIC is aimed at adding value to the microfinance sector by developing a market for sustainable microfinancing. This encompasses facilitative services, robust sector architecture, and measured risks to complement its wholesale funding role.

PMIC has achieved a high degree of market penetration, especially within MFIs, and 59% of PMIC's lending since inception is currently outstanding on its books.

Various MFPs have, with PMIC's financial support and technical assistance, evolved and matured sufficiently to the point of being able to crowd in alternative suppliers of financing, including commercial banks offering lower borrowing rates than those of PMIC[19].

PMIC itself has a low Non-Performing Loan (NPL) ratio, while its downstream partners also maintain very low NPLs (well below the NPL ratios of the banking system as a whole). PMIC has a very high level of engagement with its MFPs, supported by proactive strategies of consolidation and liquidity management. Multiple MFPs have mentioned that after initial Covid-related difficulties, the sector as a whole has recovered well. PMIC and its partner MFPs have taken a cautious approach to manage Covid-related risks and, where necessary, entities have availed regulatory relief schemes. Credit quality appears to have stabilised.

PMIC has conducted a number of innovative pilots in the past and has a pipeline of innovations under various stages of incubation (e.g., livestock digital repository, livestock microinsurance, livestock marketplace app, Shariah-compliant products including housing finance, risk capital fund, and a social impact fund in collaboration with the National Investment Trust). With the expected launch of the Munsalik platform, there is potential for sector-wide integration and development of digital ecosystems which could form the basis of innovative and potentially transformative offerings at scale.

[18] World Bank, 2013, *Are Pakistani Women Entrepreneurs being Served by the Microfinance Sector?*
[19] Please refer to Annexures for PMIC on-lending portfolio rate summary

Governance and implementation arrangements

Governance: PMIC has a seven-member Board, of which KRN has one decision-making seat and one observer seat, with FCDO also having an observer seat. KRN also chairs PMIC's Board Audit Committee and, therefore, has direct control on PMIC's auditing activities, but also has some steer in the overall direction and performance of PMIC. KRN's position within PMIC's Board allows it to ensure that the objectives of EAGR are taken into consideration when company decisions are being made, with FCDO presence holding both KRN and PMIC accountable for EAGR. There is a high level of transparency with respect to decision-making and reporting, with a mixture of qualitative and quantitative reporting. PMIC's management acknowledges that the KRN Board appointee and observer, as well as the FCDO observer, have played a pivotal role in driving the overall direction of the company. Upon review of the June, September and December 2020 monthly reports sent to KRN, the reports appear clear, consistent and include relevant information to enable KRN to monitor and oversee performance and activities of PMIC. As per the December 2020 monthly report, an ERP system is being rolled out at PMIC in phases. Phase one, which consists of the Finance module, has gone live and the remaining modules will be rolled out in subsequent phases, expected to be completed by June 2021.

As KRN is also in the process of implementing an ERP solution, there are lessons that can be learnt and gained from PMIC's experience with their ERP roll-out. The possibility of integrating KRN's ERP solution with PMIC's ERP system should also be explored to automate and streamline the existing reporting process for better reporting efficiency.

Operating structure: PMIC's management acknowledges that KRN has provided PMIC with support and helped them strengthen overall operations of the company through capacity building. KRN's support has primarily been through Board-level contributions, setting up PMIC's policies, procedures and helping develop PMIC's overall strategic direction, including the strategy and business plan.

Sustainability: PMIC's management is in ongoing discussions to further diversify its funding through other sources, including foreign and multilateral entities, for funded as well as non-funded lines, through risk sharing mechanisms. PMIC therefore appears to be sustainable as a stand-alone entity.

PMIC is making regular payments to KRN for the subordinated shareholder loan, which accounts for up to 45% of KRN's own source revenue (OSR). The high reliance on PMIC for funds poses a concentration risk to KRN, as PMIC's performance is heavily dependent on the market environment and performance of micro-enterprises. A small number of missed instalments from PMIC will have a proportionately large negative impact on KRN's OSR and, hence, sustainability.

KRN intends to eventually adopt a HoldCo structure and will rely on revenue from its subsidiaries, such as PFSL, IZP and other initiatives. However, KRN should stress-test their OSR model to identify and mitigate risks from relying on 45% of their OSR from a single source of revenue.

d. Parwaaz Financial Services Limited (PFSL)

Overview of PFSL

PFSL was incorporated on 23rd December, 2020[20], under the Companies Ordinance 1984, Companies Act 2017, NBFC rules 2003, and NBFC regulations 2008[21]. The business application was under process at the time of submitting this report, with commercial launch expected in Q2 2021. PFSL aims to cater to the SME segment, for which they have used the SME definition for NBFCs as per 2019 SECP regulations. According to this definition, SMEs can have up to 250 employees and PKR 800 mn in annual sales[22]. This has been further bifurcated with the "S" segment of SMEs having up to PKR 25 mn in annual sales, and the "M" segment having PKR 25 - 80 mn. It is understood that a unified SME definition is likely to be announced soon by the regulators, which may need revisions by PFSL for alignment. PFSL has chosen their target market within the SME segment to cover entities not targeted by commercial banks under their SME financing portfolio, and are too large to be serviced by microfinance providers. This therefore attempts to address a market failure, which is an objective of EAGR.

As part of a market sizing exercise conducted by the Small and Medium Enterprise Development Authority (SMEDA) in 2005, taking into consideration the percentage of SMEs from total entities along with a 5-10% annual graduation of microenterprises into the SME definition, the current number of SMEs are estimated at 1.2 mn[23]. Since formal SME penetration is around 15% (184,000 borrowers), this creates an untapped SME market of ~ 1 mn entities. Assuming an average loan size of PKR 2.5 mn, the total financing gap is ~ PKR 2.5 tn, part of which PFSL intends to service. In relation to value chains, as per the business planning exercise, PFSL intends to cater to multiple value chains under the SME segment. However, PFSL shall begin by focusing on the agriculture processing value chain[24].

Findings and analysis for PFSL

<u>Programme impact</u>

Accountability & result measurement: KRN's partner banks that provide finance to the SME segment under the RPA programme have a preference for mid-sized enterprises (MEs) over small-sized enterprises (SEs). One of KRN's key objectives for PFSL is to address the unmet financing needs of SEs, as reflected in the business plan.

The transition to PFSL, along with the risk of delays in its launch and operational difficulties initially, is expected to result in an initial decline in KRN's total exposure, as SME lending focus moves away from the RPA programme. Resultantly, the growth in cumulative number of SME beneficiaries will slow down, especially during the first year, resulting in difficulties in meeting existing SME outreach targets. **These targets may have to be lowered in anticipation of a potential decrease in SME outreach during the first two years of PFSL's operations.**

<u>Market development</u>

PFSL will attempt to fill a market gap for a segment consisting of at least one million viable SMEs and a financing opportunity of PKR 2 tn. Innovative approaches to customer onboarding, risk assessment and service delivery are planned, as administrative costs will need to be managed**. As an example of an innovative approach, PFSL envisions an alliance with Orix Leasing, to utilise the latter's**

[20] Stakeholder Consultation
[21] KRN, 2020, *PFSL Business Plan*
[22] KRN, 2020, *PFSL Business Plan*
[23] KRN, 2020, *PFSL Business Plan*
[24] Stakeholder Consultation

distribution network and technology platform. It will also offer business support services in order to drive the evolution of its SME customer base.

After an initial phase of building its balance sheet with loans to several reputable and creditworthy SMEs, the company intends to diversify into FMCG and agricultural supply chains. There are also plans to launch and scale up unsecured SME lending products, invoice financing and warehouse receipts.

As they break new ground, PFSL management will need to ensure that they manage risks, operational efficiency and pricing with extreme care; as the company fulfills its SME inclusion mission, it may encounter challenges from customers that are unwilling or unable to pay for value-added services. Furthermore, due emphasis will have to be placed on the quality and mindset of staff in order to distinguish PFSL from legacy lenders.

PFSL's success as a standalone entity is intended to be a signal to other financial services providers about the viability of its model, approach and risk appetite. Achieving meaningful scale within a reasonable timeframe will therefore also be a critical challenge for the institution and presents an opportunity for acquiring SME portfolios from other lenders through innovative structures.

Governance and implementation arrangements

Governance: PFSL will be a wholly-owned subsidiary of KRN. Selection and nomination of Board members is currently underway. KRN's CEO will nominate senior executive members from KRN to sit on some of PFSL's Board Committees.

PFSL, as reported in its business plan, will have the following Board committees, in addition to the Board: (1) Risk Management Committee; (2) Audit Committee; (3) HR Committee; and, (4) Credit Committee. There will be a minimum 6-member Board (including the CEO) [25]. PFSL should rely on majority independent members to serve as Board members, given the limited experience within KRN to run such an entity. Currently, two nominee directors from KRN have been appointed to the PFSL Board. FCDO is currently an Observer on the Board; however, consideration should also be given to FCDO having full Board representation.

KRN will have significant involvement at the Board level for overall management and oversight of PFSL's activities and to drive PFSL's strategy forward, ensuring it is in line with KRN's strategy and objectives. It is important, however, that such involvement does not distract the KRN nominees from their current and full-time roles in KRN, nor does it dilute the autonomy of PFSL's management.

As full Board selection and onboarding is likely to take some time, a Transitionary Board Committee will be set up at PFSL in the interim, to oversee and manage the roll-out of PFSL, for which a ToR is being developed. The current composition of the Transitionary Board Committee consists of the Chief Financial Officer (CFO), Chief Investment Officer (CIO) and Chief Risk Officer (CRO).

Operating structure: Hiring of the CEO and other management is in process, which includes the Business Head, CRO, Head of IT, and Head of HR. PFSL will partner with Fintechs and strong local banks to use their technology and provide structure through their branches, enabling PFSL to maintain a lean structure, similar to KRN. A request-for-proposal has been circulated to select a suitable fintech to provide back-end processing and user interface capabilities. Service level agreements will need to be put in place and data protection and confidentiality will need to be considered when sharing technology with banks. Strong IT and data governance is also needed.

Sustainability: Sustainability of PFSL is dependent on a number of factors: (1) Strength of the governance framework; (2) Diversity and consistency in funding and revenue sources; (3) Regulatory

[25] KRN, *NBFC Business Plan – SME Finance, page 14*

environment; (4) Portfolio performance; (5) Getting and retaining quality human capital; (6) Originating and book-building critical mass of business; and, (7) Credit quality with robust NPL management.

The strength of governance is yet to be seen. However, Board selection has been aimed at individuals with the right skills. PFSL will have a range of products (working capital finance, fixed asset finance and other financial services[26]), diversifying their revenue sources with a mix of fee and interest income, enhancing sustainability.

A diversified and consistent funding base will be critical to prevent reliance on funding from KRN. PFSL should aim to develop capital market instruments to pool funds from a diverse yet reliable set of investors, and not rely solely on traditional credit lines.

The success of PSFL will also depend on its ability to raise more funding from the market and/or development capital providers in the form of debt and equity. It will have to leverage its equity to offer prices competitive enough to create its niche vis-a-vis banks.

The State Bank of Pakistan (SBP) has been announcing initiatives to promote SME lending in Pakistan, including implementing credit guarantee programmes with local banks. SBP is also planning to set up an innovation office, with the objective of increasing collaboration of fintech’s, smaller banks and NBFIs. Although these will take time to fully implement, they will help to promote a more enabling environment for PFSL.

[26] Business Plan NBFC, Presentation to IC, Page 9

e. Pakistan Credit Guarantee Company (PCGC)

Overview of PCGC

PCGC was established in 2019 by SBP and is expected to assume the role of the existing Credit Guarantee Scheme (CGS) run by the SBP under the FIP programme, which is also funded by FCDO. It is registered with the SECP as a DFI, under the supervision of the SBP. It is envisioned as Pakistan's leading risk-sharing institution, working to grow the SME sector and promote access to finance, especially for collateral-deficient SME borrowers[27]. While PCGC is not yet operational, it intends on providing the following products & services: (1) Provide risk-sharing facilities to participating financial institutions (PFIs); (2) Design conventional & Islamic products catering to the needs of PFIs, SMEs & agriculture borrowers; (3) Provide advisory services to PFIs and stakeholders; (4) Create awareness and capacity building of stakeholders; and, (5) Implement SBP & government programs related to SME & agriculture sectors.

Subsequent to its incorporation in 2019, PCGC has announced its Board and CEO, and three Board meetings were held that year. In respect of its intended activities, it has published a "Draft Guide for Customers"[28] wherein feedback has been solicited from stakeholders for a broader, more enabling guarantee scheme (guarantee coverage ranging from 50-90%, instead of the previous 40-60% under CGS). However, there are no substantive updates on the PCGC website subsequent to 2019, and they are yet to launch.

Meanwhile, there have been further developments in respect to the formalisation of KRN's vision for PCGC. On December 25th, 2020, it was announced that the government's Economic Coordination Committee (ECC) approved 51% ownership of PCGC to KRN, reportedly under strong objection of the Ministry of Finance (MoF). As per an agreement signed in January 2015 by the Economic Affairs Division (EAD), SBP and MoF, the FIP programme's unutilised grant funds at close of the FIP programme were to be returned to FCDO or transferred to its "enterprise" (i.e. equity for PCGC); however, MoF's objection is on the basis of them desribing this agreement as "ab-initio invalid," since the initial grant funding is seen as, by definition, a one-way (i.e. non-refundable) transaction[29]. Further reporting on December 28th 2020 reflected a difference of opinion between SBP and MoF, with the former stating that (as per Rules of Business) "issues relating to foreign aid / assistance fall within the ambit of the Economic Affairs Division" and, thus, clarification was requested from the latter on whether grant money is able to be invested as equity in PCGC[30]. It is worth noting the FIP was expected to expire end of March 2021.

On 30th December 2020, the MoF was reported to have withdrawn its request to the Cabinet to ratify the conversion of unutilised FIP grant funding to equity for PCGC, whose 51% ownership was also to be transferred to KRN. As PCGC is a state-owned enterprise, its ownership cannot be transferred without a competitive bidding process in accordance with Privatisation Ordinance of 2000[31].

[27] pcgc.com.pk, 2021, CEO's Message. [Online] Available at: PCGC website
[28] PCGC, 2020, PCGC Guide [Online], PCGC Guide
[29] Express Tribune, 2021, ECC approve sale [Online], Available at: ECC approves 51% stake
[30] The News, 2021, PCGC stake [Online], Available at: KRN becomes major stakeholder
[31] Express Tribune, 2021, Gov retracts decision [Online] Available at Express Tribune

As of report publishing date, however, the MoF is assessing how PCGC will be structured, with the likely options being privatisation or the creation of a fresh venture[32]. It is also understood that FCDO is negotiating with GoP on the future of the Credit Guarantee Scheme (CGS), and how it will be managed through PCGC. KRN's shareholding in PCGC has been held up as a result.

Findings and analysis for PCGC

Market development

PCGC has been established as a legal entity. However, its future is uncertain as legal and procedural questions have been raised.

The existing credit guarantee scheme (CGS), domiciled within the SBP, is planned to be folded into the balance sheet of PCGC. It is utilised actively by just 6 banks (Habib Bank, MCB Bank, Bank of Khyber, BAFL, Allied Bank and MBL)[33] and, subsequent to revised regulations administered in 2017, average utilisation of aggregate limits is 60-70% (as per SBP). Overall NPL ratio is 2.1%.

Based on a due diligence report by Deloitte, the most active user of the scheme as at 31st March 2019 has been Habib Bank, originating 48.1% of transactions, and accounting for 39.1% of the aggregate value of loans under the scheme. Of the six eligible borrower categories, aggregate outstanding utilisation under the scheme was dominated by small enterprises (67.3%), with agriculture input (15.3%) and microfinance (10.6%) also in the mix. Of the three remaining borrower categories, women refinance loans accounted for 0.6% of outstanding utilisation, although this category was added to the scheme relatively recently[34].

Modifications in the eligibility criteria / structuring of the scheme at SBP over the years provided greater alignment with the end objectives of the scheme - i.e., incentivising / facilitating lending to deserving SMEs (including startups, women-led businesses and rural enterprises) and others (special persons) by increasing coverage in inverse proportion to the level of collateral provided.

Governance and implementation arrangements

Governance: The deal is still awaiting necessary regulatory and legislative approval; governance, therefore, has yet to be set up. Despite majority shareholding, KRN will not have majority participation on PCGC's Board. However, it intends having at least one Board seat, as well as nominees on the Credit, Risk and Audit Committees.

Operating structure: The operational set up of PCGC is yet to be determined.

Sustainability: As mentioned earlier, the future of PCGC is uncertain due to legal / procedural questions which have been raised, and there is a risk that PCGC is unable to fulfil its envisioned role as an independent provider of guarantees in a post-CGS environment. The market gap will need to be addressed, and KRN will have to consider alternative approaches to deliver guarantees for SME financing. Aside from a negotiated continuation of the scheme domiciled within SBP, potential exists for entering into alliances with one or more issuing bank with appropriately high ratings and service delivery capacity, to manage the operational and administrative side of such a programme. Any alternative to PCGC will need to consider that the market is not likely to accept a guarantee programme which is not backed by the sovereign or an established and recognised institution (e.g., a multilateral development institution).

[32] Stakeholder consultation
[33] Deloitte Yousuf Adil, Chartered Accountants, 2020. *Final Report - Due Diligence of Loan Portfolio and Drafting of Company Policies for Credit Guarantee Company*. p.10
[34] Deloitte Yousuf Adil, Chartered Accountants, 2020. *Final Report - Due Diligence of Loan Portfolio and Drafting of Company Policies for Credit Guarantee Company*. p.10, p. 77.

f. InfraZamin Pakistan (IZP)

Overview of IZP

GuarantCo, which is part of the Private Infrastructure Development Group (PIDG), is an entity established to mobilise local currency credit solutions for infrastructure projects and to support the development of capital markets in lower income countries across Africa and Asia[35]. GuarantCo has been in Pakistan since 2014 and felt the Pakistan market has scope for growth, hence the interest in setting up IZP[36]. Since GuarantCo does not conduct equity investments, it invested through its sister concern, InfraCo.

IZP was established as an investment finance company under the SECP Companies Act 2017, in accordance with NBFC rules 2003 and NBFC regulations 2008[37]. It is a credit enhancement facility, with its primary purpose to issue credit guarantees for infrastructure related debt instruments, to guarantee lenders timely repayment through its triple-A rating from Pakistan Credit Rating Agency (PACRA)[38].

Led by double bottom-line objectives, IZP has the development goal of being the catalyst to address an unmet demand within the financial infrastructure, which is aligned with EAGR's objectives for its strategic investments[39]. The initial goal of this is intended to be the crowding in of liquidity in the Pakistan financial markets. However, the longer-term goal is to make IZP a sustainable entity, accessing future private capital for its growth. As per IZP's business plan, it will have capital of PKR 4.13 bn, with GuarantCo providing a contingent capital of up to USD 25 mn, in PKR equivalent (approx. PKR 3.84 bn at prevailing rate).

Findings and analysis for IZP

Programme impact

ToC: There is a need to make a stronger connection between infrastructure financing and EAGR's over-arching objectives in the original business case and ToC. It is suggested that the ToC is revised to clearly define how IZP's focus on infrastructure projects aligns with EAGR's overall objectives. It is important to incorporate the rationale, inputs, outputs, outcomes and impact expected from IZP's investment in the EAGR results chain. Later studies can also confirm if IZP beneficiaries enabled finance for downstream SMEs including those in their value chains.

Market development

IZP has strong equity participants (InfraCo and KRN) with proven domain knowledge, implementation expertise and complementary strengths; and the additional benefit of USD 25 mn contingent capital from GuarantCo, one of its sponsors' group concerns.

IZP intends to address a specific market failure - i.e., chronic underspending on infrastructure (only 2.1% of GDP) coupled with a historic exclusion of SMEs from infrastructure finance. IZP intends to address this failure but does not plan on scaling-up enough in the short term to move macro indicators. As a first mover, however, it sees ample potential in the market to meet its commercial targets, facilitated by regulations which permit up to ten times leverage (after two years of operations). Targeted sectors

[35] guarantco.com, 2021, who we are [online], accessible at GuarantCo website
[36] Stakeholder consultation
[37] KRN, 2021, *IZP business - MOA*
[38] KRN, 2021, *IZP ToRs - CEO*
[39] KRN, 2021, *IZP ToRs - CEO*

include small-scale power, logistics, secondary roads, hospitals, education sector, telecoms, housing, water, wastewater and desalination.

IZP has very recently obtained regulatory approvals and license, and its plans include an IPO by year 7 of operations. Deal opportunities will be mobilised by the management team (currently under recruitment), with corporate players also being targeted. As a secondary option, GuarantCo might refer opportunities for deal flow.

IZP has been granted a USD 1 mn Technical Assistance Facility (TAF), which is to be repaid to GuarantCo (provider of contingent capital) after its first year of operations, contributing to negative earnings at the end of that period.

Governance and implementation arrangements

Governance: KRN is a 40% shareholder, and Indus Guarantees is a 60% shareholder. The Board will include representatives from KRN, InfraCo Asia (through Indus Guarantees), and GuarantCo. The Board and the CEO have been onboarded.

Operating structure: IZP has created a busines plan but is yet to start operating. A number of governance policies and operating manuals are close to finalisation, but are still subject to feedback from the new CEO and other key executives to be hired. The operational structure is yet to be finalised.

Sustainability: Sustainability will be dependent on a deal pipeline, which is still to be created. The ability of IZP to crowd-in underutilised pockets of liquidity in Pakistan's financial market is yet to be seen. IZP's business model rests on contingent capital by GuarantCo - a line at the back-end, given by the UK Government. It is to be seen whether that facility can ever be replaced by the market.

g. Innovation Challenge Fund (ICF)

Overview of ICF

The ICF was launched in 2016, and provides risk capital and grants to generate innovative solutions through its challenge rounds that address issues in the financial inclusion and the financial architecture space of Pakistan. It has specific focus towards access to financial services for SMEs, women and youth. The ICF rounds are theme-based, with themes catering to gaps in the financial architecture. Rounds for international remittances, Women Entrepreneurship Challenge (WEC) Financial Inclusion of Women (FIWC), and credit scoring models have been conducted, and small distributor financing challenge rounds are underway. Any entity through EOIs, be it banks or other private entities, can apply for these challenge rounds, with the criteria and theme detailed in RFPs. The aim of challenge rounds is to show a demonstration effect by presenting solutions to "change behavior towards underserved segments and catalyze a spillover effect by attracting investment from the private sector"[40]. A total of PKR ~507 mn has been disbursed through seven challenge rounds to date, which includes both, ICF and WEC (now WV). After the second ICF round in 2017, which was also the first WEC, KRN decided to run an ICF round and a WEC round each in the same year. In 2018 and 2019 both rounds were run in parallel. The fourth ICF round in 2019 (FIWC) was run in collaboration with the DFS function, to create synergies. ICF challenge round five for small distributor financing is under process, finalising applications, and disbursements are expected to start at the time of writing this report (April 2021). The success of the three WEC rounds as part of ICF rounds has led KRN to create a separate sub-stream of Women Ventures (WV), which is also under the KRN Innovation initiative, and focuses solely on women-lead businesses. WV portfolio disbursements have been PKR 367.1 mn to 21 firms, with PKR 140.3 mn distributed to ICF beneficiaries.

Table 6.9: ICF and WEC rounds, amount committed, and amount disbursed, including costs for capacity building, as per QPR Mar '21[41]
*Amounts also include grants of PKR 6.7mn extended to 11 small business in Balochistan
**Amounts include interest free working capital financing of PKR14.5mn extended to 2 businesses as part of COVID-19 Support by KRN to its portfolio SMEs

Year	Challenge Fund Rounds		Number of Grantees/ Investees	Amount Committed (PKR mn)	Amount Disbursed (PKR mn)
2016	Round 1	ICF 1: International Remittances	2	97.9	97.9
2017	Round 2	WEC 2017 (also considered ICF 2)	15	64.7*	58.0*
2018	Round 3	ICF 3: Credit scoring of SMEs	2	118.9	27.4
2018	Round 4	WEC 2018	8	213.4**	208.5**
2019	Round 5	WEC 2019	6	83.4	78.4
2019	Round 6	ICF 4: FIWC	1	15	15
2020	Round 8	WEC 2020	3	44.4	22.2
Total			**37**	**637.7**	**507.4**
2020	Round 7	ICF 5: Small distributor financing	Under process: terms negotiated, contract to be signed after Board approval in April 2021		

[40] KRN, 2020, Strategy 2020 – 2024
[41] KRN, 2021, QPR Mar '21

Performance measurement of ICF

As per table 6.10, the ICF function is on track in terms of number of ICF rounds completed. We are cognizant of this being an initiative in its early years and, given that its impact is hard to measure, KRN has used a quantity based measure, to get the momentum rolling. A FGD with KRN's management committee and FCDO senior representation recommended review of this indicator.

Table 6.10: Description of KRN achievements on output indicators pertinent to ICF, as at Mar '21, against set LF targets, as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
4.3 Cumulative number of ICF rounds - contracts with partners in place	7	7	100%

Findings, and analysis

Programme impact

ICF outcomes: Since the initiative is fairly new, there is lack of information and data on the outcomes generated through the challenge fund rounds. While there is merit to the fact that innovations take time to materialise, short term targets can still be set and achieved, with regular review and revision.

Results measurement: The existing LF and the annual reports only provide information on the progress of challenge rounds. The existing results measurement mechanism does not provide information on the application and usability of the solutions. Each ICF round can have its own short-term and long-term targets. In the short run, targets can qualitatively focus on implementation and processes whereas, for the long run, quantitative targets can be set looking at sustainability of ventures post KRN. The achievements against separate ICF targets can either be cumulatively provided in the EAGR LF or recorded separately, and reported in annual reports.

WV: WV evolved from ICF. The transformation of a small-scale challenge round into a full-fledged programme under EAGR should be considered as a success for one of the challenge rounds.

Market development

ICF is completely geared towards market development and is beginning to show results through the actions of various market participants. As an example, the challenge round pertaining to international remittances appears to have generated two demonstration effects: one of the participants, JS Bank, has decided to move ahead with further enhancement of the product deployment. Meanwhile, the other ICF remittance participant, Telenor Microfinance Bank, had decided not to continue beyond the pilot phase, but its competitor Mobilink Microfinance Bank has moved ahead to enable inbound international remittances to be credited to its m-wallet accounts.

BAFL is one of the banks developing an innovative, data-driven SME risk scorecard mechanism, having won an ICF round. The bank's SME business seeks to move beyond inadequate legacy risk-scoring models (based on commercial / corporate banking criteria), and BAFL is also in discussion with some of the telcos to merge data to get better attribute-tracking of SME clients.

In order to better align with their market development agenda, ICFs need to be viewed with a longer-term horizon – up to three years; this gives an innovative idea the time to take root and transition from an experiment into a commercial offering. When targeting a specific market need, it can require two or more rounds before a concrete result is seen.

Research by KRN's KM team informs and enriches ICFs from time-to-time. Each successive ICF round is an opportunity for a more refined methodology and approach, and lessons learned from prior rounds can make a significant contribution to the success of subsequent rounds.

Governance and implementation arrangements

Governance: ICF grants are approved through a panel of judges, also known as an Advisory Committee. The panel of judges are selected based on the type of challenge being run. Subject to their willingness to participate, a FCDO representative can also be on the panel. The head of ICF also has the opportunity to invite an external expert if specific expertise is required. Members of the panel must declare any potential conflicts of interest before reviewing applications. They are also required to sign a conflict-of-interest form. Any judges which cannot attest the absence of any conflicts are removed.

ICF provides reporting templates and framework to grant recipients for them to submit their performance evaluation reports, which are reported at least quarterly or if a milestone has been achieved. Periodic reports to the Board are provided on the performance of ICF challenge rounds.

Operating structure: The innovation function and ICF rounds are governed by the ICF operating manual, which appears to be clear, comprehensive and version controlled, in line with best practices. The head of ICF is also the head of MEL. The two functions of ICF & MEL under one head creates a conflict of interest. The MEL responsibility should be separated from any initiaive it is meant to monitor and evaluate.

Sustainability: ICF challenge rounds have been running for the last 5 years, and KRN has built enough knowledge internally, as well as awareness in the market. If KRN decides to continue with the ICF initiative after FCDO exits, it can do so. However, because of the long period of time it takes to get results, KRN may decide to abandon ICF and channel grant funds towards other interventions, or to refine the criteria for qualifying participants which may be more impactful. Examples include lending to fintechs and think tanks, or finding opportunities to bring partnerships with fintechs and big banks to effect change in the traditional banking approach.

h. Women Ventures (WV)

Overview of WV

The objective of WV is to demonstrate that women-led businesses are a good credit proposition. WV does this through supporting the growth of women-led businesses by providing business development services, mentorship, and growth funding. KRN aims to graduate these beneficiaries to the next stage where they become viable for commercial capital, creating a demonstration effect in the market. The WV portfolio allows applications across the year. More than 86 women-led businesses have been provided TA (in the form of capacity building, business planning, and trainings) and 21 have been provided growth capital. Negotiations with ten additional women-led SMEs were underway during Q1 2021[42], out of which decisions for five have been made, and an additional seven are in the pipeline. WV has a sector-agnostic approach, and target beneficiaries are high-potential and high-impact women-led businesses. KRN has a defined investment criteria, and selected candidates can receive growth capital of up to PKR 35 mn in the form of quasi-equity / convertible debt, payable in bullet form at the end of three years. In addition, KRN provides assessment to identify the critical areas where business advisory is required, advisory for business development (legal, technical, financial management), and assistance in creating a business plan.

Performance of WV

Since launch, WV has provided capital to 21 beneficiaries for a total outstanding amount of PKR 367 mn as per the March 2021 QPR. Although more awareness around the existence and benefits of the programme can be created, the requirement of no collateral has fared well with the women-lead businesses. Beneficiaries have achieved growth with KRN's investment, but the ability to repay the principal amount in a bullet payment after three years will be a key factor to assess the success of the WV portfolio. However, performance of the WV programme to date has allowed KRN to successfully deliver a proof-of-concept. Scaling the WV portfolio while retaining it within KRN might be an issue, as it will require significant resources to monitor the portfolio. Spinning it off into an independent investment platform or into PFSL can be options that can help KRN achieve scale and also maintain quality.

As per table 6.11, the programme is on track in terms of increasing the portfolio size of women entrepreneurship. It is a positive step that KRN has not utilised the number-of-rounds approach (as it has for ICF) and has, in fact, utilised the size of outstanding portfolio. Though this is a move in the right direction, regular reviews need to be conducted annually to decide whether a more pertinent indicator should be adopted.

Table 6.11: Description of KRN achievements on output indicators pertinent to WV, as at Mar '21, against set LF targets as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
4.4 Size of Women Entrepreneurship outstanding portfolio (debt and/or equity)	PKR 367 million	PKR 375 million	97.87%

[42] KRN, 2020, *QPR Oct – Dec 2020*

Findings and analysis

Programme impact

WVs is a relatively new initiative and its actual impact with respect to growth, revenues and jobs will be determined during the second half of EAGR. Latest studies underscore the importance of women-led businesses for inclusive growth and job creation. Unfortunately, women-led businesses remain largely unbanked in Pakistan, limiting their potential to grow. WV addresses this market failure, which exists primarily due to lack of:

- Awareness amongst women entrepreneurs on existing financing programmes;
- Availability of financing products specifically for women-led organisations;
- Marketing campaigns by banks to promote existing women-specific programmes - e.g., a programme of the SBP for women entrepreneurs is not actively marketed by banks;
- Business support services provided by government, development agencies and donor agencies;
- Understanding on how to deal with women and gender specific policies and practices.

KRN has put a considerable amount of time and effort to on-board FIs for financing women-led businesses. A debt facility draft was prepared and presented to banks. Unfortunately, the banks expressed little faith and deemed this venture to be of high-risk, demanding liquidity along with 100% risk sharing and management costs for the venture.

A due diligence study conducted by Deloitte sheds light on the gaps in the existing schemes for women-led businesses. A refinance scheme for women launched by SBP provides credit guarantees to partner FIs to lend collateral free (up to 60%) loans to WVs. However, the study highlights that most banks preferred collateral over guarantees from the programme. Keeping this in view, WV provides a researchable model for directly reaching out to WVs instead of depending on FIs[43]. The efficiency and impact of the WV programme can become a model for the market to follow. More importantly, it can place Karandaaz in a position to become a PMO for donors interested in similar programmes.

Market development

WV has evolved since its inception, supported and facilitated by partnerships with incubators and a VC firm. Supportive government policies are being passed, promoting women entrepreneurship. KRN has played a role in making this happen through engagement and policy recommendations.

PKR 371 mn have been disbursed to 21 firms as at March 2021; by the end of 2021, another 12 firms will be added to take the total investment to around PKR 500 mn. Since inception, there have been over 490 applicants; 86 received business development assistance; and a total of 21 firms qualified to receive funding.

WV’s current performance target is to add four beneficiaries every year, perhaps falling short of enabling a demonstration effect. The KM team is conducting a study on women entrepreneurship in Pakistan, with emphasis on SMEs. Suitable metrics may subsequently be established to determine when the “needle has moved” and whether the current outreach effort to identify WV candidates is extensive enough to achieve the desired impact at scale.

Ultimately, the WV team expects its beneficiaries would graduate to raising finance directly through FIs, for which the team has been training its borrowers through engagement and awareness building.

[43] KRN, 2020, *Due Diligence of Loan Portfolio and Drafting of Company Policies for Credit Guarantee Company, March*

Governance and implementation arrangements

Governance: A management investment committee has been formed to approve investments in WV, which has participation from the Head of ICF / WV, the CRO and the CEO. The Head of ICF / WV seeks support from CIC team and CIO when shortlisting ventures.

KRN's shareholding in WV portfolio companies cannot exceed 20%, as per KRN's policy.

Post-disbursement monitoring and evaluation is done by a third-party service provider, which submits reports to the Head of WV on a semi-annul basis.

In line with KRN's reporting disciplines, regular updates are provided to the Board on the performance of the WV initiative.

Operating structure: As mentioned earlier, there is a conflict of interest whereby WV as a business initiative is measured and evaluated by the same team that manages it – i.e., MEL, which should be separated from ICF and WV.

WV is governed by the ICF manual, as the operational procedures are the same. A WV process memo exists; however, a formalised operating manual and an investment policy is recommended for the WV programme.

Sustainability: The portfolio is growing rapidly, creating a challenge for KRN to balance business disciplines with the need to support women-led businesses. The leniency with respect to repayments will not be feasible going forward and, therefore, internal mechanisms and procedures need to be put in place to ensure that the initiative can be commercially successful as well.

The current repayment model requires portfolio companies to repay the principal finance amount as a bullet payment three years after investment. KRN should reconsider this model for repayments, as most of the WV beneficiaries are not sufficiently disciplined in finance and may incur problems at the time of repayment. It is therefore suggested that the repayment plans should include regular principal repayments, to create good repayment habits and to avoid the possible risk of default at the end of the financing term is avoided.

Sustainability of WV beneficiaries and, therefore, of the WV programme is also dependent on upskilling them on financial discipline and governance. KRN should therefore consider mentoring programmes to accompany the financing provided to WVs.

KRN should reconsider their overall strategy for the WV initiative, with a view to expand and scale it up.

WV's future position in KRN is yet to be determined. There is an opportunity for it to be moved to PFSL or a separate investment platform. Either way, KRN continues to drive this initiative forward, expanding on the current mandate.

i. IFC Technical Assistance (TA)

Overview of IFC TA

The second component of EAGR is a £15 mn trust fund with the IFC. The IFC Trust Fund aims to address systemic issues that hinder the ability of SMEs to raise and access finance and the market's ability to provide it. The IFC Trust Fund is structured around four themes:

Access to finance: For improving access to Finance, IFC has provided technical support to SECP to develop a Secured Transactions Registry (STR) and has worked to improve the regulatory and legislative space around the implementation of STR to make it sustainable. IFC will be delivering trainings and courses for stakeholder groups to enhance STR's usability. Technical assistance on digitalisation of the agri-lending portfolio of Khushhali Bank is provided, and a rural banking strategy is being created. IFC has provided supply-chain financing to MBL, helping enhance the SME portfolio and developing three new SME products, two of which have been launched, and the third is delayed due to Covid.

MSMEs' and farmers' capacity building: IFC is providing sugar supply-chain financing to 15,000 farmers, aiming for higher yield and quality. They initiated an approved clean seed programme, trainings on standards and on-site compliance. IFC aims to continue enhancing capacities of farmers, providing skill certifications, and launching a digital application for farm advisory.

Investment climate: To improve the investment climate, IFC is helping improve Pakistan's ease-of-doing-business rankings[44] (further explained in the market development segment of this section). Some initiatives include: (1) Technical guidance for a 100-day reform implementation; (2) An online dashboard upgraded to track reforms, communicate & collect private sector feedback on reforms' quality; (3) Business trainings to individuals & MSMEs; (4) Women entrepreneurship trainings.

Off-grid lighting solutions: The lighting programme was aimed at providing safe and affordable lighting in Pakistan, focused on high-quality off-grid solar products. IFC provided firm-level activities to support private sector firms entering the solar market, market intelligence, quality assurance and business development support, and market level activities to improve consumers knowledge about solar products and advocate to the Government to adopt quality standards[45].

Performance of IFC TA

Being a five-year programme which ended in 2019, March 2020 achievements and targets for performance measurement were considered. As per table 6.14, IFC has slightly underperformed; however, gender contribution has been as per target, which is a positive sign for the programme.

Table 6.14: Description of IFC's achievements on output indicators pertinent to IFC TA, as at Mar '20, against LF targets, as per Dec '20 QPR

Achievements against output indicators (March '20)	Targets for Mar '20 (set in '17)	Targets for Mar '20 (set in '18)	Targets for Mar '20 (set in '19)	Achieved as at Mar '20
Number of SME individuals trained in business development	6,600 (20% women)	18,600 (20% women)	13,000 (20% women)	12,277 (20% women)

[44] World Bank, 2019, Doing Business [Online] Available here
[45] FCDO 2020, *EAGR TF Report Sept 2020*

Findings and analysis

Programme impact

Under IFC TA, EAGR has a whole gamut of interventions. These interventions primarily target strengthening access to MSME finance through structural improvements, knowledge enhancement and TA to banks. IFC's Business Edge initiative was a five-year programme implemented under EAGR. Under this initiative, which concluded in 2019, capacity building workshops were conducted for SME professionals to upskill their business and management capabilities. The training workshops were conducted by IFC Business Edge accredited training providers. It was a five-year programme that ended in 2019.

Are more capacity building programmes required: While EAGR focuses more on supply-side issues of MSME financing, various stakeholders raised lack of readiness among MSMEs as a cause of difficulty in raising finance. KRN should engage third-party training providers to continue this much-needed capacity building initiative linked with KRN's investments. A connection can also be made with the future beneficiaries of PFSL, who will most likely require such services.

Market development

IFC and KRN have aligned and complementary objectives in tackling systemic issues that impact MSMEs, and the IFC TA initiatives have made significant progress in moving the needle in the areas of access-to-finance, MSME / farmers' capacity building, off-grid lighting solutions, and improvement of the investment climate.

IFC provided training on capacity building to BAFL and MBL to develop their supply-chain finance capabilities; these two banks have been major success stories for SME lending through risk participation[46]. IFC is also engaged in the digitalisation of the agri-lending portfolio at Khushhali Microfinance Bank (the largest microfinance bank in Pakistan), including development of a scoring model[47].

The IFC team has provided capacity building support to SBP on policy approach and drafting a policy framework on fintechs. IFC also provided support to the provincial governments of Punjab and Sindh to improve the "doing business" rankings, including eliminating gender-based requirements for company registration. 60 administrative and legal reforms were delivered during the period of April 2019 - March 2020, and Pakistan has seen its global ranking rise up 28 spots to 108 in the latest report[48].

[46] IFC, 2020, *Supporting Private Sector Development in Pakistan (Semi-Annual Operational Report Jan-Jun 2020), p. 3*
[47] Stakeholder consultation
[48] World Bank, 2019, Doing Business Rankings [Online], Available here

7. EAGR Mid-Term Assessment – Findings & analysis

a. ToC

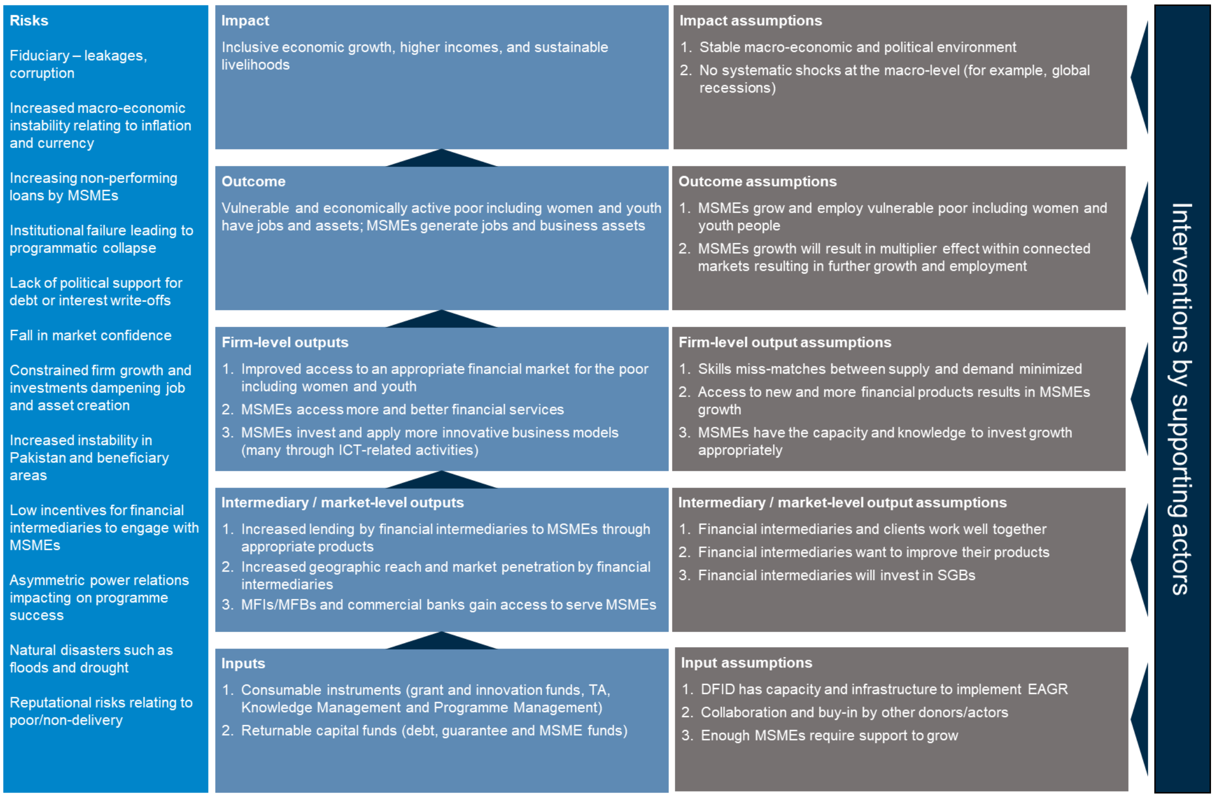
Purpose of ToC sub-section

This section discusses the original EAGR ToC. For the purpose of this assessment, the ToC is considered as the EAGR programme's results chain which, as per graph 7.1, is the visual representation of the ToC in action. An overview of the ToC is followed by an assessment of the assumptions and relevance to the future of EAGR, as well as to KRN's overall strategy. It reviews achievements and provides course corrective measures for the remainder of the EAGR programme.

An intermediary / market model

To achieve its objectives to address identified market failures, EAGR uses the results chain, creating a value chain of inputs, outputs, outcomes and impact. The existing ToC strategises how to highlight the increased bankability of the MSME sector through an intermediary / market model, by providing financial and technical support to FIs which are providing finance to the MSME segment. This strategy is based on various assumptions:

Diagram 7.1: EAGR results chain as per original ToC



Findings and analysis of ToC assumptions

<u>Were the ToC assumptions robust:</u> While some of the assumptions held true, others fell short and adversely impacted programme performance.

<u>Intermediary / market level output assumptions:</u>

<u>Assumption:</u> "Financial intermediaries and clients work well together." The following findings emerged from KIIs:

- End-borrowers expressed their discomfort with banks, based on their approach to SME borrowers, their past history, and the know-your-customer (KYC) compliance requirements;
- End-borrowers discomfort with banks was more conspicuous among the WV beneficiaries. Reasons included a general lack of understanding in dealing with women. Women-led businesses do not find FIs a welcoming or easy medium to raise funds.

This assumption requires further internal review, as although it received divergent feedback, the sample size was not large enough to conclude if the assumption is entirely invalid.

<u>Assumption:</u> "Financial intermediaries will invest in SGBs." (i.e. MSMEs). This was one of the most critical programme assumptions and displayed its reliance on the intermediary market to improve MSME's access to finance. The following findings emerged consultations and performance of programme initiatives:

- EAGR was unable to change banks' behaviour towards MSMEs, because they find micro and small enterprises to be a high-risk & costly segment. Majority of partner FIs' portfolios consisted of medium-sized enterprises (MEs), leaving the financial needs of small-sized enterprises (SEs) unmet;
- MSMEs continue to be a low-priority segment for majority of the banks;
- High government borrowing from private banks leaves little incentive for them to invest in MSMEs.

This assumption did not hold true, and led KRN towards direct interventions through PFSL, IZP and WV.

<u>Firm level output assumptions:</u>

<u>Assumption:</u> "SGBs have the capacity and knowledge to invest in growth appropriately." The following findings emerged from consultations, research and analysis:

- "Lack of preparedness among SMEs" was categorised as a demand-side impediment for improved access-to-finance by both, regulators and banks;
- EAGR itself conducted a capacity building programme for SME owners, pointing towards a gap in existing capacity and knowledge;
- A need for capacity building initiatives exists, to further improve the outcomes of the WV programme.

While there is a significant SME market available that has the required capacity and knowledge, it is still a minority. This assumption, therefore, does not hold true for the majority of SMEs, as divergent information was received from programme stakeholders.

Impact assumptions

Assumption: "Stable macroeconomic and political environment." Pakistan's political environment remained volatile from 2014 – 2020, with multiple street protests, some of them in the capital. This assumption did not hold true as EAGR was implemented in a politically hostile environment. Furthermore, it was an ambitious assumption to put in the ToC, given Pakistan's political history. This assumption should be moved to the risk section of the ToC.

Assumption: "No systemic shocks at macro-level (for example global recession)." The first half of EAGR went through two major systemic shocks: (1) Pakistani rupee depreciated by almost 60% between 2014 – 2020; (2) Covid caused lockdowns resulting in slow growth and loan deferments. This assumption did not hold true during the programme period.

Missing assumption in the existing ToC: Assumptions mentioned in the ToC cover a wide range of social, political and economic factors; however, based on consultations with banks and regulators, one important assumption pertaining to the central government is missing. While the ToC discusses macroeconomic stability in holistic terms, it remains silent on the impact of the government's continued excessive dependence on borrowing from the banking sector, which is an attractive situation for banks. This impacts the macroeconomic stability of Pakistan and disincentivises banks from lending to SMEs. The ToC should be revised to include this either as an assumption or a risk[49].

Relevance of ToC for the remaining programme period: SMEs constitute 90 percent of all enterprises in Pakistan, whereas credit provided to SMEs is under seven percent of total bank credit to the private sector; this represents only 14.7 percent of GDP in 2014. Table 7.2 below presents the grim reality of the SME segment.

Table 7.2: Description of SMEs performance from 2014-2016 based on SBP data

Indicator	2014	2020
NPL ratio of SME financing	33.83%	17.1%
SME financing as percentage of total bank credit to the private sector	6.26%	6.21%
Domestic credit to private sector (% of GDP) [50]	15.4%	18.0% (2019)

Literature suggests that MSMEs grow at a higher pace than large firms, leading to higher job creation. Macro-level analyses indicate that a one percent rise in SME credit leads to a decrease in unemployment of about 0.1 percent for a sample of emerging market and developing economies, and of up to 0.2 percent for MENAP and CCA countries[51]. However, the working capital needs of the MSME sector remain largely unmet due to higher priority given to large corporate entities. The existing ToC captures this market failure and, therefore, remains relevant.

Is KRN on the path to achieve its targets, as per the ToC?

Although genuine effort was made to nudge the SME sector through the intermediary market (i.e. banks and NBFIs), the partner FIs are not fully aligned with KRN's objectives to achieve the desired impact of the EAGR programme. Given the inconsistent performance by the partner FIs, the objective to develop a bankable market for MSMEs by changing banks' behavior towards them would be difficult to achieve through a direct market approach. Further, to increase financing to women-led businesses through an intermediary model would have been challenging for KRN, as there is a lack of evidence to support that FIs would have increased their portfolio of women-led businesses.

[49] State Bank of Pakistan, 2020, *SME Financing Data Tables*, September
[50] World Bank, 2021, Data [Online] Available here
[51] IMF E-Library, 2019, *Financial Inclusion of Small and Medium-Sized Enterprises in the Middle East and Central Asia,* February

KRN follows IFC's definition of MSMEs, which is USD denominated. With a year-on-year devaluation trend, especially the large devaluation of 2019, the equivalent PKR value has increased and, as a result, higher-end SMEs and even some large corporates have qualified under the IFC SME definition in PKR equivalent values. This has provided partner FIs the ability to lend to higher-end SMEs and larger corporate entities. Meanwhile, it is understood that the regulators have, in principle, agreed to a standard unified definition for SMEs, with a formal notification yet to be issued. Even without a government notification, there is an urgent need to standardise and use a PKR denominated SME definition, especially before PFSL becomes operational.

Rather than developing a bankable ecosystem through an intermediary market, KRN is now focusing on direct market interventions through its subsidiaries. The revised ToC needs to cater to this revised approach to address market failures. Since KRN has revised its approach to achieve programme objectives through direct market interventions, the outlook of the revised ToC should align itself with that of a holding company. As a result, LF changes should follow suit.

b. Results measurement approach (RMA)

Purpose of RMA section

Performance evaluation is an imperative for the EAGR programme to measure outcomes and impact. The evaluation can vary between intended and unintended outcomes. It is undertaken for the following[52]:

- Formative purposes - i.e., improving or reorienting a programme;
- Summative purposes - i.e., taking informed decisions on continuation, discontinuation, upscaling and replication of the programme.

Overview of KRN's RMA

KRN's MEL function has extensive reporting responsibilities for monitoring and evaluation, reporting, and processes, detailed in the MEL strategy document and operations manual. The manual also maps the key processes for third-party or direct monitoring, evaluation and assessment process, and reporting requirements. The strategy details the tools for MEL, and reports for reporting requirements.

MEL has developed 18 monitoring reports, five annual reports and has been involved in periodic reporting to sponsors. KRN's MEL function should consider engaging a third-party agency who can provide temporary resources on a needs-basis - for example, when specific reports are due or when workload is higher than usual, though MEL should aim to increase its internal capacity and capability to conduct specialised assessments, reducing the use of external consultants for programme assessments. MEL is also responsible for post-investment monitoring of the WV portfolio, engaging Ernst & Young (EY) to assist with this exercise.

A gender and youth policy is also created, which will be monitored from Q2 2021. **KRN should update the MEL operating manual by adding a date, correctly tracking version control, assigning an owner, and adding an annual review and maintenance cycle, while ensuring that all key processes are mapped. The MEL strategy should also be reviewed on a periodic basis.**

Findings and analysis for the MEL function

Going forward, KRN intends to conduct evaluations of its projects at an earlier stage, except for smaller projects where this is not feasible. A framework should be developed and documented to help determine the stage at which an assessment should be undertaken, based on the planned length of the project. This should be formalised and agreed by the Head of MEL and the Board.

[52] UNICEF, 2014 *UNICEF report*

The assessments conducted by KRN to date include:

Table 7.2a: Assessments conducted by KRN to date

Internally conducted by MEL	• Assessment of FINCA SIM Women Community Mobilisation Entity Project • Rapid assessment of supply chain finance program
Conducted by external consultants	• Evaluation of DFS outputs in research & policy verticals • Assessment of WEC • DFS strategic review, external & internal • Draft assessment of ICF round 1 • FDC programme evaluation • PMIC baseline assessment • Two WEC case studies • MTA of EAGR (ongoing)

It is difficult to have a unified RMA for large scale programmes such as EAGR, which has multiple partners and diverse set of initiatives, each initiative demanding a focused RMA. Therefore, multiple approaches are used by KRN to measure and evaluate EAGR's performance:

<u>Self-reporting:</u> This approach is used wherever KRN requires / depends on data from PMIC and partner FIs. KRN verifies results received from its partners wherever it can.

<u>Modelled estimations:</u> KRN and FCDO agreed on certain indicators (mentioned below) to be made part of the result measurement:

- Incremental revenue generated by MSMEs with KRN's investments;
- Number of jobs supported by KRN's investments;
- Number of jobs supported for women and youth by KRN's investments.

The achievements against these indicators are estimated using a modelled approach. The methodology and efficiency of the used model is included in the annexures section of this report.

<u>Internal reporting:</u> This approach is used wherever LF indicators require input from verticals within KRN, including CIC, DFS, ICF, WV, KM&C and Operations.

<u>Third party evaluations:</u> Other than the approaches mentioned above, KRN has, on a need basis, conducted baseline studies to set benchmarks and evaluate programme progress in the future. Similarly, third-party evaluations have been conducted to gauge programme progress and impact. The MTA report is one such example.

The result measurement approach used by KRN on LF indicators is mentioned below:

Table 7.2b: EAGR RMA under LF

Self- Reporting		Modelled Estimation		Internal Reporting	

Outcome Level Indicators
Cumulative number of beneficiaries accessing KRN supported financial services
Cumulative incremental contribution to revenue/output of enterprises due to KRN financing
Cumulative total number of jobs supported by KRN financing
Cumulative total number of jobs supported for women and youth
Cumulative number of partners that institutionalise SME finance innovations and/or non-partners that copy or adapt partner innovations
KRN support to government, regulatory bodies & associations on regulations, policy decisions to encourage improvements in architecture of the financial sector.
Output 1: Sustained/enhanced flow of funds for microfinance (PMIC)
Outstanding loan portfolio of Pakistan Microfinance Investment Company (PMIC)
Percentage of outstanding portfolio under MF Plus Initiatives
Leverage factor i.e. all funding raised by PMIC other than KRN divided by total KRN financing to PMIC
Output 2: Leveraging technology for enhancing access of FS for enterprise growth & inclusion of poor and financially excluded regions
Size of branchless banking transactions (cumulative) generated by solutions supported by KRN financing
Cumulative number of branchless banking transactions generated by solutions supported by KRN financing
Cumulative number of digital financial solutions/pilots financed by KRN
Output 3: Enhanced access to and usage of appropriate financial services by SMEs
Size of outstanding SME Financing (debt and/or equity) portfolio leveraged via KRN supported facilities
Investment Return [Annual]
Size of outstanding portfolio leveraged via non-bank financial channels
Percentage of KRN credit portfolio at risk *Over 90 days
Output 4: Improved financial architecture and financial sector, with enhanced market knowledge, offering innovative SME finance products
Cumulative number of SME finance knowledge products (policy briefs, studies, analytical notes, data portal etc.) for informing KRN investments
Cumulative number of Innovation Challenge Fund rounds - contracts with partners in place
Size of Women Entrepreneurship (WEC) outstanding portfolio (debt and/or equity)
Output 5: Effective, professionally managed and sustainable SPV
Percentage of operating cost that can be supported from own source revenue
Develop and implement a robust ESG management system
High quality strategic and performance management
Cumulative number of communication events and visibility products

Assessment of available RMAs:

KRN uses a wide range of approaches to measure and evaluate programme progress, achievements and impact. These approaches are tailored as per the needs of different initiatives. Under the existing RMA, almost 42% of the achievements in the LF are measured through self-reporting and modelled estimations, which may have higher variance than internal reporting. Moreover, there are time and resource limitations in validating the results reported by partner FIs, further increasing the risk on data received from partner FIs. Therefore, these two approaches are riskier than self-reporting, due to higher potential of variances in data. Third-party assessments lack the capability to mitigate this risk, as they have limited scope and can only provide information on focused subjects.

Since the outcome level indicators on incremental revenue and job support are agreed upon with FCDO and can only be measured through modelled estimation, **there is a need to decrease the dependence on self-reporting via partner FIs**, which we understand is difficult to achieve under indirect market interventions. However, for KRN's direct interventions through equity investments, direct lending to corporates and the WV programme, dependence over self-reporting should increase. More strategic investments are in the pipeline to increase KRN's direct market interventions. **This assessment expects that, with higher visibility on investments in future, KRN will rely more on self-reporting. This will lead to a more coherent result measurement framework**.

Modelled estimations: Although there are various RMAs that are available to measure short-term and long-term programmes (see annexures), they are not aligned with KRN's specific needs. Since EAGR is a donor-funded long-term programme that has so far used an intermediary model to finance MSMEs: (1) Its RMA has to be aligned with the results measurement indicators identified and mutually agreed upon between FCDO and KRN; (2) Identification of beneficiary SMEs (end-borrowers) is a challenging task under indirect interventions through intermediary markets, making sample-based pre-post programme assessments less effective.

EAGR focuses on improved access to MSME finance and connects its objectives with incremental revenues and job creation at the first level, and job creation for women and youth at the second level. Therefore, the other RMAs do not fit with EAGR's results measurement indicators and, consequently, the SRQ model serves as a best fit. However, sample-based RMAs could be used to assess the impact of recent strategic investments, as in the long run KRN will have more direct visibility of the end-borrower.

Assessment of SRQ model's limitations

Although SRQ is a better-fit, given EAGR priority areas, it has certain limitations like any other model:

- The actual impact of KRN's MSME financing may differ as the realised impact presented in the LF is based on modelled estimations;
- Other factors may have impacted incremental revenue and job creation and, therefore, assigning the entire increment to KRN's financing may not be a valid assumption. We are cognizant of the attribution factor being an element to consider, when developing impact models, which is why there is no silver bullet to measure impact of interventions where multiple interventions are ongoing. The entire increment approach is misleading - for example, it emerged from KIIs with majority of end-borrowers that they had multiple lines of credit and, hence, other sources of their funding (debt and equity) would have also contributed to the incremental revenue and jobs supported;
- The benchmarks (GTAP datasets) for SRQ's sectoral multipliers were created in 2011 and may now be redundant. The recent impact of climate disruptions and Covid are not incorporated in the existing SRQ model.

While conducting this assessment, the Joint Impact Model (JIM) was reviewed, which is an updated version of SRQ[53]. KRN's discussion with JIM have been ongoing since 2020 over the methodology and the applicability of this model on the EAGR programme. KRN has recently become a member of the JIM Foundation. JIM's input variables differ from that of the SRQ model. The SRQ model uses "total outstanding loans for a given period" as an input, whereas the JIM model takes "firm revenues" as input to estimate outputs. This input data is difficult to obtain using an intermediary market intervention model. However, with KRNs strategic investments operationalising, this model may serve KRN better than the SRQ model in the longer run. KRN plans to use both, SRQ and JIM models, to assess which model provides better results. **While it is too early to comment on the applicability of JIM on the EAGR programme, but the process of moving towards a new RMA is a positive step given the limitations in the SRQ model, which will only increase each year unless its benchmarks are updated.**

[53] Steward Redqueen, 2021, *Joint Impact Model: Methodology paper, February*

c. VfM

VfM in the context of EAGR

In the context of the EAGR programme, KRN's definition for VfM is:

- Optimal use of resources in improving MSME's access to financial services, translating into higher economic benefits for the poor and marginalised groups.

Utilising this definition, EAGR measures VfM through the LF, the primary results measurement framework which also integrated the EAGR ToC into its framework. This ensures VfM measured by EAGR is aligned with the EAGR business case and summary.

Performance of VfM as per EAGR

As per table 7.3, the EAGR programme is providing excellent VfM in terms of economy and efficiency, and good VfM in terms of effectiveness, as per the Mar 2021 results. Even though the efficiency indicators 6 and 7 seem low in absolute terms for the MTA, they are quite close to their 2021 benchmarks, as per the Mar 2021 QPR; therefore, only a slight up-tick is required in average growth to meet indicators. The equity indicators are the ones on which KRN needs to particularly focus. The indictor related to number of women-led SMEs is the one which needs the most focus, and KRN's focus on WV is an initiative which is being scaled to service this.

Table 7.3: EAGR VfM assessment to date, as per Mar '21 results

Indicator		Target, '24	Result, Mar '21
A.	**Economy (Spending Less)**		
1.	Operating cost as % of total expenditure	<10%	2.60%
2.	% of operating costs shared with other donors	>35%	66.6%
B.	**Efficiency (spending well)**		
3.	Leverage factor in SME lending	>2	2.4
4.	PAR of KRN compared to the wider SME sector (%)	Below SBP sector NPL ratio – 17.1% as per Mar '21 QPR	0.4%
5.	Efficiency of deployment	>95%	Mar '21: 95.8%; 3M avg: 86.0%; 12M avg: 88.0%
C.	**Effectiveness (spending wisely)**		
6.	Additional number of KRN beneficiaries accessing financial services: i) microfinance; ii) SMEs	i) PKR 1.3 mn ii) PKR 5,966	i) PKR 824,707 ii) PKR 1,973
7.	Cumulative increase in additional revenue of small and medium business receiving loans from KRN Credit programmes	PKR 169.5 bn	PKR 67.1 bn
8.	Job multiplier - No. of jobs per PKR 1 million invested (against total KRN portfolio which includes leveraged funds)	>1.7	2.6
D.	**Equity**		
9.	Number of women-led SMEs benefitting from KRN investments (ICF+loans+equity) as a % of total SMEs supported	>10%	4%
10.	% of women in KRN's professional staff	40%	30%

Best practices

As FCDO programmes globally have matured, so has the understanding of VfM. In order to gauge whether EAGR is utilising best practices which can be adapted to the local context, these have been studied from a global perspective. The best practices have been reviewed from the perspective of what the EAGR VfM approach currently provides, and what can be built on from that. Though multiple sources have been used, the VfM study by Julian King and the OPM Working Group are found to be highly insightful. Some key findings are as follows:

- VfM can be used across the whole design cycle, with a focus on economy and efficiency, and a transition to looking at all indicators, during the implementation phase;
- Although the FCDO conceptual framework is commonly referred to as “4 E’s”, there is one more criterion, cost effectiveness, to encapsulate. This compares impact or outcomes to total costs;
- Standards should be set for what the 4E’s would like for different levels of performance and what traffic-light rating systems can be used to support judgements on VfM;
- Equity is used to make sure development results are targeted at the poorest, which includes sufficient targeting of women and girls;
- Equity involves outreach for women and girls, youth, poor people, people with disabilities, people living in remote rural areas, and other marginalised groups. The programme objectives should therefore cascade to them as well, as efficiently and cost-effectively as possible;
- Performance standards for each criterion should be set, in order to distinguish between excellent, good, acceptable, and poor performance;
- The results chain should be detailed, having intermediate steps or strong detail of the journey from outputs to outcomes to impact. This would detail how results would be measured on that journey, and how VfM can be better captured;
- VfM has to be tailored into the systems of learning, adaptations and improvement, so that project, organisation and systems can be tailored to better offer VfM.

Findings and analysis

VfM is assessed and analysed based on the following objectives:

- Is the EAGR program delivering VfM?
- How can the VfM be realistically improved? (FCDO’s 4E approach to VfM should be used which focuses on economy, effectiveness, efficiency, and equity)

<u>VfM delivery</u>

- In relation to end targets, EAGR is delivering excellent value in terms of economy and efficiency, good value in terms of effectiveness, and acceptable value in terms of equity – there is time to improve, given this is the mid-term of the programme.

<u>Efficiency and effectiveness</u>

- EAGR provides good VfM in terms of efficiency and effectiveness; as per best practice, this suggests that the programme design and vendor procurement processes are run effectively to onboard vendors, which can provide economy and efficiency. As the programme progresses, there should be a focus on all types of indicators, though in the initial years there should be a process rather than results-based focus. EAGR has now reached the mid-term stage and, therefore, this transition should start so that effectiveness and equity are better catered to for the rest of the programme. As per KRN’s VfM strategy, a detailed evaluation should be conducted every three years, which means KRN should be completing/have completed their second evaluation. **The next evaluation should highlight the successes of the economy and efficiency framework, and highlight the lessons learnt from the effectiveness and equity indicators, which can be tailored into VfM redesign.**

- EAGRs current efficiency indicators focus on technical efficiency, which are about maximising outputs from a given level of inputs. **However, in the EAGR context, as is best practice, we recommend incorporating efficiency indicators related to allocative efficiency, which are about assessing whether EAGR has the right mix of interventions to maximise outcomes and impact. In consultation with FCDO, allocative efficiency indicators should be incorporated.**

Equity

- KRN is targeting women as part of their equity framework; this is aligned with best practice, as women are one of the demographics the equity framework caters to. However, youth have not been targeted, who are also first level impact beneficiaries, as per the EAGR results chain. As per best practice, youth are one of the target beneficiaries for the equity framework. Given Pakistan's youth bulge, this would make youth employment a critical aspect for FCDO to address, through the EAGR programme. **In consultation with FCDO, an equity indicator should be added which captures the provision of equity to youth and is aligned with EAGR's objectives. The ToC and LF should be reassessed with this change in mind.**

Performance measurement

- KRN uses the traffic light system, which is an FCDO best practice, to measure the strength of indicators. The traffic light system however is not being used to provide an overall programme rating. Utilising a system to assess the overall programme rating will allow FCDO to better measure the success of their global programmes, relative to others. **KRN can use the general rubric as per the VfM study by Julian King, or any other mutually agreed system between FCDO and KRN, which will allow FCDO to better assess relative performance of the EAGR programme, based on VfM, and compare with other programmes**.
- KRN does not currently have a system to measure how each indicator has performed on a relative scale, only an end target for each indicator. Performance standards for each criterion should be set, in order to distinguish between excellent, good, acceptable, and poor performance. For example, EAGR is providing excellent VfM in terms of economy and efficiency, and that would be more evident through such performance standards. **Complementing the general rubric approach for performance at the programme level, KRN can either use that or another mutually agreed system, to set mutually agreed performance standards for each indicator; in consultation with FCDO, this will allow more granularity on relative achievements, and where lessons can be learnt.**

d. Gender

As per the preceding VfM section, the gender lens is a critical element of the equity indicators, as per FCDO best practices. FCDO is willing to balance economy, efficiency, and effectiveness indicators, as long as women outreach exists. From a programme perspective, women outreach requires investment of time and resources, and therefore the financial return on investment may not be as high as, in comparison, what could be achieved from targeting other segments. However, given the commitment of FCDO and KRN to the gender lens, they have utilised a focused and long-term approach towards gender empowerment, through greater access to MSME financial services.

In previous sections, this report has highlighted limited access-to-finance for women being a major economic hurdle. KRN's strategy, implementation and results measurement approaches have women focussed objectives, initiatives and targets respectively – exhibiting a conscious focus on uplifting women and providing them opportunities that are otherwise unavailable.

Some of KRN's most noteworthy actions in this regard are mentioned below:

- **Strategy:** KRN has developed a gender strategy. Its implementation will be assessed in FY 2021-22;
- **LF:** The existing LF has specific targets for KRN's outreach to women MSME borrowers, number of jobs supported for women and the women venture programme;
- **WV:** This programme was launched in July 2020, with applications now being accepted on a rolling basis, so better conceptualised and developed applications can be submitted. More than 250 applications (inclusive of WEC) have been received since launch;
- **Financial Inclusion for Women Challenge:** NRSP Bank has initiated their process of on-boarding female agents that will be trained to launch their branchless banking solution. System integration testing and user-acceptance testing (UAT) are being finalised, with a pilot launch planned in Gujjar Khan District to serve women in rural areas;
- **Microfinance:** PMIC's role in providing access-to-finance to women is quintessential where an overwhelming majority of microfinance borrowers are women. It has indirectly supported financial inclusion of women and promoted use of digital finance by women;
- **Trainings:** Specific targets were set and achieved to train women employees of SMEs under the IFC Business Edge programme. Under the programme almost 2,500 women were trained;
- **Institutional:** KRN has a relatively high gender balance compared to FIs in Pakistan. In SBP's "Banking on Equality" draft policy, SBP reported that women represented an average 13.2% of total bank staff in Pakistan. In KRN, however, there is strong representation in management and decision-making authority across the organisation. The Board has set targets to track organisational progress on gender related indicators. Some highlights from the Mar 2021 QPR are as follows:

    - 38% (3 of 8) independent directors and management committee members are women;
    - 43% (3 of 7) team leads are women;
    - More than 30% of staff report to female supervisors;
    - 30% of the professional team are women.

In line with best practice, the HR manual sets out the different recruitment policies and compensation for promoting gender equality.

e. Demonstration effect

Overview of demonstration effect

Demonstration effect is a term commonly used by FCDO and other donor agencies, contextualised to the programme being implemented. The demonstration comes from the initial intervention, and the outcome is a change in behaviour- e.g., establishment of sustainable business models of SME finance, growth in financial inclusion, etc., attributable to the examples set by EAGR-linked initiatives.

Demonstration effect in the EAGR context

Across the spectrum of EAGR initiatives, there have been varied levels of success in achieving demonstration effects. Some of the notable instances are as follows:

- **Sector-specific investments** have also seen generally positive outcomes, albeit still at an early stage, in key areas such as logistics, agriculture and healthcare;
- **Direct-to-Corporate (D2C)** lending has proven to be productive and yielded greater insights than bank collaborations. As an example, reverse factoring with JSK Feeds has stabilised the working capital cycle for both buyers and sellers in an economical and sustainable way, while advancing the cause of financial inclusion (as unbanked farmers opened accounts for the first time); most importantly, JSK has now received a similarly structured financing offer from Habib Bank, the country's largest commercial bank.

However, during consultations with partner FIs, a range of views on risk appetite, scalability and viability of SME lending came across, showing that the demonstration effect was not being achieved satisfactorily (please refer to the "Partnerships" section below).

There is one outcome indicator in the LF relating to the "cumulative number of partners that institutionalise SME finance innovations and/or non-partners that copy or adapt partner innovations" (as per table 7.4 below). This is a good start in defining a demonstration effect. Although the 2021 LF targets for this indicator were met, KRN intends to modify its market-centric approach on account of an insufficient demonstration effect.

Table 7.4: Achievements against Mar '21 LF targets, as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
5. Cumulative number of partners that institutionalise SME finance innovations and/or non-partners that copy or adapt partner innovations	2 out of 6 partner banks institutionalised innovation; 1 non-partner FI adopted innovation	1/3 of existing partners institutionalise innovations; 1 non-partner FI adopt innovation	100% on partners and non-partner FIs

Through consultations, it is clear that the concept of demonstration effect is deeply embedded in KRN's management and Board. There has been constant conversation about the demonstration effect and, as per consultation feedback, the demonstration effect has not been seen at sufficient scale. This has provided impetus for a shift from the market-centric approach (as per the original ToC) to a more direct approach, where KRN can influence the market through investments and direct interventions.

Strategic investments such as IZP, PFSL and PCGC are presently in the pre-launch stage of commercial operations, and all have the potential to be catalysts for wide-ranging changes in the financial services arena. They are designed to operate through direct, institution-level delivery of services that are aligned with key market gaps; they show the promise of not only closing these gaps but also driving significant demonstration effects for the broader financial sector through multi-product, multi-tenor appetite for SME risk. PMIC is a clear example of KRN's success in addressing such a market gap.

Promising results are also seen in the early stages of KRN-linked market architecture enhancements, such as PMN digitialisation and STR.

By its nature, demonstration effect can be challenging to attribute directly to interventions, although a number of credible instances have been observed as programme outcomes, and there is ample momentum for further progress in this regard as KRN continues to operate with a wide-ranging and macro level approach to filling gaps in financial services architecture.

Next steps for demonstration effect

It is evident that KRN values the demonstration effect, which is a positive sign for FCDO. The next step is to tailor that concept into the ToC and LF, so that this can be refined and measured. Demonstration effects can vary for programmes and projects, which is why each EAGR initiative can have its own demonstration effect, which can be iteratively designed and measured, based on the changing programme approach.

As it adopts this more direct approach to intervention in the market, we suggest that (in consultation with FCDO), KRN should: define demonstration effects wherever feasible, when developing the revised ToC and LF; track their performance; adopt learnings and course corrections where expectations for demonstration effects have not been met; and engage the KM&C workstream to publicise the successful demonstration effects as and when these are accomplished.

Given that EAGR is used to create a demonstration effect for commercial viability of MSME financing, a case can be made for a natural progression to transition maturing, sustainable EAGR investments to the private sector, including CDC.

f. Partnerships

Overview of FI partnerships

KRN is a Section 42 company (not for profit), and has therefore entered into partnerships with FIs, in order to harness service delivery capabilities and distribution networks of well-established and professionally managed financial services providers. These partnerships have also provided the opportunity to build valuable insights into market participants' approaches & priorities, while also guiding KRN in terms of strategic course corrections in its drive to build support for SME-centric access-to-finance. KRN has formed partnerships with five banks (BAFL, MBL, JSBL, Soneri Bank and MIB) and a leasing company (Orix Leasing) to establish co-financing programmes for increased lending to SMEs. As at March 2021, a total of 1,880 SMEs received an aggregate financing value of ~ PKR 10.96 bn through these FI partnerships[54].

Of the partners, BAFL and MBL are seen to have the greatest alignment with KRN in terms of growing SME financing across various product lines, with a willingness to try innovative approaches. MBL has succeeded in making significant progress despite having the added challenge of building and testing Shariah-compliant variants of the SME-oriented financing products, particularly in the area of supply-chain financing.

Orix Leasing, the dominant leader in its field with over 80% market share, is another well aligned partnership, having SMEs as the majority of its customer base and risk appetite for growth. Its reliance on standardised, programme-based financing products with rapid processing and turnaround times have allowed it to remain a viable and competitive business, despite charging higher rates than banks.

JSBL has been seen as receptive to the goals of EAGR. It has provided financing to a significant number of SMEs through the partnership with KRN, and has developed some innovative services to develop its SME portfolio. Yet, the success of the partnership has depended on one or more individuals within the bank, leading to setbacks when such individuals were reassigned or left the institution.

Soneri Bank did not have significant SME risk appetite; rather, its need for Tier II capital drove its decision to partner with KRN when the latter agreed to invest in the former's debt issue; SME financing was included as an accompanying initiative. The bank does not see any significant incremental SME lending appetite beyond the confines of the existing limit agreed with KRN.

MIB's partnership became active recently, as there was a significant lead-time for formalising the SME co-financing programme (including adaptation to Shariah principles).

Other partnerships

KRN has a number of additional relationships with regulatory agencies and public sector / quasi-public sector entities that complement its core activities and facilitate the achievement of its main objectives. It has provided guidance and input on regulations and policy decisions to encourage improvements in architecture of the financial sector.

KRN has representation on the steering committee of SBP's National Financial Inclusion Strategy, where it is leading the implementation of different digital transformation projects such as Micro Payment Gateway (MPG); SECP LEAP (Leading Efficiency through Automation Prowess) [55] which aims to make the law easier to understand and access; and technical support was provided to SECP on its Equity Crowdfunding Regulatory Framework. KRN also provided TA in assessing the IT architecture and the formulation of the IT strategy of BISP, the largest social safety net payment programme in Pakistan.

[54] KRN, 2020, *EAGR Quarterly Performance Report, Jan.-Mar. 2021*
[55] LEAP, 2020, Legal Access [Online] Available at

KRN had entered into the arrangement with SBP to support the digitalisation process of SECP by automating the latter's internal business processes, digitising financial and business data reporting by companies to SECP and facilitating creation of the collateral registry, all of which will drive down both costs and turnaround times for companies dealing with SECP, and generally improving the ease of doing business in the country.

Under the BMGF-funded "Level One Project", KRN acquired and implemented a micro-payments gateway (MPG) for SBP. A Deputy Governor of SBP was the key sponsor, heading the implementation committee for this initiative. This important component of financial sector architecture is intended to provide a cost-effective payment system to individuals and small businesses to make small value digital payments.

KRN performed an advisory role in the digitalisation of the Central Directorate of National Savings (CDNS), a state–owned institution serving over 7 mn retail investors with aggregate savings of PKR 3.4 tn (~£16.5 bn). The project will benefit millions of pensioners and small depositors by transforming their interaction with CDNS, reducing the need for physical interaction at CDNS branches and reliance on paper-based transactions as this initiative is fully implemented. Features of this initiative range across improvements and enhancements, including a centralised database, better internal controls, and integrations with various national digital payment and money transfer channels.

Partnerships within the EAGR context

KRN has been reasonably successful in building and sustaining partnerships in pursuit of its goals. However, in aggregate, SME financing generated by the FI partnerships is seen to have been too risk–averse and, therefore, not aligned with the overall spirit of EAGR - i.e., to encourage and grow market-based SME financing. This view is based on the overall portfolio-at-risk (PAR) over 90 days, which is intended to be capped at 15% but has historically been much lower (0.4% at Mar 21[56]). By comparison, the overall banking industry's SME NPL ratio stood at 17.1% (as per SBP's Banking Compendium).

Next steps for partnerships

Partner FIs vary in their size, scope and risk appetite; in addition, other potential partners remain untapped. Further details on the way forward may be found in the "Recommendations" sections later in this document. Meanwhile, continued constructive engagement with the public sector will build on an already well-established track record, while positioning KRN as a leading exponent of advancement for the cause of the public good.

[56] KRN, 2020, *EAGR Quarterly Performance Report, Jan.-Mar. 2021*

g. Knowledge Management & Communications (KM&C)

Overview of KM&C[57]

The KM&C function houses the two sub-streams of Knowledge Management (KM) & Communications.

- KM is a research function for KRN to bridge knowledge gaps in the financial inclusion space. It develops and disseminates evidence-based insights and solutions for the industry as a whole, and also performs research and landscaping for initiatives of KRN. In respect of the latter, it performs an interactive collaboration with other verticals within the organisation. In addition, it has interactions with third parties within the public sector (SECP, Ministry of IT, etc.) as well as the private sector (Orix Leasing) to develop policy proposals and research.
- The Communications function creates awareness and runs campaigns of KRN's initiatives, creates impact videos, and works on improving the organisation's brand image through effective management of its social media presence.

KM&C within the EAGR context

As per the table below, the KM&C function has performed strongly on its targets for indicators related to both, the knowledge management and communications functions. As per the FGD, KRN is constantly searching for more pertinent indicators for impact measurement for this function. The attribution of impact through KM&C outputs is difficult to ascertain, which is why the quantity-based approach continues to be used. Recommendations for revisions have been provided further in this report.

Table 7.5: Description of KRN achievements on outcome indicators pertinent to KM&C, as at Mar '21, against set LF targets as per Mar '21 QPR

Achievements against outcome indicators (Mar '21)	Achievements (As at Mar '21)	Targets for Mar '21 (set in '21)	Achievements against targets
4.4 Cumulative number of SME finance knowledge products (policy briefs, studies, analytical notes, data portal* etc.) for informing KRN investments	23	22	104.55%
5.4 Cumulative number of communication events and visibility products	97 events	99 events	106.45%
	200 visibility products	190 visibility products	105.26%

**The KM&C function has recently launched an interactive data portal covering financial and economic data / indicators for Pakistan*

Next steps for KM&C

The KM&C function has a critical role to play in achieving KRN's ambitions within EAGR. KRN will continue to build on its extensive investments, delivering significant new financial infrastructure and expanding options for MSMEs and other financially excluded populations. The formal documentation of its trailblazing efforts and its unique insights into its numerous beneficiary ecosystems should enable KRN to not only cement its position as the leader in its field in Pakistan, but also as a first-choice subject matter expert for implementation and innovation in financial inclusion programmes in emerging markets. Detailed recommendations are noted in the next section of this report.

[57] Further details about the KM&C workstream can be found in section 7i

h. Institutional assessment: Governance

KRN is evolving from its current operating model with a number of activities and initiatives, to eventually assume a holding company (HoldCo) model and structure. The governance framework is therefore assessed from the as-is perspective as well as readiness and maturity for the eventual HoldCo model.

The International Finance Corporation's ("IFC's") Corporate Governance Code Matrix for Financial Institutions is considered the most relevant baseline approach for KRN, given IFC's role as a development financial institution, similar to KRN. Based on the IFC model, a KRN-specific governance maturity assessment model was tailored for the assessment, which should also provide ease of comparison with the previous assessment IFC conducted on KRN's corporate governance in 2018.

Current Board & committee structure

KRN is governed by a nine-member Board of directors, of which eight, including the chairperson, are independent non-executive directors ("INED"s), and one is the CEO of KRN. KRN's sponsors, the FCDO and BMGF, have observer seats, two for FCDO and one for BMGF. The observers participate in Board meetings but do not have decision-making or voting rights. KRN's Board is independent of donor participation and, hence, is designed to survive exit of the donors.

KRN, as a section 42 company, is required to have a General Body to select and approve changes to Board constitution. In organisations held by shares, investors, through the Shareholder Assembly, will be responsible for holding the Board accountable. In the case of Karandaaz, the members of General Body theoretically act as the Shareholder Assembly. However, since the General Body membership is the same as the Board, there is no forum that is currently holding the Board accountable.

FCDO on the other hand, as a sponsor, should be considered as the same status as that of an "investor" for a company, because of its long-term objectives and vested interests in KRN. It's role within the Board should therefore be formalised, either by way of a policy revision or by converting them into Board members, for a defined period after dependence on their funding ends.

Board decision-making is collective, with the chairperson holding a casting vote in the event of a tie. It is understood there are instances where the chairperson's vote has been the casting vote even when there is not tie, over-riding the decisions of other Board members and not aligned with the views of donors / sponsors. Consideration should be given to either giving donors / sponsors voting rights in the event of a tie or, as already stated, converting the donors into Board members, or making clear that no one member has a majority voting right independently except in the case of a tie.

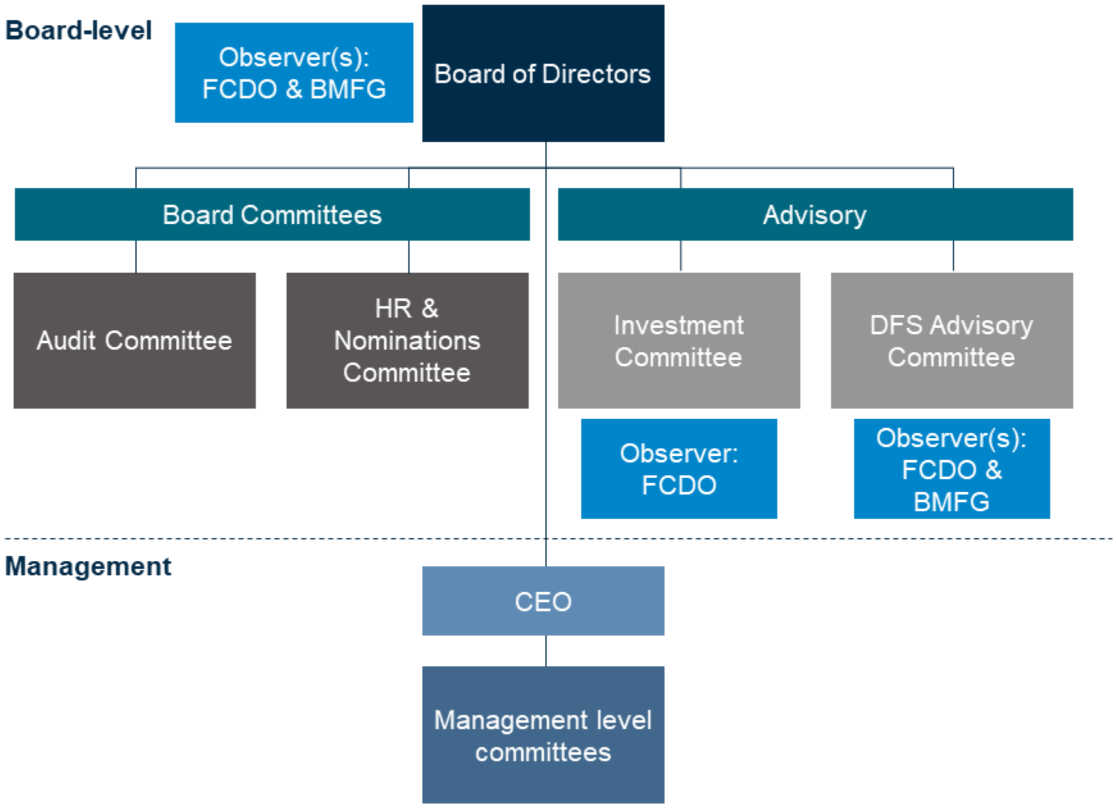
The Board provides competent oversight, deliberating on and providing strategic direction, overall risk management of the organisation, and maintaining the integrity of external reporting.

As per the Board charter, the Board meets at least quarterly, with ad-hoc meetings held as and when the Directors see fit. According to the Board meeting tracker, KRN has held regular Board meetings for the last six years, adapting to the Covid pandemic by moving these online via Zoom since June 2020. Although the size and composition of the Board has changed since inception, a high level of independence has been maintained. This is in line with global best practice.

All the Board members are distinguished, experienced and respected professionals with long-standing experience in various sectors, including financial services and the government. A third of the Board is composed of females, which is also good practice, and diversifies Board composition from a gender perspective.

The Board receives regular reports in the form of Board packs, which are collated and consolidated by the Company Secretary. Input for the Board packs are collected from all functions, including HR & Finance.

Diagram 7.6: Illustration of the current governance structure



Board committees

Four Board committees have been formed, formalised by charters and each headed by a Board member. There are two Board committees, Audit and HR & Nominations, and two Advisory committees, the Investment and DFS Advisory committees.

The advisory committees, although named as such, are considered Board committees since both have been constituted by the Board. They have been set up, as per global best practice, to augment the knowledge and skills of the Board members, through participation of technical experts. Advisory committees have been set up to guide the Board and organisation effectively.

The Audit Committee follows global best practices in terms of its role and, with a Board Risk Committee yet to be formed, is also responsible for overseeing the risk management functions of KRN across operational, compliance and regulatory risks. The Audit Committee meets on a quarterly basis. All decisions and action items from the committee meetings are documented and recorded by way of clear and comprehensive minutes. The committee currently has three members, which is in line with global best practices. Specific members of KRN's management team participate by invitation only, which usually includes the Head of Risk & Compliance and the Finance Controller.

The Board HR & Nominations ("HR & N") committee manages KRN's corporate governance arrangements. Current committee membership is two members, although global best practice is to have a minimum of three, ideally five. The committee meets quarterly, which is in accordance with best practices.

The Investment Committee provides oversight of all credit and equity related activities. Although referred to by KRN as an advisory committee, it has delegated authority to make credit lending decisions of certain transactions. As per the ToR, the committee meets as frequently as it considers appropriate, but not less than twice a year. There is no standard best practice for frequency of credit or investment committees, and they are typically aligned to the nature and number of transactions which require review or approval. Given the low transactions volume and the existence of a management investment committee, semi-annual meetings are sufficient in the case of KRN.

The DFS Advisory Committee is a specialist committee put in place to guide the DFS function on strategy and provide recommendations to the Board for DFS' projects. The committee has six members, with the provision of two technical experts. Meetings are held quarterly and responsibilities are clearly documented in the ToR.

All committees receive agendas and reading materials, which are organised, clear and comprehensive. Materials are shared in sufficient time for the Board to read ahead of the meeting. Detailed minutes are taken to document decisions and actions, which are tracked separately by the company secretary. A register of all committee meetings (including AGMs and EGMs) is also maintained to track the frequency and participants. These follow global best practices.

The Director of Operations holds the additional responsibility of Company Secretary. In light of the increasing workload at the operational level, the Board has approved hiring a dedicated Company Secretary. The role should be filled with someone sufficiently senior with a broad skill set to be able to manage corporate and legal affairs.

Pipeline maintenance needs to be administered for the General Body members and the Board.

Board Risk Committee

KRN has decided to implement a Board Risk Committee which, given KRN's business activities, is a necessary requirement and in line with global best practice. This will enhance oversight and management of operational risks, for which the responsibility will move from the Audit Committee.

Management Committees

KRN has three management committees:

Table 7.7:KRN Management committees

Committee	Participants	Frequency	Responsibility	ToRs in place
Management Committee	CEO and all functional heads	Fortnightly (weekly during Covid)	• Overall management of the organisation • Review progress against work plans • Monitor progress towards achievement of strategic goals • Explore collaboration opportunities • Identify items to be escalated to the Board	Yes
Management Investment Committee for CIC	CIO, CEO, CRO	Monthly	• Approval of transactions which are less than or equal to PKR 200 mn • Identify transactions to be escalated to the IC or the Board • Updates on portfolio risk and risk management activities	Yes
Management Investment Committee for Women Ventures	Head of ICF & MEL, CEO, CRO	Monthly	• Approval of all transactions for WV • Board is informed of all transactions approved by the MIC	Yes

KRN should consider maintaining the weekly frequency for Management Committee meetings even after Covid, given the new initiatives and dynamism of the organisation as it evolves towards assuming a holding company structure.

KRN should also consider having the CIO in the Management Investment Committee for Women Ventures, to maintain alignment with investment criteria, practices, objectives and management.

In accordance with best practices, a delegation-of-authority matrix should be put in place for the Board and management, including respective committees, clearly defining decision-making responsibilities.

Governance maturity assessment

As part of the assessment, the maturity of KRN's corporate governance framework has been assessed using a tool tailored for KRN, based on IFC's corporate governance assessment tool. The final results and methodology have been included in the appendix of this report. In summary, out of the 14 categories assessed, KRN meets leadership practices for three categories, nine meet international practices and one meets intermediate practice.

In summary, KRN's governance is relatively mature, with 70% of categories meeting international best practices. There were no areas where KRN did not meet basic requirements and, for 25% of the categories, KRN was implementing leadership practices, representing a strong governance framework.

Given that KRN is evolving into a HoldCo model, a high level of corporate governance standards should be maintained, which can then influence its portfolio and subsidiary entities.

Board evaluation

A Board evaluation framework in the form of director self-evaluations was put in place in 2017 and has been conducted annually since. Annual evaluations are in line with global best practices. The framework was also developed in line with IFC's global corporate governance practices.

Questionnaires in the form of Google® surveys are distributed to Board members to complete. Answers are collated and presented by an external consultancy firm in a comprehensive report, with clearly marked ratings and results. Results are a mix of qualitative and quantitative measurements, which is good practice. Board members remain anonymous, which enables the process to elicit valuable and candid feedback, which is also good practice.

The Board evaluation report is directly shared with FCDO and KRN's Company Secretary, who then share it with KRN's Board. An action tracker to track and monitor outcomes of the Board evaluations is maintained by the Company Secretary.

A Board skill-gap analysis template captures the technical skills of each Board member, the tenures, years of experience and education. The template serves its purposes and enables KRN to quickly identify any knowledge or skill gaps at the Board level.

Governance and control framework for disbursement / investment decisions

KRN has documented its EAGR equity investment and credit transaction decision-making process in its Credit Policy and Investment Policy.

Credit transactions are defined as new loans, renewals, restructuring of facilities, rescheduling of facilities and debt-equity swaps with borrowers wanting to fully or partially settle their outstanding loan.

KRN has differentiated the level of governance required, based on the size and nature of transactions (i.e., equity or debt). Board approval is required for all equity decisions, and material credit transactions. Material credit transactions defined by KRN are greater than PKR 500 mn in value.

The four committees / forums involved in the approval of credit transactions include:

- CIC weekly meeting: Initial discussions of proposals with the Head of CIC to determine whether a proposal or initiative is worth pursuing;
- Management Investment Committee (MIC): approval required for transactions up to PKR 200 mn;
- Investment Committee (IC): approval required for transactions greater than PKR 200 mn but less than PKR 500 mn;
- Board of Directors: approval required for transactions greater than PKR 500 mn. There are escalated through the IC. The Board is also informed of all approvals made by the IC and MIC.

Delegated authority for credit transactions to MIC and IC is good practice, as it reduces reliance on the Board for decision-making. It is also global best practice for management to be accountable to the Board for credit transactions approved by management and, with the low volume of such transactions, it is good practice to inform the Board of all credit approvals. KRN should continue this practice.

Board approval is required for all equity investments which, given KRN's low number of high value equity investments, is good practice. The Board and the IC receive regular portfolio performance reports from the Risk & Compliance team, which enables them to monitor and oversee portfolio performance.

Post-transaction and investment controls:

- The CEO (on recommendation of the CIO) appoints nominee directors to serve on the Board of investee companies. This ensures KRN has oversight and decision-making authority at portfolio company level, to be able to steer company performance and protect KRN's interests;
- KRN receives regular reports from investee companies. Quarterly, semi-annual and annual performance reports are provided from portfolio companies, as agreed in the terms of the transaction. The CIC team uses this information to prepare semi-annual and annual performance reports which are shared with the IC. KRN has put in place good reporting and monitoring disciplines for its portfolio companies, and the sample reports provided appear to be clear and comprehensive;
- The MEL team annually assesses the performance of initiatives against original objectives, which includes performance of portfolio companies and credit transactions. Information is shared by the CIC team to MEL for their independent assessment.

Future governance

KRN should continue to follow best governance practices and uphold high governance standards. Once it becomes a holding company, KRN should serve as the minimum standard for governance at subsidiary, to consistently maintain current governance practices across the group.

At the holding company's operating level, the governance framework should include a subsidiary governance framework, whereby the holding entity is able to effectively govern and monitor the performance of subsidiaries. KRN should provide direction on how relationships and exercise of power within the group (HoldCo and subsidiaries) should be structured to achieve group objectives. This includes direction on what should be driven centrally by KRN versus locally by each subsidiary.

Additionally, KRN should consider the impact on its bargaining / negotiating power with local authorities, post-FCDO exit. As FCDO is an arm of the UK government, it is perceived to have a higher level of command relative to locally incorporated entities. Representation of FCDO on KRN's Board is important, especially after the EAGR programme ends, so that KRN can continue to carry out their transformative work and influence regulatory and legislative changes.

i. Institutional assessment: Operations

KRN's as-is operating model and functional structure has been assessed, alongside its readiness and capacity to deliver on its future ambitions & strategies, across three categories:

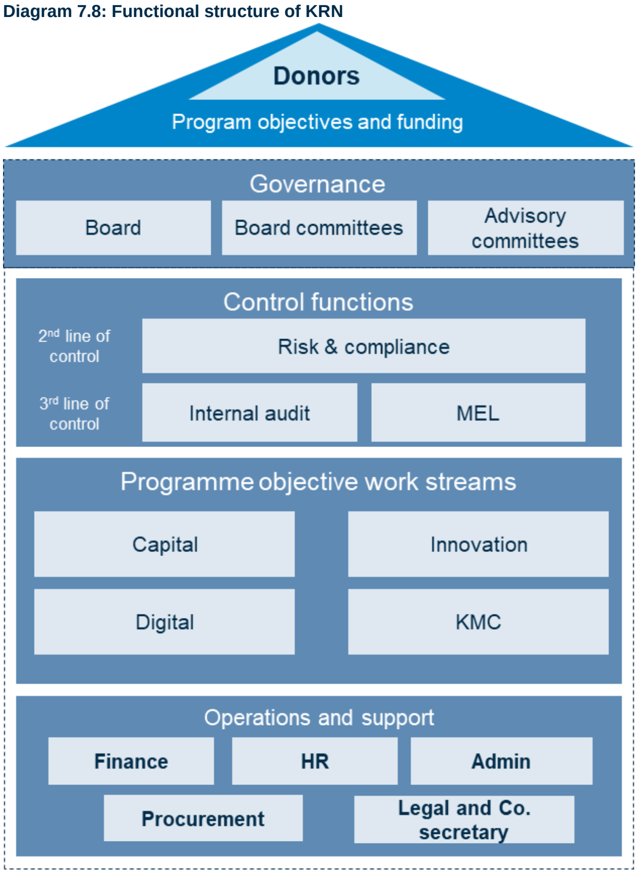
- People and functional structure: Assessment of the current functional and organisational structure, roles and responsibilities of functions, and capacity & capability of resources, keeping the organisational objectives in mind;
- Processes and policies: Assessment of the policies in place and their adequacy, quality of process documentation, mapping of processes, their maintenance and implementation, and the institutional risk management framework;
- Systems: Assessment of the applicability and use of automation and technology within KRN.

Functional and organisation structure

KRN's organisation structure is designed to implement programmes and initiatives that meet FCDO and BMGF objectives. CIC, Innovation, and DFS are the main functions which drive the strategic direction of the company, using the tools (research, studies, etc.) of the KM&C function to promote its work and expand its reach.

Control functions ensure KRN makes progress towards established goals. Support functions provide back-office support required for delivery of objectives. Diagram 7.8 depicts the functional structure of KRN.

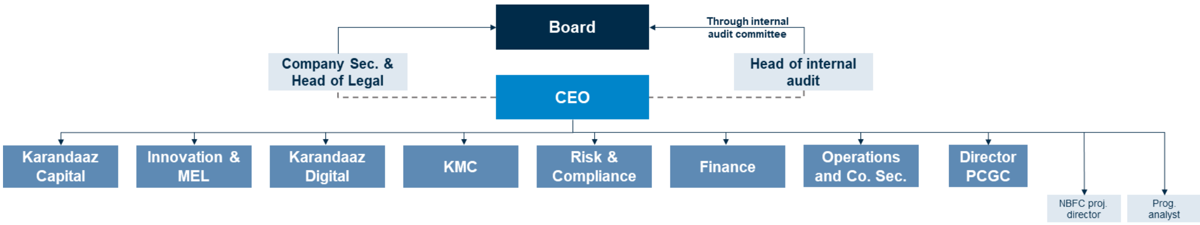
Diagram 7.8: Functional structure of KRN



CIC and Innovation functions primarily execute FCDO-funded objectives, whereas the DFS function is largely funded by the BMGF. BMGF and FCDO have common goals with respect to promoting financial inclusion in Pakistan. BMGF has provided funding for specific initiatives through the DFS function, with focus towards financial inclusion through digitalisation and technology. Additionally, FCDO has funded two digitalisation projects led by the DFS function, which have been covered earlier in Section 6 of this report.

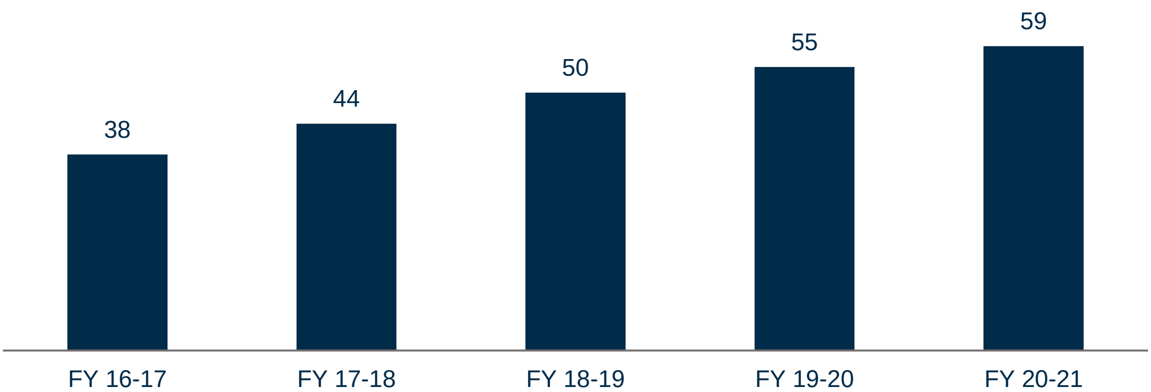
Function level organisation structure of KRN

Diagram 7.9: Current organisation structure of KRN *(till senior management level only)*



As of March 2021, KRN has a total of 60 employees, out of the approved 78 positions, with approved positions hired as the need arises. KRN has maintained a lean organisation structure since inception, outsourcing activities to third-parties or technical experts, where such outsourcing is considered efficient and effective, such as post-monitoring evaluations and assessments, and specialised due diligence activities. With the increase in requirements and activities, KRN should consider increasing in-house capabilities, including the set-up of a PMO function, to reduce dependency on outsourcing *(see capacity and capabilities section of this report ahead)*.

Graph 7.10: Total year end resources employed at KRN



KRN has grown rapidly since inception. Growth has primarily been driven by the initiatives and programmes of the CIC and DFS functions. The organisation structure has also evolved, upon management's recommendation and Board's approval, with growing needs. Seven new positions were approved by the Board in December 2020, five of which are for CIC, one for an Operations / HR analyst and one Associate ICF in WV[58].

As part of maturing the organisation, management has implemented various controls and systems. Operating manuals and functional strategies have been created that govern each function and division. A risk management framework has also been implemented at KRN, with an active risk register. All policies and manuals created are collated in a centralised repository on GoogleDrive® and, in line with best practices, are easily accessible to all staff.

[58] KRN, 2020, *QPR Oct – Dec 2020*

KRN has a relatively low uptake of systems. Finance and HR have implemented internal systems in place, which will be integrated with the new ERP system being rolled out. CIC's portfolio management system will be discontinued and the ERP system will eventually be used for portfolio management and reporting. Functional reporting through the ERP internal processes will also be automated, and it is expected to be rolled out by mid-2021. Implementing an organisation-wide ERP is good practice and complements the organisation's efforts to strengthening internal management systems and reporting, and will help KRN achieve sustainability.

KRN is on the path to establishing strategic investments, and is expanding its SME equity investments portfolio along with a focus on enhancing WV. The ICF rounds are expected to continue, and the digital function is also working on promoting financial inclusion through digitalisation. KRN is working towards achieving programme objectives and, keeping future operations and targets for the organisation in mind, KRN is in the right direction of strengthening its operating structure and systems to become a sustainable and efficient entity.

To fully achieve that state, however, there are still steps and measures to take that can further align KRN with its future needs. KRN should formulate a strategy for the post–2024 period, which should cover the operating structure, systems and controls implemented. There are areas of improvements in terms of creating synergies, enhancing organisation structure, building capacity and capabilities, and diversifying revenue streams that will assist KRN to become a sustainable and commercially viable entity in the post-FCDO period.

Findings and observations for peoples' capacity and capability

This section highlights the overarching resource capacity and capability findings pertaining to the organisation, also identifying areas to improve. The findings are summarised and should be read in tandem with subsequent segments, and the annexures of this report.

Understaffing and resource retention: Multiple functions and divisions, specifically support functions (HR, Risk, Finance, MEL), are understaffed, and retention of resources has also been an issue over time. 109 individuals have been hired till date, and the strength at time of writing this report is 59, from a total of 78 approved positions. Limited career progression opportunities at KRN can be a cause for retention issues as KRN has a lean organisation structure. Furthermore, variable benefits are lower than market, but considering KRN is a donor-funded organisation, not all variable benefits comparable to the market can be provided. KRN has taken steps to improve the variable benefits provided to employees, such as providing fuel cards and child-care allowance. The subsequent section of this report suggests improvements in the organisation structure, which can present career progression opportunities for employees by creating sub-divisional levels within the functions. As strategic investments are made in new ventures, resources can also be given growth opportunities in those subsidiaries.

Succession risk: Multiple departments are currently exposed to succession planning risk, with a gap between team leads / heads and one-downs. KRN has implemented a succession planning policy; however, succession plans are not in place. The exercise started with the management suite before Covid, which was halted during the year due to changes and adaptations towards work-from-home. HR has recently resumed the exercise – listing eligible back-up candidates, and selection of existing employees to create specialised resources via trainings that can handle functional work temporarily in the absence of team leads / heads, but the exercise is yet to be completed. The succession planning exercise should be completed as a priority, with a succession plan put in place.

Synergies and segregation of duties: Research activities are being carried out in multiple departments, with low accountability and impact of research conducted; an integrated and collaborative approach to research can help create better synergies. The KM&C function further details this observation. There is also some overlap in functions which causes issues in segregation of duties, such as Innovation and MEL being clubbed together, and the Director of Operations performing multiple functions.

Absence of key functionality: A Project Management Office (PMO) function, which is necessary for transformational growth, is missing. This could start leading to unnecessary delays in project implementation, as KRN's takes on more new initiatives that require significant coordination with various stakeholder groups. KRN should establish a PMO function, led by a project management professional (PMP) as the Head of the PMO function. Some of the key responsibilities of the function would be to lead strategic initiatives, develop and monitor program plans, manage project bdgets, review program initiatives' goals and objectives, and coordinate & facilitate delivery, providing frequent reporting. *(additional details in the annexures)*

<u>KRN Capital (Corporate Investment and Credit - CIC)</u>

The KRN Capital function focuses on deepening access to finance and providing growth capital to SMEs through debt and equity investments, by piloting innovative products and establishing & using innovative platforms. In addition to generating financial returns for the company, the development aspect of the investments aims at creating additionality and demonstrating to the market the benefits and success of SME financing. Debt and equity investments by KRN Capital are carried out by strategic investments, direct investments, wholesale investments, and energy investments.

The CIC function is allocated the bulk of the EAGR programme funding, ~85%[59] of the total committed funding of FCDO, and has been growing the fastest in relation to other functions, with the approval of five new positions attained in the 33rd Board meeting in December 2020. The function has 22 approved positions, out of which 10 are currently filled. *(additional details in the annexures)*

Findings and analysis for the CIC function

Retention of resources is an issue observed for CIC, with 37% turnover for CIC in 2019 – 2020. Hiring for CIC function, which requires specialised resources, is also an issue, taking up to 2 months on average to fill a position. There are 12 positions currently vacant in the CIC function, with a high workload. KRN should prioritise and hire resources proactively and in anticipation of workload increase, to avoid operational issues. In terms of retention of resources, a lean organisational structure decreases career progression opportunities for middle and junior staff. The average length of service of staff across the organisation is up to ~three years for associate level and above.

A succession plan has not been developed for the CIO, with currently no senior level resource identified to manage the CIC function if the CIO moves, exposing the function to succession risk. Key-man risk exposes the organisation to operational risks and can hamper achieving programme outcomes and objectives. Succession planning and training for one-downs should take place to minimise succession risk. As the function grows, KRN may wish to create sub-divisions within the CIC team, one for equity and one for credit, to mitigate the succession planning risk, and an added position can also add a layer for career progression *(additional details in the annexures).* It is likely, however, that all the debt / credit programmes and activities may be transferred to PFSL, thus reducing CIC's capacity requirements.

[59] KRN, 2020, *KRN Strategy 2020 - 2024*

ESG guidelines are imbedded in the investment strategy, against which all interventions are assessed. All investments have to comply with the ESG framework; the partnerships established by KRN also have to be compliant with the ESG framework. Post-disbursement monitoring of ESG compliance is required, but has not been performed for the portfolio. A specialised resource should be hired and the portfolio assessment for ESG compliance should be conducted *(additional details in the annexures).*

Going forward

As KRN has the ambition to assume a holding company structure, the role of CIC will expand to include subsidiary management, and reporting requirements will also significantly increase. The CIO will be focusing more on the success of strategic initiatives, ensuring they are successfully spun off and made into sustainable / commercially viable entities, whilst also executing pilot programmes and other equity investments at KRN. KRN can also consider spinning-off its equity portfolio into an independent fund, as the portfolio grows.

With subsidiaries being rolled out and new initiatives being implemented at KRN, governance, reporting, and post-investment monitoring will significantly increase under the holding company structure. KRN should enhance capacity to support the CIO in operations and leading sub-divisions as recommended above, while building capacity for subsidiary management and investment monitoring.

Digital Financial Services (DFS) function

The DFS function works with regulators, policymakers, government agencies, banks, public sectors services, businesses and researchers by providing financial and technical assistance. The DFS function has been instrumental in conducting digitalisation activities in the financial sector of Pakistan and has been instrumental in improving KRN’s digitalisation momentum in the market. The function is led by the Chief Digital Officer (CDO), who has been with KRN since November 2016. The function employs a total of 12 people out of the approved 15.

The EAGR LF reflects the DFS function via output 2. As part of the financial inclusion objectives, with funding for DFS coming from BMGF as stated in section 2 earlier, some BMGF-funded initiatives[60] for digitalisation and financial inclusion through technology are:

- Fintech disrupt challenge;
- Micro-payments gateway (RAAST) with SBP;
- Digitalisation of Central Directorate of National Savings (CDNS);
- Information Technology and Information Security strategies for Benazir Income Support Programme (BISP);
- Regulatory frameworks for digital banks;
- E-commerce regulations;
- Digital strategy for National Bank of Pakistan covering Government to Person (G2P) and Person to Government (P2G) payments.

(additional details in the annexures)

Findings and analysis for DFS

Majority of the interaction of the two donors is as observers only at the Board. All projects are funded by either BMGF of FCDO, with low to no collaboration and effort to create synergies between the two

[60] KRN, 2020, QPR Oct – Dec 2020

donor organisations. The two donors should hold reguar meetings to collaborate in an effort to create synergies for increased impact of their objectves and interventions.

The ERP system being implemented at KRN is being rolled out by the DFS function. Considering the expertise developed by the DFS function through digitalisation projects, it seems viable for the DFS function to sponsor and manage implementation of the ERP system. Essentially, though, global best practice is for an ERP system to be owned and sponsored by the Finance function and managed by a PMO function with IT support.

From consultations with the DFS function, it has been observed that the DFS programme manager is overseeing up to 20 projects and runs the programme office for all, with support from two senior analysts. The role of the DFS programme office is to monitor projects, internal reporting, and reporting to donors. This could be the start of a PMO function but needs to be formalised with necessary capacity and capability. Overburdening can lead to programme management issues and execution delays, adversely impacting the measurement of programme objectives and effectiveness. An exercise to assess the work requirements now and for the near future should be conducted; in line with the results from the exercise, additional resources should be considered, if the need arises, to segregate responsibilities.

Going forward

KRN’s strategic investments are aimed to be technology driven. The DFS function is on its way to becoming a center for digital excellence, and the role of DFS can expand to providing technology and digital services for KRN’s subsidiaries.

The BMGF is under discussion for its role post-2024. An extension of their funding and involvement can prove beneficial for the organisation and its efforts to improve the financial MSME landscape of Pakistan. The continued involvement of a bilateral donor like BMGF also adds a layer to governance and accountability.

KRN Knowledge Management and Communication (KM&C)

The KM&C function has two sub-streams; Knowledge Management, and Communications. Knowledge Management (KM) is a research function for KRN to bridge knowledge gaps in the financial inclusion space. It develops and disseminates evidence-based insights and solutions for the industry as a whole, and also performs research and landscaping studies for initiatives of KRN, and in areas of financial architecture were knowledge gaps exist. The communications function creates awareness, and runs campaigns of KRN’s initiatives’, creates impact videos, and works on improving the organisations brand image, via managing its social media presence.

The function is led by a Director, reporting to the CEO. The current director of KM&C has been at KRN since February 2016. Initially, ICF was part of the KM&C function till it was carved-out and grouped with the MEL function in 2016. The function deploys a lean team structure of 6 staff *(additional details in the annexures).*

Findings and analysis for the KM&C function

The Director of KM&C regularly participates in management meetings, where research priorities and activities are discussed and approved. However, there seems to be room for improved coordination and utilisation as some functions conduct their own research for different purposes. Additional synergies can be created if research activities (industry, segments, landscaping, regulatory, etc.) for all functions is integrated within the KM&C function, which will reduce duplication of effort *(additional details in the annexures).*

The KM&C function's targets and objectives are derived from the LF, and it is a cost centre within KRN. Considering that the KM&C function is conducting research of multiple segments and industries, and is regularly involved with external stakeholders and regulators for research, policy discussions and recommendations, a management level KM committee should be considered, to include participation of the designated technical experts from each function (CIC, DFS, ICF, WV) to discuss findings, news, updates on policy and research activities. Each person could be designated the responsibility of relaying and coordinating research efforts within their respective function.

The KM&C function often underutilises its budget and has not asked for an addition to the budget over the years. Budget underutilisation implies that either the budget setting process is incorrect, or the KM&C function is underutilised. The budget setting process for the function should be revisited and analyzed. KPIs and objectives of the KM&C function should be assessed for better allocation and better utilisation, which will also help improve internal productivity.

Going forward

As KRN evolves into a holding company structure, with strategic investments being spun-off, the Board and management has the ambition to become a knowledge center for its subsidiaries, its equity investees, and the market. Post-FCDO exit, a strategy should be created for the KM&C function to set its objectives and drive functionality as the current targets are laid out in the LF. To convert KRN into a knowledge center, the KM&C function needs to build its capacity by hiring resources in order to build the function's capabilities and increase connectivity with the market. Budget allocation should be revisited and increased for the KM&C function. The KM&C function can also provide shared services to KRN's strategic investments and assist with group-wide research development activities, going forward.

The ICF & MEL function

The KRN Innovation function is part of the ICF & MEL department. In 2016, ICF was carved out from the KM&C function and clubbed with MEL, led by a Head of ICF & MEL. The current Head of ICF &MEL joined KRN in 2020, replacing the previous head of ICF & MEL who led the function from 2017 to 2019.

The Innovation function provides risk capital and grants to generate innovative solutions through its challenge rounds to address issues in financial inclusion for the EAGR programme. The Innovation function has run six Challenge Fund rounds (ICF & WEC) across various areas for financial inclusion. Over time, based on learnings from the initial rounds, the Innovation function has established criterion for ICF. The Innovation function has also run multiple rounds with specific focus on promoting women entrepreneurship, namely Women Entrepreneurship Challenge (WEC) fund for women-owned SMEs. The success of these rounds has enabled a separate sub-function and WEC has been renamed as Women Ventures *(additional details in the annexures).*

The Monitoring Evaluation & Learnings (MEL) function is designed as an independent control function responsible for:

- Assessing the context & environment in which KRN is operating, to gauge if a change in any external factors will impact the programme;
- Assessing the programme and project level objectives, targets, outcomes and results to gauge the progress of achieving output milestones;
- How the results contribute to KRN's LF.

Review and evaluation is conducted through various assessments, field visits, stakeholder interviews, deep-dive studies, rapid assessments, and data quality assessments to see how a project has succeeded or been constrained in achieving intended results. MEL reviews and assesses the results models that KRN uses, providing recommendations for change and improvement. The results and findings are reported periodically to multiple internal and external stakeholders, which are then used for accountability, evidence-based decision making, achieving better VfM, improving programme performance, and course-correction. Additional details on the MEL function are provided in the annexures of this report.

Findings and analysis for the ICF & MEL functions

Innovation and MEL functions are led by the same individual. Innovation is a function executing programme objectives, and MEL is supposed to be an independent control, assessment, and evaluation function. With the MEL function reporting to the same team lead as ICF, conflicts of interest exist. Best practice is to have a clear segregation of duties and independence in the reporting hierarchy for the lines of defense[61]. The two functions should be separated, creating independent functions for each. The MEL function should be separated from any of the initiatives it is meant to monitor and evaluate.

Findings and analysis for Innovation function

There is an increased focus on expansion of the WV portfolio by taking in rolling applications, which has increased the amount of work for the same number of resources. Understaffing and over exhaustion of resources can lead to poor outcomes of the function and ultimately the function could fall short of achieving its objectives. As the portfolio continues to grow, approvals for additional resources should be taken from the Board to hire and onboard required resources. Keeping cost considerations in mind, sub-divisions of ICF and WV can be created going forward, reporting to the Head of ICF, with a dedicated senior level resource for each sub-function supported by an associate or a senior analyst, also mitigation succession planning risk *(additional details in the annexures).*

[61] WB, 2015, Report on Risk Culture, Risk Governance, and Balanced Initiatives

Going forward

KRN intends to continue executing the ICF rounds, though discussion is ongoing on whether the rounds should be conducted in a similar manner - i.e., adding new challenges per each round, or running multiple rounds of the same challenge till a visible impact is seen, or diverting the funds towards other initiatives. The WV portfolio will continue accepting applications on a rolling basis in the near to medium term, with discussions in place to assess and finalise the strategy going forward. The WV portfolio can be converted and spun-off into a separate and an independent fund, specific for women-led businesses.

Findings and analysis for the MEL function

Ten internal assessments[62], evaluations, reviews, and case studies have been conducted by the MEL function since inception, by external consultants. Only two assessments have been conducted in-house along with development of 19 monitoring reports of the initiatives.

Baseline assessments of DFS' MPG and CDNS projects are aimed for this year, and the assessments previously on hold for SECP digitalisation / STR and BISP due to programme related delays are now expected to be conducted thereafter. KRN has learned that conducting impact assessments for projects should be carried out at an earlier stage of implementation, in order to apply course correction and lessons learned during the initial stage of the project.

As initiatives of the EAGR programme are maturing, the number of evaluations and assessments required will increase, which in turn will increase the MEL function's workload. The MEL function, with only two resources, is understaffed to handle significant increase in workload. The frequency and volume of reporting to the Board and donors is likely to increase as the EAGR programme is nearing completion, and as strategic investments are also rolled out. Though the ERP system being implemented will assist in operational data recording and reporting, in the absence of a centralised coordination function, such as a PMO function, the MEL function is likely to be receiving and coordinating various reporting requirements from subsidiary entities, also increasing the workload of the MEL function. As mentioned earlier, the MEL function should be separated from ICF. *(additional details in the annexures).*

Going forward

Going forward, the workload for MEL will increase considerably as, in the second phase of the programme, assessment and evaluation of all initiatives is intended, in addition to the imminent launch of new strategic initiatives and SBUs. Currently, a lot of reporting and evaluation requirements come from donors as part of programme compliance. Post-FCDO, the Board's oversight of the MEL function would have to increase to ensure functional responsibilities. Capacity enhancement of the function is required by hiring additional resources.

Risk & Compliance function

The Risk & Compliance function is responsible for overseeing, monitoring and advising on credit and equity risk on a portfolio basis and on a transaction basis, providing an opinion to the Investment Committee on the proposals shared by the CIC team. It is also responsible for managing the overall risks of the organisation. With bulk of the EAGR programme's funding going towards CIC investments, robust risk management and oversight is critical at KRN.

[62] KRN 2020, MEL assessments provided

The Chief Risk Officer (CRO) was hired in 2019, following recommendations of the prior EAGR annual review 2018 to build capacity of the risk function. Before formalisation of the Risk function in 2019, risk related activities at KRN were the responsibility of the Finance function, and investment proposals were shared directly by the CIC team with the Board and Investment Committee, without a proper detailed risk assessment. The Risk function now conducts independent assessments of investment proposals, as outlined in the Credit Policy and Investment Manual. The opinions are presented during the Management Investment Committees and also considered by the Board Investment Committee, depending on the size of the investment or transaction being proposed. The CRO is also nominated for the Board and Board Audit Committee of PFSL *(additional details in the annexures).*

Findings and analysis for the Risk function

There are only 3 resources, including the CRO, who are responsible for overseeing and assessing transaction risk. Some due diligence responsibilities are also delegated to external consultants - e.g., commercial due diligence for private equity transactions. The Risk function is also responsible for regular monitoring of all transactions and on a portfolio basis, along with regular reporting requirements to the Audit Committee. Reporting to the Board and implementation of various controls for the Risk function implies good capability of the function. The Risk function intends to transition into a Group Risk function as KRN assumes a holding company structure.

It was observed that there is no succession plan for the CRO, which should be developed. Capacity of the Risk function also needs to be enhanced if KRN is expected to continue to increase its risk management activities, given the increase expected in direct interventions and activities *(additional details in the annexures).* It is likely, however, that a number of direct interventions for credit due dilligence may shift to PFSL.

<u>**Finance function**</u>

The Finance function is responsible for financial management, including business planning and analysis, treasury / cash management, budgeting and capital calls, and book-keeping. Finance is also responsible for generating, maintaining and providing timely and accurate management information reports to all other functions. The Finance function is also responsible for financial reporting to Regulators, Board, Board Committees, and Donors *(additional details in the annexures section).*

Findings and analysis for the Finance function

The present Finance function at KRN is largely an accounting function, focused on book-keeping and payment processing activities. The CFO and the Finance function should also focus on strategic activities, supporting the management in business planning. Considering the evolution of KRN into a holding company, the current Finance function has a low role in the organisation’s strategy and transformation. As such, the Finance function needs to transform, with an enhanced and centralised role in the organisation *(additional details in the annexure section).*

<u>Going forward</u>

Under a holding company structure of a Group Finance function, and moving away from donor funding, the Finance function should be responsible for creating investment documents and memorandum for capital raising, developing and coordinating group strategies, monitoring performance and be the single source-of-truth for all data. The role will increase as the strategic initiatives start to roll out and become operational.

An assessment should be made for additional specialised resources required for subsidiary management, to increase functional capacity.

Operations and Company Secretary functions

The HR, Admin, Procurement, and IT functions are clubbed under the Operations department, which is led by a Director Operations, who is also the Company Secretary. The Director Operations was previously the Head of HR and has been at KRN since inception. There are a total of 14 resources across the three functions of HR, Admin, and Procurement *(additional details in the annexures).*

Findings and analysis for the Operations department

As KRN assumes a holding company structure going forward, KRN should consider transforming the existing Operations function into a shared services centre for all new portfolio entities, in order to achieve efficiencies and consistencies across the group. To cope with the increased responsibilities of the Operations function, KRN should hire a dedicated Company Secretary.

Considering implementation of an ERP platform and the expected increase of technology within KRN, a dedicated IT department should be created under Operations, with responsibility of IT-related procurement, vendor management, implementation, maintenance and integrations. While 1 IT resource currently exists under Operations, the capacity needs to increase with the defined responsibilities of an IT function.

Findings and analysis for the HR function

There are only two HR resources (excluding the Director Operations, who is also the Head of HR) for an employee base of 59. There is a large amount of operational work that is being handled by one Operations Manager and one Engagement Manager, which includes HR operations, recruitment, goal setting, performance evaluation, exit management, training and development. The HR function is understaffed, which can lead to ineffective performance.

A manpower plan is absent. HR should create and manage a 3-year manpower plan in consultation with other functions to align the HR needs, and should be developed keeping a holding company structure in mind. This can also help increase efficiency as strategic planning happens proactively.

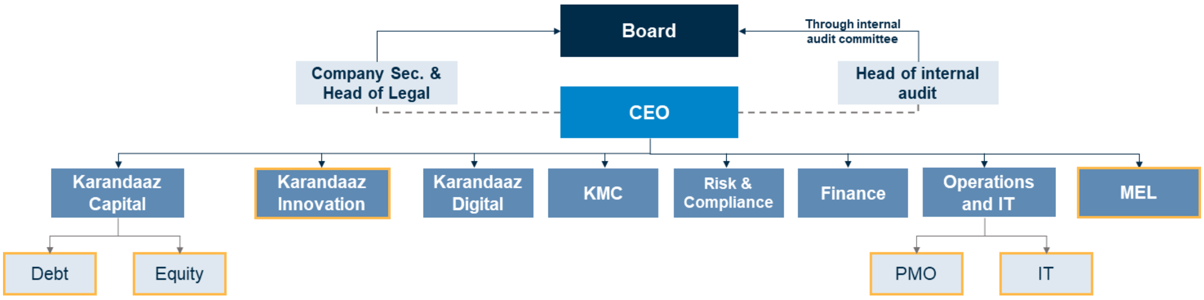
The HR function is also responsible for succession planning across the organisation. A succession planning policy has been implemented since last year, and the process to create a succession plan is underway, though not yet created. This is an example of an important role of the HR function not being carried out due to under-staffing. Capacity needs to be enhanced as the function takes on more responsibility *(additional details in the annexures).*

<u>Going forward</u>

As the organisation grows and all the 78 approved positions are filled, significant HR responsibilities will increase, also considering that KRN has a lot of specialised hiring. Additionally, as the HR function assumes the role of a group HR function and provides shared services, assisting subsidiaries and equity investees with their HR needs, significant capacity building will be required.

The recommended interim organisational structure with key changes is as below

Diagram 7.11: Suggested changes to the organisation structure of KRN



- **The highlighted boxes in orange are the key changes and additions to the organisation chart for overall improvements to the organisation structure.**

Performance against the LF

- Output 5 of the LF measures indicators against efficient, visible, and professionally managed and sustainable SPVs. Output 5.3 measuring indicators for high quality strategic and performance management, against which KRN fared well, meeting all of the indicators

Since inception, KRN's organisational structure has evolved as the needs of the organisation have grown and new initiatives rolled out. Controls and systems are being added and strengthened to mature the organisation to align with programme objectives and to protect programme assets. Various controls such as a risk framework and governance measures are already implemented. Policies, procedures and manuals are also being continuously developed and implemented. Considerations for possible strategic direction, as assessed from consultation, are provided in the annexure section of this report.

Key risks & challenges for the operating structure

- Hiring of appropriate resources, considering KRN has a lot of specialised hiring, specifically for the risk function (of KRN and strategic investments). Considering the target future state and group functions providing shared services, more specialised resources will be required, and absence of the available pool can lead to delay in hiring and operations;
- Retention issues, especially for senior management, and undue turnover of staff can add to the existing succession planning risk, which can impact organisation's growth;
- As KRN evolves into a holding structure, new policies, procedures and processes will need to be developed. Absence of these, or developing poor quality policies and manuals can lead to inconsistent operations, or incorrect recording of data, impacting programme level objectives. If there is poor governance, the implementation of policies can be hindered.

j. Institutional assessment: Sustainability

The EAGR programme envisioned KRN to graduate over time from being donor dependent to an independent revenue-generating entity, able to support its own operations. Therefore, since inception, KRN has been committed to the goal of achieving sustainability. KRN's preparedness for FCDO exit will be assessed, with consideration for items to be resolved prior to FCDO exit.

Steps to sustainability

KRN's Board is already independent from FCDO and BMGF participation and, hence, is designed for sustainability from that perspective. The FCDO is yet to formalise the level of involvement with KRN, post official exit.

KRN is evolving its current operating model to eventually assume a holding company structure, rolling-out its initiatives into subsidiaries. For KRN to be sustainable, individual subsidiaries need to be sustainable in their own right, operationally and financially.

Corporate governance arrangements for individual entities need to be robust and should be guided by KRN's own governance framework, as described in the Governance section of this report, keeping in mind the principle of proportionality. KRN should continue to be guided by the SECP's 2019 Corporate Code of Governance for their future governance framework.

KRN's management will have nominee directors on subsidiary Boards, which will help with general oversight of company performance but also enable KRN to directly influence strategy, decision-making and ensure KRN's interests are protected. Necessary training should be provided to the management nominees so that they understand their responsibilities as Board members. KRN should also be mindful of the risk of diverting attention of key management members from their existing KRN responsibilities, as their time could be heavily consumed in the new initiatives they will be on the Board of.

Given subsidiary entities will be regulated, there should be clear delineation of KRN and subsidiary governance and responsibilities of Boards, to ensure KRN is not exercising any power or rights over regulated activities.

Integrated reporting disciplines should be put in place to enable KRN to make informed assessments of the performance of its subsidiaries. KRN should provide clarity on the process for reporting, especially in terms of quality and frequency. KRN should use PMIC reporting disciplines as best practice for other subsidiaries and portfolio companies.

Implementation of a group-wide ERP system would be ideal. However, this may not be viable or possible due to specific requirements of each subsidiary. KRN should plan to at least integrate reporting through the individual ERP platforms set up at subsidiary level.

KRN is operationally set up to function as a stand-alone entity. Therefore, FCDO's exit will not impact their ability to operate. However, given the reliance of the ICF, MEL and KM&C functions on grant funding, their performance will be impacted by FCDO's exit. The impact on performance of these initiatives will need to be considered prior to FCDO's exit.

KRN's focus has primarily been on achieving financial independence from its donors, through the growth of their credit investment arm. KRN has already achieved partial operational sustainability[63] which is primarily a result of the increasing annual debt repayments. By making portfolio investments and strategic initiatives, it has also been working towards diversifying its revenue, which will eventually comprise of capital gains at exits and dividend pay outs from equity investments.

KRN will need to carefully plan and model within their financial projections, when they will be expecting capital gains and dividend pay-outs. Portfolio exits, although planned for all equity investments, are not expected in the short to medium term. KRN's Finance function needs to enhance its capability to financially project expected revenue streams.

KRN can also enhance the KM function, with the objective of becoming a center of knowledge and excellence for the market. KRN has already taken steps in this direction, such as the launching the data portal.

<u>Strategic initiatives</u>

Sustainability of KRN is also heavily dependent on the financial strength of portfolio entities and subsidiaries:

- PMIC is making regular payments to KRN for the subordinated shareholder loan, which accounts for up to 45% of KRN's own source revenue (OSR). The high reliance on PMIC for funds poses a concentration risk to KRN. A small number of missed instalments from PMIC will have a proportionately large negative impact on KRN's OSR and, hence, sustainability. KRN's balance sheet concentration risk of PMIC subordinated debt needs to be addressed prior to FCDO exit;
- PFSL: It is a NBFC which is not yet operational, with a low / nil capital base and non-existent balance sheet. It will take some time for PFSL to be fully operational and be a commercially viable entity, and will face a number of challenges and risks;
- IZP & PCGC: Similarly, PCGC and IZP are in the nascent stages of implementation. PCGC still has some regulatory hurdles to cross before becoming operational and IZP is still being set up operationally. There is little capital buffer at both these entities to be able to help keep KRN sustainable in the short to medium term;
- Equity Investments: KRN has only just started to receive dividend payments from some of its equity investments, which will not be significant in the short-to-medium term. Capital gains from exits are also not expected in the short-to-medium term, as KRN is expecting to hold its investments for the next five to seven years;
- Wholesale investments: The future of KRN's RPA arrangements is to be determined, depending on whether or not the RPA programme will be replaced by PFSL's direct lending. Sustainability is therefore dependent on the decision taken regarding the RPA programme;
- Others: Women Ventures, ICF and other initiatives are much smaller in scale and impact. Unless KRN decide to scale these, they will not have much impact on operational or financial sustainability of KRN.

[63] Stakeholder consultation

Conclusions

There is some way to go before KRN can be fully sustainable without donor assistance and donor oversight, especially given the nascent stage of most initiatives and lack of performance of some. Although they may be able to sustain themselves operationally, due consideration needs to be taken on whether they can be as successful without donor support.

There are a number of risks which need to be mitigated prior to FCDO exit, which include:

- Succession planning and key-man risk: no succession plans have been put in place at management level. Departure of a senior manager will create significant knowledge gaps and impact KRN's ability to transition effectively into a HoldCo;
- Concentration risk of PMIC's subordinated debt repayment on balance sheet;
- Impact on performance of functions and initiatives solely funded by FCDO;
- Diversification of product portfolio to diversify revenue streams;
- Capacity constraints at operational level
- Accountability and continued FCDO oversight and support.

Sustainability of KRN will largely depend on the robustness of the holding company and subsidiary governance frameworks, and risk management practices implemented group-wide, which should ensure continuous monitoring and course correction of activities.

k. Institutional assessment: Financial

This section provides an assessment of whether KRN has achieved success in bringing in capital from additional sources through any if its interventions and, if so, the quantum in terms of leverage factor. KRN's strategy and balance sheet is driven by LF indicators. How KRN aims to achieve those with the perspective of its own balance sheet is also assessed.

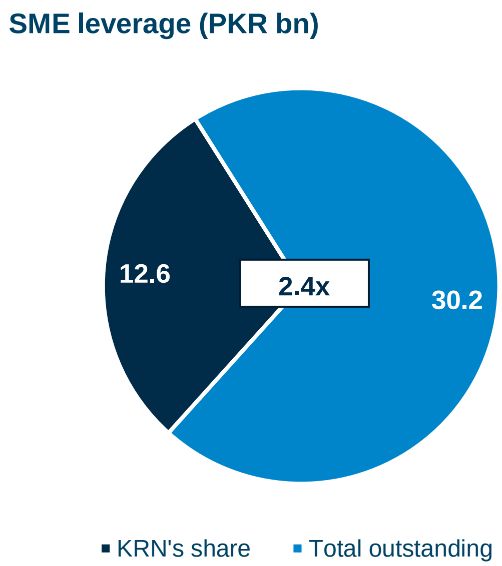
KRN is already leveraging its own balance sheet through its RPAs and other wholesale lending, direct SME equity investments, and strategic investments as these interventions have been successful in raising capital from other resources.

Two leverage factors are calculated - an MSME leverage factor, and an SME leverage factor - with the difference in the two being investment in PMIC and the capital it has leveraged. Capital crowded-in that is attributable to KRN's intervention is considered - e.g., where some equity investees have raised a debt line that they would have managed even prior to KRN's intervention, are this is not included to calculate KRN's leverage factor.

Output indicator 3.1 - Size of outstanding SME financing (debt and equity) portfolio leveraged via KRN supported facilities is the LF indicator. The indicator value in the QPR Jan – Mar 2021 has a value of outstanding SME financing at PKR 30.2 bn through KRN's disbursement of PKR 12.56 bn (leverage factor of 2.4x).

For the MSME leverage factor, the investment (equity + shareholder's debt) in PMIC and the capital PMIC has crowded-in are added.

Graph 7.12: SME portfolio leverage



Graph 7.13: MSME portfolio leverage

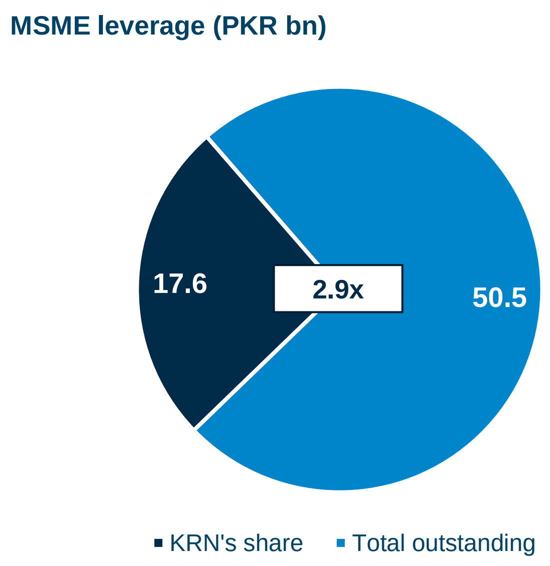


Table 7.14: Outstanding MSME financing

	KRN's share (PKR bn)	Size of outstanding financing (PKR bn)	Leverage (x)
RPAs, TFC, MTN	4.10	10.74	2.6
Total wholesale lending (including direct lending and SH debt to excel labs)	5.45	12.17	2.2
SME equity	3.96	8.30	2.1
SME strategic investments	3.15	9.75	3.1
PFSL	*1.50*	*1.50*	*1*
IZP	*1.65*	*8.25*	*5*
PCGC	-	-	-
Total for SME equity and strategic investments	7.11	18.05	2.5
Total SME portfolio leverage	**12.56**	**30.22**	**2.4**
PMIC*	5.02	20.25	4
Total MSME portfolio leverage	**17.58**	**50.47**	**2.9**

**PMIC's leverage factor is also independently referenced in the LF through output indicator 1.3*

- The calculation above does not include the quasi-equity PKR 367.1 mn disbursements under the WV portfolio. No WV beneficiaries have raised debt or equity post KRN's intervention until now. The corresponding LF indicator (3.1) also excludes the WV portfolio, which is separately referenced in the LF.

Owing to PMIC's success in crowding-in capital, the (total) MSME portfolio leverage factor is higher than the SME portfolio leverage factor. The RPA programme has the highest leverage factor of 3.48x after PMIC, showing that the instrument has success in bringing additional money into the SME space. Viewing the leverage factor independently does not present a complete picture. Whether the crowding in of capital has shown a viable demonstration effect or not depends on the overall success of that particular intervention, not just crowding-in of additional capital.

Although the RPA, TFC & MTN programmes has a leverage factor of 2.67x, KRN believes it has not achieved the success and demonstration it wanted through this programmes, thus the direction towards PFSL. Similarly, amongst SME equity investments, HAC-Agri is leveraged 5.24x (considering its total financing raised of PKR 2.15 bn – which is not included in the calculations above – only KRN's share of PKR 410 mn is used), but KRN is planning an exit from it due to equity erosion resulting from operational issues in the company. SME equity investments in Excel Labs and Secure Logistics Group is 1x and 2x respectively, lower than others, but are proving as viable interventions from the performance to date.

The strategic investments of KRN have a leverage factor 3.1x (excluding PMIC). However, it is important to note that out of KRN's 3 strategic investments, PMIC is the only operational entity, with PFSL and IZP expected to go operational this year. PMIC has been a successful entity in terms of performance and growing the balance sheet, with a leverage factor of 4.03x.

How KRN aims to grow its balance sheet, the interventions and their strategies going forward, the performance of initiatives, and more specifically, the performance of strategic investments will have an impact on the leverage factor. The risks and challenges to the leverage factor and balance sheet are also discussed in this report.

What is KRN's long term view on growth of its own balance sheet?

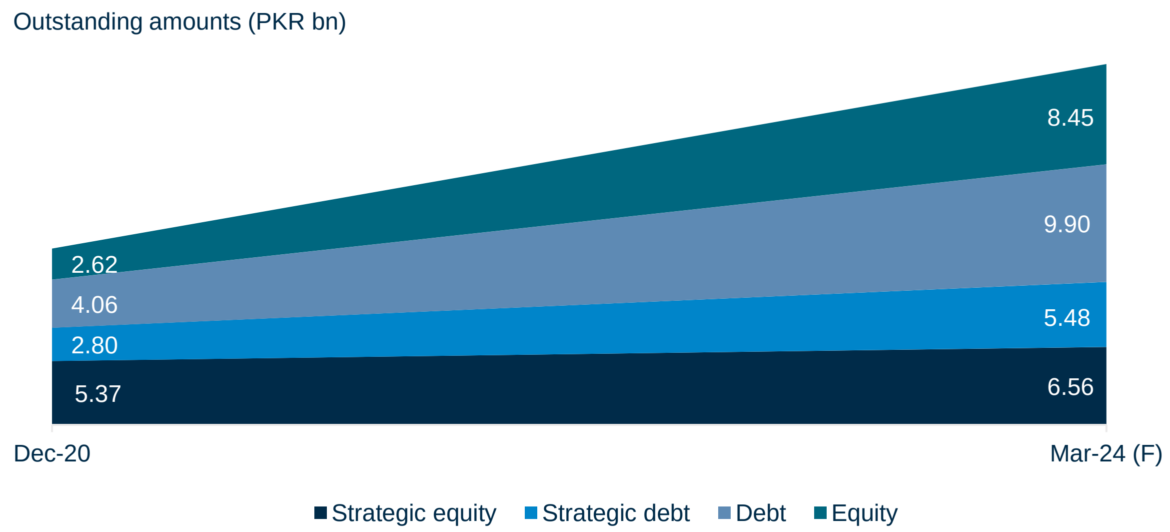
The LF indicator 3.1 has a March 2024 target for KRN of size of outstanding SME financing (debt and/or equity) portfolio leveraged via KRN supported facilities* to be PKR 51.9 bn[64]. The outstanding portfolio (inclusive of PFSL) for SME is at PKR 30.22 bn at Mar 2021.

Going forward, KRN has an ambition to become a holding company, managing its strategic investments. KRN is viewing growth in its balance sheet through increasing its asset base, which comprises of four key components:

- Strategic equity (PFSL, PMIC etc.);
- Strategic debt (Shareholder loan to PMIC);
- Debt (Wholesale lending);
- Equity (Excel Labs, SLG, Techlogix etc.).

The graph below shows the current values versus the target for March 2024, as per the strategy document.

Graph 7.15: Targets for assets as per the KRN strategy 2020 – 2024 document



[64] KRN, 2020, Logframe Feb 2021

KRN has disbursed funds in 3 strategic equity investments, and PCGC is under progress. The direct SME equity investments being made are expected to continue with target of up to three equity investments annually with a PKR threshold equivalent to USD 3 mn. Converting the direct equity investments as a strategic equity spin-off into an independent direct investment platform is an option to be considered. As the need arises and the market landscape allows, additional strategic investments / spin-offs can also be considered, such as spinning off the WV portfolio.

KRN intends to move most of its wholesale lending (debt) to PFSL. The current equity investment in PFSL is PKR 1.5 bn and is expected to increase to PKR 3 bn in year three, after which additional capital via borrowings are expected to be raised. Moving KRN's debt portfolio to PFSL will have an impact on the leverage factor as well. RPAs through KRN have a higher leverage factor, but PFSL's direct lending will have a leverage factor of 1x initially. It is yet to be decided if the current RPA portfolios will be transferred to PFSL, as it has burdensome administrational work of amending each individual contract under the RPA, which will require the presence of the end-beneficiary as well. Current RPAs can be retained under KRN to avoid the operational task and CIC further intends to execute pilots and riskier wholesale lending programmes from KRN which, upon success, can be taken up by PFSL. The shareholder's debt to PMIC and any such additional facility provided will be retained on KRN's balance sheet as they also contribute to KRN's own source revenue.

The balance sheet numbers and the leverage factor will also be dependent on KRN's exit strategy from its investments. Exit from PMIC or other equity investments will reduce the exposure and can reduce leverage, but a successful exit at a higher multiple can also impact the balance sheet positively, which should be the objective.

Additional components of the asset base are the SEED programme and the WV portfolio. The target to build the SEED equity and debt portfolio with 50% split is PKR 3.1 bn by 2024[65]. The programme is still awaiting approvals before it can be continued. Although the WV portfolio is not used in calculating the leverage factor, the quasi-equity provided to beneficiaries is part of the asset base. The LF output indicator 4.4 for WV has a target of PKR 600 mn[66] and KRN aims to build a quasi-equity base of PKR ~761 mn, investing up to PKR 75 mn annually[67].

The overall target to achieve a balance sheet asset base is of PKR 34 bn by March 2024, from current ~15 bn. The March 2024 target of output indicator 3.1 of outstanding SME portfolio of PKR 51.9 bn is aimed to be achieved through crowding-in capital under its wholesale, direct, and strategic investments. KRN will require active monitoring of performance of its strategic investments to achieve this target.

KRN also has to plan growth in its capital base / funds post-FCDO's exit. It will be dependent on outside capital and funds, contributions, grants from other donors or sources. In addition to its own income to finance its investments, KRN can accept contributions, donations, grants from sources such as bilateral donors. As budget for FCDO's funding towards financial sector in Pakistan is reducing, additional budget for export growth and climate investments are being planned. Use of bilateral agencies to increase its capital base will help KRN retain the current development mandate. KRN can also borrow or raise capital as per the Companies Act 2017 and, considering its objectives, raising debt post-FCDO exit, or establishing an endowment fund to achieve its objectives is an option that can be considered[68].

Key risks and challenges to leverage and balance sheet

[65] KRN, 2020, KRN strategy 2020 - 2024
[66] KRN, 2021, EAGR Logframe Feb 2021
[67] KRN, 2020, KRN strategy 2020 - 2024

[68] SECP, Companies Act, 2017

The performance of the investments and initiatives will have a rolling effect on the balance sheet. The balance sheet value can increase through share in profits and deteriorate through equity erosion or default on debt. For example, poor exposures taken by PFSL, or the guarantee companies can significantly impact the capital base, in turn affecting KRN’s investment. Performance of SME investments will also have to be monitored as losses there will adversely affect KRN’s balance sheet - e.g., the current loss in HAC-Agri is causing equity erosion of KRN, impacting KRN’s balance sheet negatively.

Regulatory and legislative issues can hamper raising equity for KRN, if there are increased controls to foreign currency movement in and out of Pakistan. The regulatory environment around section 42 companies is already stringent, and there is increased focus on AML/ CFT monitoring. Budget cuts from bilateral agencies can also make it difficult to raise additional capital as the bilateral agencies would be more analytical in allocating their limited resources.

I. Programme Accountability and Impact

Accountability

Purpose EAGR overall accountability

The purpose of this section is to provide a holistic and evidence-based assessment of KRNs performance on EAGR, based on the EAGR LF.

Assessment of EAGR's end-of-program targets against mid-term achievements

This section uses the below mentioned categories for assessment of EAGR's progress with respect to end-of-programme targets. The assessment uses 50% as the assessment benchmark. However, information obtained through consultations related to EAGR progress is also accounted for & documented, where required. Output 2 is related to DFS, and targets are to be populated after the first use-case of the Micro-Payment Gateway is rolled out by April 2021; hence, they have not been added to this assessment.

On-Track	**'24: ≥ 50%**	**In the right direction**	**50 < '24 ≥ 40%**	**At risk**	**'24: < 40%**

Table 7.16: Outcome indicators (for microfinance)

Outcome indicators (for microfinance)	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
Cumulative number of beneficiaries accessing microfinance from PMIC	1,297,308	824,707	63.57%
Cumulative incremental contribution to revenue/output of enterprises due to PMIC (PKR bn)	198	83	41.90%
Cumulative total number of jobs supported by PMIC	2,365,476	819,566	34.65%

PMIC's growth was hampered in 2019 & 2020. It is expected that PMIC will pick up pace from 2021, providing strength to the future outlook of its indicators. 2022 year will be critical and if PMIC does not perform well, a downward revision may be required in the targets for 2024.

Table 7.17: Outcome indicators (for SME financing)

Outcome indicators (for SME financing)	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
Cumulative number of SME beneficiaries accessing KRN supported financial services	5,966	1,973	33.07%
Cumulative incremental contribution to revenue/output of SMEs (PKR bn)	169.50	67.10	39.59%
Cumulative total number of jobs supported by SMEs	127,474	52,857	41.47%

The SME segment is trailing behind its end-of-programme objectives. Although a significant increase is witnessed from January – March 2021, more effort is required to achieve 2024 targets. Otherwise, a downward revision will be required for 2024 SME targets.

Table 7.18: Outcome Indicators (for job support)

Outcome Indicators (for job support)	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
Cumulative total number of jobs supported for women	1,331,384	557,980	41.91%
Cumulative total number of jobs supported for youth	1,051,141	425,266	40.46%

PMIC is the main contributor in supporting jobs for women and youth. As discussed above, the progress of PMIC against March 2022 targets will determine if the targets for 2024 need to be lowered.

Table 7.19: Output 1: PMIC

Output 1: PMIC			
Output indicators	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
1.1 Outstanding loan portfolio of PMIC (PKR bn)	57.7	23.1	40.03%
1.2 Percentage of outstanding portfolio under Microfinance Plus (MF+) Initiatives	15.50%	5.50%	35.48%
1.3 Leverage factor i.e. all funding raised by PMIC other than KRN divided by total KRN financing to PMIC	7.20	4.03	55.97%

Table 7.20: Output 3: SMEs

Output 3: SMEs			
Output indicators	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
3.1 Size of outstanding SME Financing (debt and/or equity) portfolio leveraged via KRN supported facilities (PKR bn)	51.9	30.2	58.19%
3.2 Investment Return [Annual]	8.40%	6.30%	75.00%
3.3 Size of outstanding portfolio leveraged via non-bank financial channels (PKR bn)	27.2	11.6	42.65%
3.4 Percentage of KRN credit portfolio at risk *Over 90 days	<15%	0.40%	100.00%

Output 3.3 is currently behind schedule as PFSL, IZP and PCGC have not yet become operational. While this assessment understands that PFSL and IZP will become operational soon, the regulatory hurdles faced by PCGC are issues which may continue to impact this indicator adversely.

Table 7.21: Output 4: SME Finance Products

Output 4: SME Finance Products			
Output indicators	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
4.2 Cumulative number of SME finance knowledge products (policy briefs, studies, analytical notes, data portal etc) for informing KRN investments	40	23	57.50%
4.3 Cumulative number of Innovation Challenge Fund rounds - contracts with partners in place	10	7	70.00%
4.4 Size of Women Entrepreneurship outstanding portfolio (debt and/or equity) (PKR mn)	600	367	61.17%

Table 7.22: Output 5: SPV

Output 5: SPV			
Output indicators	Targets (March '24, set in '21)	Achieved (Mar '21)	Prog. on Mar '24 targets
5.1 Percentage of operating cost that can be supported from own source revenue	100%	83%	83.00%
5.4 Cumulative number of Communication Events (CE) and Visibility Products (VP)	129 CE	99 CE	76.74%
	265 VP	200 VP	75.47%

EAGR LF Assessment

The table below provides an assessment of EAGR's existing LF (2021). This assessment is based on indicators identified from various literature on LFs (already referred to in this section) that are required for an effective results measurement tool.

Table 7.23: Assessment of EAGR's LF

Indicators	Ratings (1 to 5) 1 = poor and 5 = good Reasons mentioned in footnotes for scores < 4
Provides common understanding among programme stakeholders with agreed and focused objectives	5
Establishes a logical hierarchy of means by which objectives will be reached	5
Objectives are clear, coherent and measurable	5
Makes your main goals and objectives clear to anyone who is interested in your outcomes and impact	4
Provides a systematic framework for monitoring and evaluation.	4.5
Identifies potential risks	4.5
Presents a summary of the intervention in a standard format.	4.5
Concrete evidence is sought for activities that work and those that do not	4.5
Provides information to analyse problems systematically	5
Comparisons can be drawn across projects/ programmes[69]	3.5
Organises your ideas and thoughts to express them to other people who might be interested in your projects/ programmes	4.5

[69] Due to limitations in SRQ, the bifurcation of achievements by type of SME investments is currently not available in the LF. The LF provides cumulative achievements of debt through FIs, D2C and equity investments in SMEs

Recommendations

As EAGR and KRN both evolve, continuous amendments and improvements will be required in the LF. Based on the FGD, KIIs and literature review, we suggest the following LF changes to capture KRN's future needs, which are tailored to a more direct market intervention: A holistic change in approach and outlook will be required when strategic investments mature.

<u>KRN moving towards a direct intervention model:</u> EAGR will be more active with direct market interventios, as opposed to the current indirect intermediary market model. This new approach will allow KRN to have a more direct influence on improving access to MSME finance through PFSL, IZP and PCGC. After making strategic investments to launch these platforms, KRN is expected to follow a holding company structure. Resultantly, the existing LF will lose its efficacy and will require significant revisions, which are to be made in consultation with FCDO and KRN. These include the following: (1) Similar to PMIC, separate output level thematic areas will have to be framed for all strategic investments connecting them with the pertinent outcome indicators; (2) There may be a need for separate LFs for strategic investments that are more detailed. Separate LFs can provide strategic level inputs and its top-line indicators can connect with EAGR's LF, which can be tailored to the revised holding company structure. For this purpose, separate business cases and ToCs will have to be made to provide foundations for the LF.

<u>**Programme / initiative level suggestions**</u>

<u>Risk management:</u> Existing LF has limited indicators to capture programme risk, leaving room for improvement for future risk assessment. Risk assessment will become more pertinent after PFSL operationalises, as direct interventions have higher risks than an indirect market intervention through partner FIs. For this purpose: (1) KRN may add a sectoral view on the total exposure; (2) Benchmarking can be conducted following bank's methods on assessing their sectoral landscape; (3) Total exposure can be bifurcated under working capital & long term financing.

<u>KM:</u> Measuring the impact of knowledge products can be challenging. However, measuring only the number of knowledge products each year does not reasonably reflect the actual outcome of the KM&C function. A survey can be conducted with pertinent sector stakeholders to assess whether KRN is providing input to MSME segment needs and decision-making, resulting in greater SME finance.

<u>ICF:</u> This is a relatively new initiative and is evolving over time with respect to selecting thematic areas and innovators. However, similar to KM&C, the LF does not do justice to the ICF initiative. In the short run, similar to KM, a more focused approach is required to assess the actual outcomes and impact of ICF, linking it with the following: (1) Relevance (the process with which thematic areas / market failures are identified for ICF rounds); (2) Application (whether the innovations became available for usage). In the longer run, project sustainability may be determined post KRN and whether it creates competition in the market. There may be a need to commit to lesser innovation rounds, but staying on course with it throughout its lifecycle. Therefore, the process with which ICF rounds are designed to address a market failure is of significant importance.

<u>Governance:</u> Output indicator 5.2 contains targets set at programme inception and relates to procedural documentation and its compliance of ESG management system. The development of this system stands achieved and the only target left to track is its compliance, which is an ongoing activity. Instead of using this indicator in the LF, ESG compliance can become a component for KRN's reporting to FCDO. Therefore, the indicator can be removed unless KRN plans to add new targets under this indicator other than compliance.

Impact

Purpose of overall impact section

The purpose is to provide an evidence-based assessment of the impact of results delivered, both planned and its spill-over effects.

Programme's causality with top-line objectives

EAGR benchmarks its impact with Pakistan's SME financing as a percentage of total private sector financing and unemployment rate, which did not witness a positive change during the assessment period. However, the expectation of one programme impacting national indicators does not hold merit. KRN's focus areas are aligned with national and international literature in assuming that an effective MSME financing ecosystem can trigger higher revenues and jobs at a national level.

As per the Asian Development Bank (ADB), SMEs account for an average of 62% of the national labour forces across the Asia SME Finance Monitoring (ASM) countries[70]. Data reveals that SMEs contribute an average of 42% of the gross domestic product (GDP) or manufacturing value added in ASM countries. Further, SMEs have significant impact on trade as they account for more than 40% of the total export values for China and India, followed by 26% for Thailand, 19% for the Republic of Korea, and 16% for Indonesia[71].

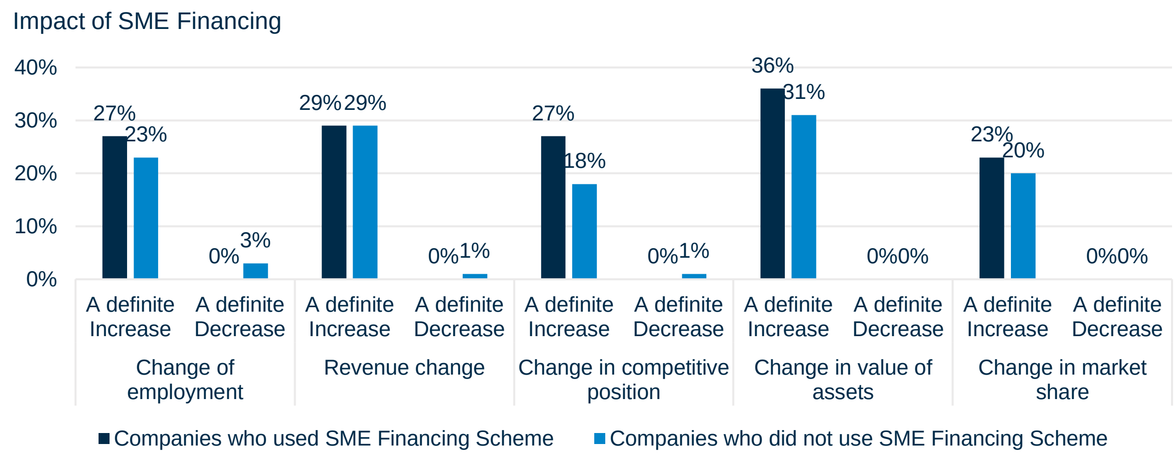
Programme overall impact

A study conducted in Poland provides insightful benchmarks for evaluating the impact of the EAGR programme[72]. While Poland is an unrelated economy for Pakistan, the results of this study still hold significant value due to two reasons:

- The results are directly related with EAGR's focus areas;
- SMEs play a larger role in developing countries where 7 out of 10 jobs are created by SMEs[73]. Therefore, Poland's example is unlikely to exaggerate EAGR's impact.

The results of this study (illustrated below) ascertain the EAGR programme's significance in creating jobs, increasing revenues and improving SMEs' competitive position, value of assets and market share.

Graph 7.24: Likelihood estimation of MSME financing post programme implementation



[70] 20 countries from 5 regions of Asia
[71] ADB Working Paper, 2018, *The Role of SMEs in Asia and their Difficulties in Accessing Finance*, November
[72] MDPI, 2020, *Results of SME Investment Activities: A Comparative Analysis among Enterprises Using and Not Using EU Subsidies in Poland,* November
[73] World Bank SME Finance, *Improving SME's Access to Finance and Finding Innovative Solutions to Unlock Sources of Capital*

EAGRs direct impact:

Microfinance	SMEs	Digital Finance	
824,707 Total beneficiaries	**1,973** Total beneficiaries	**7,041,512** Total utilization	**First Level Impact**
PKR 83 bn Incremental Revenue	**PKR 67.1 bn** Incremental Revenue	**33.6 mn** Branchless Banking Transactions (number)	
819,566 Jobs Supported	**52,857** Jobs Supported	**PKR 61.3 bn** Branchless Banking Transactions (value)	
557,980 Jobs Supported for Women	**425,266** Jobs Supported for Youth		**Second Level Impact**

EAGR's Spill-Over Effect

Increased access to finance
Through enhanced geographical outreach of FIs

Women empowerment
Through increased access to finance, trainings & resultant financial literacy

Promoting business-women
Through women ventures programme and mentorship

Improved financial literacy
Through KRN's MF Plus segment and trainings

Improved technical skills through IFC
13,000 SME individuals trained

New lending products
For transport and agricultural value chain

Programme Comparison

EAGR programme has 2 main sectors - i.e., SME financing and microfinance. The assessment below compares the impact generated from both sectors in line with KRN's investment till March 2021.

Table 7.25: KRN's investment & outcomes in MF and SME segment, (exclusive of IZP & PFSL, as they are not operationalised at this stage)

Indicator	Microfinance	SME (debt + equity)
Total investment by KRN (%)	28.5%	53.5%
Total investment by KRN	PKR 5.03 bn	PKR 9.40 bn
Total outstanding portfolio	PKR 23.1 bn	PKR 21.9 bn
Incremental revenue supported by KRN financing	PKR 83 bn	PKR 67.1 bn
Jobs supported by KRN financing	819,344	52,857

The data on total outstanding loan portfolio and incremental revenue supported by KRN financing is used to extract per-rupee output of KRN's investment under its SME and microfinance segment (illustrated below)[74]:

Microfinance	SMEs
1-rupee ot total outstanding loan has generated 3.53 rupees in incremental revenue	1-rupee ot total outstanding SME investment has generated 3.06 rupees in incremental revenue
PKR 28,674 financing supported 1 job	PKR 414,325 financing supported 1 job

<u>Important considerations</u>

- KRN calculates the achievements of SMEs and microfinance with two separate methods. Therefore, an apple to apple comparison is not possible.
- Performance of both segments got negatively impacted by Covid due to loan deferments
- SMEs' contribution to the economy is much higher than that of microfinance through value addition, trade and taxation.
- The jobs supported by SMEs are of higher quality and are more sustainable than microfinance. Therefore, requires bigger investment
- SMEs generate more incremental revenue from financing than microfinance but this anomaly may be due to the difference in measuring methods and require further analysis

[74] The total outstanding exposure of SME investment is 19.6 billion out of which, 4.12 bn is of InfraZamin, which has not been utilized yet and is therefore, not used in the calculation of incremental revenue and job creation

8. Recommendations for course correction, based on learnings

This section provides a shortlist of the most important recommendations for each sub-section of the MTA report. These build on the findings and analysis provided in Sections 6 and 7 of this report for different initiatives and sub-sections. Each sub-section had questions assigned to it (as provided in the "about this report" sub-section of this report) which this MTA aims to address. These have been stated before the pertinent recommendations have been provided below. The columns of the table are explained as per below:

- Sub-section: Sub-sections of the SoW;
- Recommendation: These are actionable items which KRN, in consultation with FCDO, can pursue. Each recommendation requires follow-up consultations with internal and/or external stakeholders to assess its feasibility and priority, and to detail the action required;
- Priority: Priority has been assigned in the following three levels:
  - High: Should be completed within six months;
  - Medium: Should be completed within one year;
  - Low: Should be completed within two years;
- Responsibility: This is the KRN function which will have primary responsibility, being the major touch point for recommendation addressal.

All recommendations are provided in the tables below. **KRN should consider developing a revised overall strategy for the EAGR programme, to address the major directional change of moving from a market-centric approach that relies on intermediaries (i.e., RPAs through partner FIs) to a direct intervention approach (i.e., PFSL, PCGC, IZP).**

As part of KRNs transition from a market-centric approach to a more direct approach, the recommendations are broken down into iterative steps:

- The ToC needs to be redesigned to take into account this change in approach, along with suggestions made on programme risks and assumptions. The ToC shall set the revised programme strategy for FCDO to monitor, and KRN to implement;
- The LF needs to be tailored to effectively incorporate the revised ToC. New strategic investments need to be initially incorporated into the LF, with the assigned weightage representative of their role in achieving EAGR objectives based on this new approach. Initiative-specific LF can be conducted thereafter;
- Demonstration effects can be defined and measured based on this new approach, specifically for the new strategic initiatives which shall lead this more direct approach;
- At an institutional level, KRN should setup an Enterprise Project Management Office (E-PMO) to manage this transition. Even though recommendations shall be implemented by pertinent functions, the E-PMO shall be responsible for seeing the recommendations through;
- At an institutional level, KRN and FCDO should decide on the intended impact of this new approach, on the sustainability of KRN, post-FCDO exit in 2024. Pertinent governance, operations, and financial measures should be taken to reinforce KRNs sustainability.

a. Overall

#	Sub-section	Recommendation	Priority
Provide a wholistic and evidence-based assessment of KRN's performance on the results framework			
1	Accountability	Similar to PMIC, separate output level thematic areas can be framed for strategic investments, connecting them to pertinent outcome indicators. Separate ToCs and business case will be required for this purpose	High
2	Accountability	Reassess and add (if required) LF indicators for risk assessment and ICF and KM&C verticals based on the assessment mentioned in "Section 7 – Programme Accountability and Impact"	Medium
3	Accountability	Remove output indicator 5.2 (Develop and implement a robust ESG management system) as it has been developed and its implementation can be highlighted in the quarterly reports	High

b. Programme impact

#	Sub-section	Recommendation	Priority
Is the ToC in the original business case still relevant to KRN or does it need to evolve? Does the KRN LF adequately capture the TOC?			
1	ToC	Reassess assumptions as mentioned in Section 6 of this report in relation to: FIs working well with SMEs; FIs investing in SMEs; SME capacity & knowledge to invest; and stable macroeconomic and political conditions	Medium
2	ToC	Follow a PKR denominated SME definition and, preferably, adopt the unified PKR denominated SME definition which regulators will release soon	High
3	ToC	Develop a connection between the ToC and initiatives such as IZP and SEED, that are sector-specific	Medium
Are the results measurement approaches used by KRN adequate? How should the results measurement approach change to capture future needs of KRN?			
1	Results measurement	Continue using the SRQ model simultaneously with JIM until the modelled estimations from the JIM model are found to be more robust	Low
2	Result Measurement	Assess and incorporate the effects of Covid19 and slowed economy in the LF targets, including the possibility of high NPLs	High
3	Result Measurement	Define performance measurement metrics for PFSL to avoid deviation from focus on small enterprises	Medium
Is program delivering VfM? How can the VFM be realistically improved?			
1	VfM	Add an allocative efficiency indicator	Low
2	VfM	Add a youth-centric equity indicator	Low
3	VfM	Use the general rubric or another best practice to measure overall EAGR performance	Low
4	VfM	Use the general rubric to set performance standards for each indicator	Medium

c. Market development

#	Sub-section	Recommendation	Priority
Is KRN on the pathway to create a demonstration effect in the market on sustainable business models of SME finance?			
1	Demonstration effect	KRN is evolving toward direct market interventions including via their lending subsidiary PFSL, whose balance sheet is intended (among other things) to deliver results that RPAs did not. Nevertheless, banks offer scale / distribution and balance sheet capacity far greater than that of PSFL, particularly in its early years of launch. Even though RPAs have had mixed results, they have delivered key insights for course correction: • Existing partner banks should be split into different categories, keeping in view the relative responsiveness to the overall objectives of EAGR; RPAs should be retained and relationships deepened with responsive partner banks, while those with trailing banks should be scaled back / dropped • Partnerships with additional banks should be explored, in order to achieve scale and create a demonstration effect • As an alternative, KRN should consider a bank as a strategic partner for PFSL, which provides distribution capability, liquidity, deal flow and necessary capabilities (e.g. credit risk management) – one suggestion is BAFL	High
2	Demonstration effect	The model deployed at Soneri Bank (Tier 2 capital investment, coupled with a side agreement for creation of an SME portfolio of double the investment size, with no risk-sharing component for KRN) should be explored for replication elsewhere in the industry	Medium
3	Demonstration effect	Orix Leasing has shown agility as a partner NBFI, and appetite for SME financing growth • KRN should devise a cost-effective funding facility that leverages Orix's strengths • The facility can also be considered for inclusive financing in hitherto unexplored / untapped (i.e. riskier) borrower segments • Further opportunities exist for executing an RPA between Orix and PFSL to facilitate the latter's growth objectives, provided Orix is willing to book or transfer the portfolio to PFSL's balance sheet	High
4	Demonstration effect	Enhanced analysis and insight needed when funding ecosystems, especially with a large proportion of end-borrowers from the undocumented or informal economy (as seen in the case of FAW)	Medium
5	Demonstration Effect	KRN should consider investing more in Shariah-compliant R&D: given market demand, there is scope for Shariah-compliant product development cooperation with all banks that are entirely Islamic, or operate with Islamic windows; the output of collaboration with Meezan and MIB has the potential to be replicated on a much larger scale	Medium
Is KRN innovative in its approach? Is it focusing on the right areas of innovation? How scalable are its innovations?			
1	Innovation	The PFSL business plan should be supported with a clear breakdown of the overall cost savings from digital and other related initiatives, to demonstrate the competitiveness of its pricing assumptions	Medium
2	Innovation	SME financing has historically had higher operational / delivery costs, which has squeezed margins and has crowded in more attractive lending	Medium

#	Sub-section	Recommendation	Priority
		opportunities. The optimisation, automation and digitalisation of SME borrower ecosystems should be prioritised	
3	Innovation	Innovation in the SME segment is one of the key areas EAGR is focused on, through the ICF. MEL can share ICF learnings with the PMIC Challenge Fund implementation team, in order to extract synergies	Low
Is the organisation's risk appetite appropriate for the role that KRN is expected to play in the market and to achieve its own institutional ambition?			
1	Risk appetite	KRN should conduct a review of declined / ineligible transactions across all partner banks under the RPA programme, to determine whether one or more market failures occurred, with a view to reviewing credit criteria for greater responsiveness to SME borrowers' needs	Low
2	Risk Appetite	As relief packages, deferrals and moratoriums come to an end, global projections and opinions indicate a high percentage of NPLs in the SME segment. While this concern was not evident in any stakeholder discussions, KRN should be in proactive discussions with partner banks for portfolio reviews and prepare for loan restructuring, which could mean extending RPA periods, as well as expect potential NPLs that could lead to loan losses	High
3	Risk appetite	In order to rapidly scale up and diversity PSFL's balance sheet, replicate one or two supply chain clusters proven to be successful in partner banks' supply-chain portfolios (to be done in consultation with a partner bank)	Medium
4	Risk appetite	In consultation with regulators, devise an innovatively structured solution for wholesale novation of RPA portfolios (from banks whose partnerships are to be wound up) to the PFSL balance sheet in the near-term	High
5	Risk appetite	Review partner FIs origination approach under the RPA programme and, if necessary, revise/impose credit criteria and terms to ensure higher risk is taken (supported by setting provisioning targets)	High

#	Sub-section	Recommendation	Priority
How well positioned is KM in: a) supporting KRN investment decisions; b) addressing information gaps & catalysing market players; c) transferring & creation of domain knowledge?			
1	Knowledge Management	KM function should greatly enhance and formalise its outreach and collaboration with global academia, in order to build itself as the leading source of research and analysis on MSME financial inclusion in Pakistan	Medium
2	Knowledge Management	As the pandemic begins to come under control and partner FIs' portfolios will start to experience life in the post-deferment / government relief scheme era, KRN should have a strategy for documenting, analysing and responding in these circumstances (deeper industry insights about SME creditworthiness across various segments, post-pandemic and post-pandemic relief)	Medium
3	Knowledge Management	PMIC can provide technical assistance in the form of innovation and capacity building support to its MFPs, specifically to extract value from the new Munsalik platform. KRN's Knowledge Management and Communications function can research scalable models being used in other emerging markets, which can be adapted to the Pakistan micro-enterprise context	Medium

#	Sub-section	Recommendation	Priority
Is KRN support to women led businesses successfully creating a demonstration effect. Is the design aligned with ambition and market need?			
1	Women Ventures	The structure and delivery channels of WV should be revisited: • The programme needs to engage more partners, including SBP, to onboard significantly higher numbers of business development recipients • This will make it possible to deliver a greater proportion of qualified funding recipients • Programme beneficiaries in sufficient numbers (to be established within the scope of a restructured initiative) will constitute a proof of concept, and ideally will create a demonstration effect	High
2	Women Ventures	The KRN team should formalise the balance between business discipline and supportiveness, to manage the women-led businesses' transition from the "handholding" / mentoring phase to the repayment stage	High
Other recommendations			
1	Financial sector architecture	As implementation of the PMN digital platform will lead to broad ranging efficiency gains in the microfinance industry, its ultimate beneficiaries (individual customers and micro-enterprises) can look forward to better service standards and more competitive pricing. Research and analysis should be conducted for all direct and indirect monetary benefits accruing to the microfinance sector, due to the activities of the platform	Medium
2	Sustainability of initiatives	PMIC's "Push Products" should be categorised, prioritised and assessed according to the level of value addition, and high-value offerings should be considered for continuation as an embedded part of financing rather than being grant-based	Medium
3	Financial sector strengthening	PMIC should consider that the process of graduating its partner MFIs via funding and value addition may lead to some of them becoming "for profit" entities (presently all are non-profits except ASA Pakistan). This may extend to a requirement for provision of Tier-II capital, as and when necessary. A business case should also be developed to obtain regulatory support and approval from the SECP to provide subordinated debt to MFIs	Medium
4	Financial sector strengthening	To further refine medium-term funding strategy for PMIC, KRN should assess how well PMIC's balance sheet appetite / capacity is aligned with the unmet demand / growth aspirations of MFPs of varying levels of maturity, including Tier-II capital; wholesale funds for on-lending; TA and capacity building; attracting and bringing in new entrants to the industry; and eventually even equity stakes in suitable MFPs	Medium

d. Institutional assessment: Governance

#	Sub-section	Recommendation	Priority
1) Is the KRN governance structure appropriate and aligned with its operations? 2) Is it structured to protect the mission and assets when FCDO exits?			
Assessment: KRN's current governance framework is relatively mature and, in many areas, follows international best practices. It should serve as an example governance framework implemented at individual subsidiaries. Some actions can be taken to enhance readiness for transition to a holding company operation			
1	Governance structure	Pipeline maintenance needs to be administered for General Body, Board and management team	High
3	Governance structure	Create delegation of authority and delegated authority matrix for Board-level, CEO, and management level committees	High

e. Institutional assessment: Operating structure

#	Recommendation	Priority
	1) Does KRN have the right systems in place to become a commercially sustainable/ viable entity? 2) Is it on the path to strengthen them in line with growing needs and size of the organisation?	
	Assessment: KRN is on the path to become a commercially sustainable entity, with controls, policies, manuals, systems being implemented and strengthened. However, certain steps to improve the organisational structure and internal communication to create synergies should be taken	
1	Create a succession plan for all functions, particularly in CIC, ICF, Risk, HR as they are at higher risk *(and hire resources as suggested below for mitigation of this risk)*	High
2	Improve the following specific functional roles & responsibilities, and internal synergies	High
	i. Integrate research responsibilities of all functions with KM&C to increase synergies and reduce duplication of effort. Set up an internal management level KM committee to increase collaboration	High
	ii. The Finance function should play a larger role in terms of strategic activities, business planning, maintaining and managing data, monitoring performance and transformation into a holding company structure	High
3	Restructure organisation to segregate functions and add missing functions (to help achieve strategic objectives, reduce workload and mitigate succession risk)	High
	i. Establish an E-PMO function under Operations, with specialised resources aligned with the planned initiatives of all key functions (e.g., CIC, DFS, etc.)	High
	ii. Separate the MEL function from ICF & WV function and make it an independent function	High
	iii. Create a dedicated IT department with defined roles and responsibilities, within Operations, and enhance the Operations function into Operations & IT	High
4	Capacity building and enhancement	High
	i. Due to increased activities and interventions going forward, increase risk & compliance capacity, which should also mitigate succession planning risk	Medium
	ii. Increase the capacity of the Finance function to position it for increased role in strategic direction of KRN, and for building capital raising capabilities post FCDO exit	High
5	Policies and manuals should be updated by incorporating the date created, maintaining version control, adding process owners, and ensuring all key processes are documented and mapped, with a yearly review and maintenance cycle	Medium

f. Institutional assessment: Sustainability

#	Sub-section	Recommendation	Priority
1) Is KRN on the path of sustainability, post FCDO exit? 2) What are the key considerations that should be resolved prior to FCDO exit?			
Assessment: KRN was envisioned to be operationally sustainable from inception and, therefore, has been set up for the eventual exits of FCDO and BMGF. There are some key considerations that should be resolved prior to FCDO exit and prior to adopting a holding company operating structure			
1	Sustainability	Balance sheet concentration risk of PMIC subordinated debt needs to be addressed prior to FCDO exit	High
2	Sustainability	Consider strategies for diversification of OSR through enhancement of product portfolio	Medium
3	Sustainability	Design a governance framework which can be replicated at portfolio companies	Medium
4	Sustainability	Consider FCDO's continued role, possibly by way of a Board seat, to ensure the programme objectives continue to be met after FCDO funding ends	Low

g. Institutional assessment: Financing

#	Recommendation	Priority
	1) Has KRN been able to leverage its own balance sheet and those at subsidiary level to crowd in capital from commercial and private sources? 2) What is KRN's long term view on growth of its own balance sheet?	
	Assessment: KRN has been able to leverage its own balance sheet through its various initiatives. Going forward, KRN aims to grow its balance sheet as per LF targets	
1.	KRN should define a clear path and timeline to adopting and assuming a HoldCo structure, so the initiatives can be executed in a planned manner. The balance sheet of the strategic initiatives should be leveraged going forward, that will reflect in KRN's balance sheet on a consolidated basis. KRN should subsequently exit or retain a minority interest, recycling the capital earned from the divestment	High
2.	KRN should consider executing initiatives through a complete end-to-end value chain. The efficiencies created for KRN by investing in a specific value chain can have a multiplier effect and the spill-over through verticals can also help achieve higher returns	Medium

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