3.3 Performance and Risk Analysis of Microfinance Banks

Microfinance Banks (MFBs) continue to witness a significant growth. With expansion in rural advances, growing customer base and improving profitability, the lending model is heading towards maturity. Advances have seen broad based surge across enterprises, agriculture and livestock segments, while accelerated expansion in deposits have provided the necessary funds. Asset quality has improved, solvency remains comfortable with high capital ratios and liquidity stays at adequate level. Branchless Banking, as an alternate cost-effective solution to bricks and mortar model, has witnessed a prolific growth. However, lack of financial literacy represents a major hurdle in attaining the goals of financial inclusion and growth of MFBs.

Microfinance plays a critical role in financial inclusion as it targets underserved segment of population, which, generally, does not have access to traditional collateralized and documented mode of finance.

MFBs grow substantially…

Although the asset base of MFBs stands at 1.33 percent of the total assets of the banking sector as of end CY17, they have immense growth opportunities owing to their alternative lending mechanism and outreach in far-flung and remote areas. This is evident from the fact that MFBs have shown higher growth (300 percent) since CY13 compared to commercial banks (74 percent). Moreover, MFBs have witnessed 45 percent expansion in balance sheet size in CY17 alone.

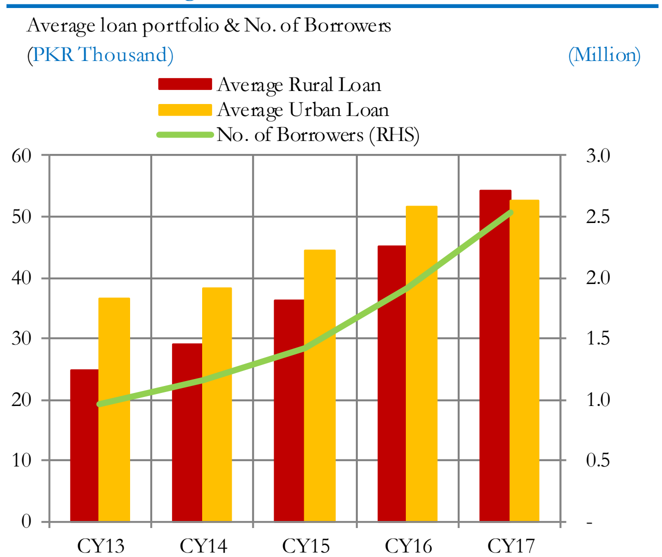
…mainly driven by rise in advances

Advances have surged by 52 percent in CY17, reaching PKR 133.0 billion. This is driven by increased average loan size (14 percent) and broadened customer base (33 percent) (**Figure 3.3.1**).

Moreover, the pace of growth in rural loans is more than that of urban ones. Average annual rise in rural loans during CY13-17 is 61.19 percent as compared to 44.15 percent average annual rise in urban loans. Moreover, the average size of rural loans has jumped from PKR 20,437 in CY13 to PKR 54,208 in CY17, against rise in urban loans from PKR 33,416 in CY13 to PKR 52,637 in CY17.

In terms of outreach, the branch network has expanded by 12 percent (from 792 in CY16 to 893 in CY17) along with 22 percent rise in workforce, during the year.

Figure 3.3.1
Increase in Average Loan Size and Customer Base



Source: SBP

Two-third of MFB's loans comprise of rural borrowers…

In the context of Pakistan, where more than half of the population lives in rural areas, MFBs are of paramount importance for economic development. Rural areas are difficult to approach by commercial banks due to high operational cost arising from remote access and sparse population. MFBs, on the contrary, with alternate delivery channels and extensive field force are well suited to cater to the needs of these underserved areas. This is the reason that more than two third of MFBs' loans portfolio comprises of rural loans.

The success of MFBs in rural areas is attributed to their unique lending methodology. MFBs put social pressure on borrowers using Group Lending mechanism to enforce financial discipline. More than one third of the disbursed loans are on group basis.

MFBs are catering to the needs of borrowers having shorter horizon…

More than 85 percent of the loans of MFBs have maturity of less than 1 year. MFBs provide financing to sectors (i.e. agriculture and livestock) that have shorter production cycles, which, generally, leads to higher turnover of loans. MFBs exposure to agriculture and livestock sectors is 69.17 percent.

Despite their smaller share in assets, investments of MFBs have increased significantly

MFBs have just 20 percent of their assets parked in investments (mostly in government securities). However, these investments have registered 46 percent growth in CY17. The major portion of the investments is required for meeting the Statutory Liquidity Requirements prescribed by SBP.

Deposits remain the mainstay of funds mobilized…

Deposits and borrowing stand at PKR 185.8 billion and PKR 13.5 billion, respectively, as of end CY17. Deposits have increased by more than 50 percent in CY17. (**Table 3.3.1**). However, more than half of the deposits are in the form of Term Deposits that are costly, which may influence the profitability of MFBs.

Table 3.3.1

Financial Soundness Indicators

	CY13	CY14	CY15	CY16	CY17
Key Variables (PKR Million)					
Total Assets	58,197	70,060	97,476	170,244	247,218
Investments (net)	12,913	14,579	13,334	33,433	48,869
Advances (net)	28,073	36,505	54,733	87,772	133,707
Deposits	33,580	42,730	63,105	120,172	185,827
Borrowing from FIs	8,002	8,665	10,893	13,714	13,563
Lending to FIs	1,518	1,150	3,276	2,452	4,693
Equity	12,770	14,869	18,332	24,309	32,577
Profit Before Tax	895	1,529	2,956	4,213	7,548
Profit After Tax	538	1,090	1,997	2,709	5,247
NPLs	289	426	730	2,200	2,043
NPLs (Net of Provisions)	30	48	86	300	(503)
Key FSIs (Percentage)					
NPLs to Loans (Gross)	1.02	1.16	1.32	2.45	1.50
Net NPLs to Net Loans	0.11	0.13	0.16	0.34	(0.38)
Net NPL to Capital	0.25	0.34	0.47	1.20	(1.49)
Provision to NPL	90%	89%	88%	86%	125%
ROA (Before Tax)	1.07	1.74	2.45	2.08	3.01
ROE (Before Tax)	7.78	11.18	17.75	19.46	29.44
CAR	42.6	37.7	29.1	23.7	21.4
Advances to Deposit Ratio	83.6	85.4	86.7	73.0	72.0

Source: SBP

…while equity base has also grown considerably

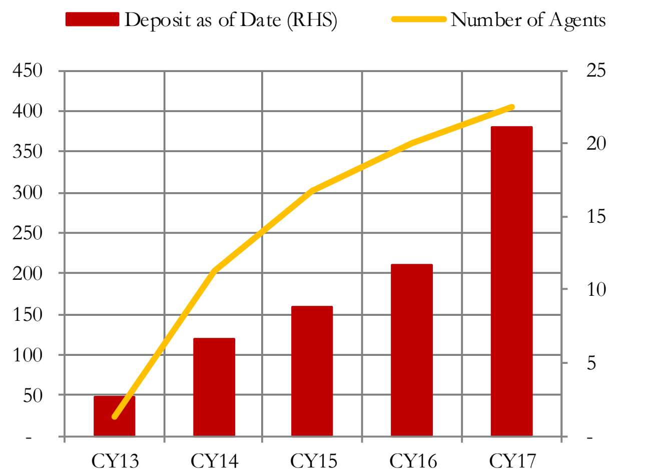
Equity of MFBs has grown by more than 33 percent in CY17, due to gradual growth in profits and increase in share capital.

Branchless Banking has witnessed prolific growth…

With the introduction of Branchless Banking (BB), the outreach of MFBs has expanded exponentially and this channel has shown considerable growth over the past few years. The number of BB agents have grown from 24,214 in CY13 to 405,673 as of December 2017. BB account deposit base has also grown over eight times during the period reaching to PKR 21 billion (**Figure 3.3.2**).

Figure 3.3.2
Growth in Branchless Banking Agents and Deposits

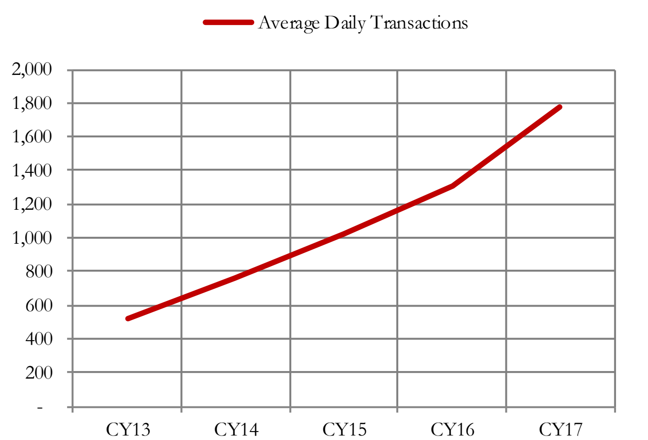
Branchless Banking Agents & Deposits
(Thousand) (PKR Billion)



Source: SBP

Figure 3.3.3
Growth in Average Daily Transactions

No. of Branchless Banking Transactions
(Thousand)



Source: SBP

…as average daily transactions tripled in last four years

With the increase in BB agents, there has been a steady increase in average daily transactions of BB and the number has more than tripled since CY13. This channel has facilitated more than 1.7 million daily transactions, on average, (**Figure 3.3.3**). With average transaction size of less than PKR 5,000, majority of the BB customers are those who have otherwise no or limited access to financial services.

Asset quality of MFBs has improved

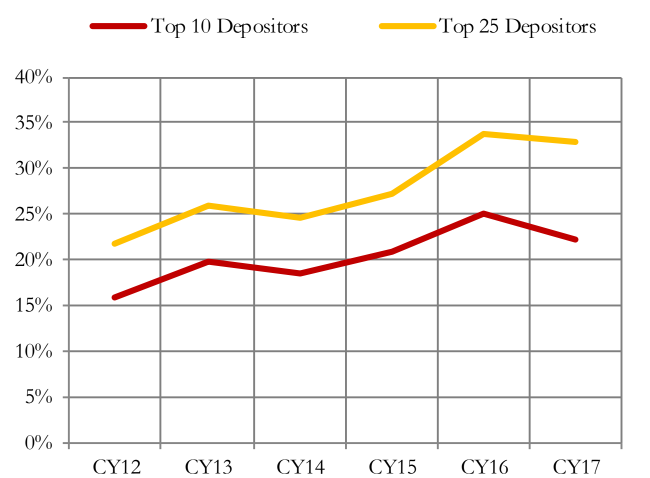
Infection ratio, a key determinant of asset quality, has declined during CY17 and stands at 1.5 percent as of end CY17. MFBs have already secured themselves by making excessive provisions against the NPLs. The provision coverage ratio is 125 percent in CY17.

Concentration in deposits may increase liquidity risk for MFBs

Despite growth and better performance, MFBs are still exposed to concentration risks on the liability side. Contribution of top 10 depositors in total deposit base has increased to 22 percent in CY17 from 15 percent in CY12. Similarly, the share of top 25 depositors has jumped from 22 percent to 33 percent over the same period (**Figure 3.3.4**). MFBs' reliance on few depositors creates liquidity risk. They need to diversify their funding sources by exploring alternate avenues.

Figure 3.3.4
Increase in Top Depositor Concentration

Top Depositors Concentration
(As percentage of Top Deposits)



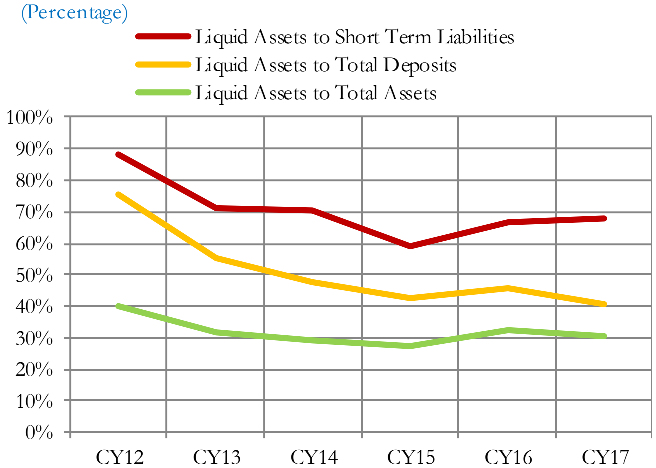
Source: SBP

Key Liquidity ratios have followed downward trend

Due to prolific growth in the loans during the past few years, the key liquidity ratios have experienced downward trend, but are still at comfortable levels (**Figure 3.3.5**). MFBs need to be vigilant about liquidity risk.

Figure 3.3.5
Deterioration in Key Liquidity Ratios

Key Liquidity ratios
(Percentage)



Source: SBP

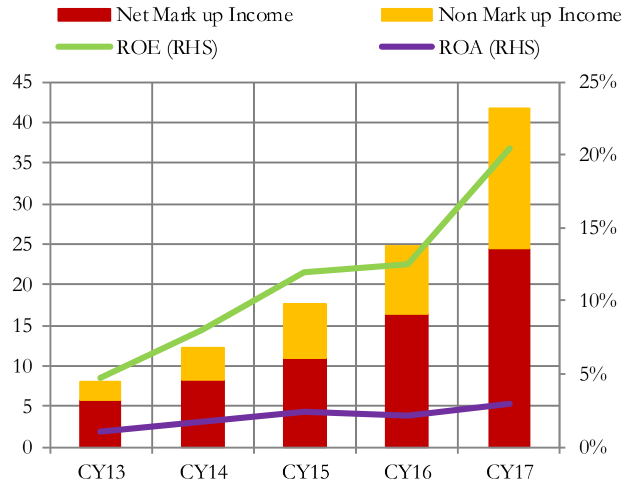
Profitability of MFBs rises …

With increased lending and financial services, both interest and non-interest income have contributed to the overall profitability of MFBs. Profit (after tax) has almost doubled in CY17; PKR 5.2 billion as compared to PKR 2.7 billion in CY16. Resultantly, ROA and ROE have inched up to 3.01 percent and 20.46 percent, respectively, as of end CY17 **(Figure 3.3.6)**.

Return on advances has improved in CY17 to 24.13 percent as compared to 23.79 percent in CY16. However, cost of funding also increased from 5.04 percent to 5.65 percent over the same period. Greater increase in term deposits as compared to total deposits can be the reason of increased funding costs.

Figure 3.3.6
Growth in Income and ROE

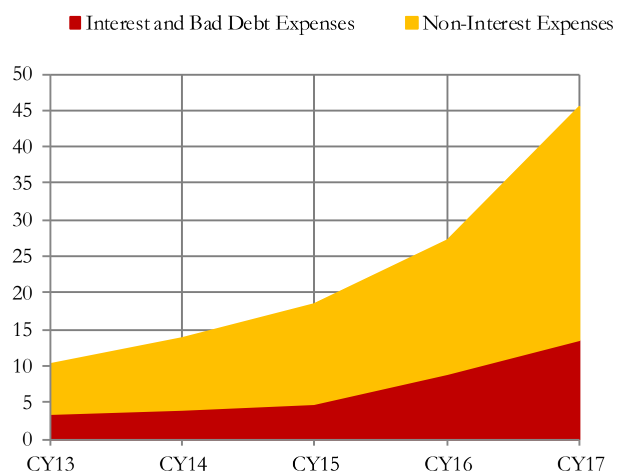
Interest/Non-Interest Income & ROE/ROA
(PKR Billions) (Percentage)



Source: SBP

Figure 3.3.7
Growth in Non-Interest Expense

Interest & non-Interest Expense
(PKR Billion)



Source: SBP

Non-interest expense is the major cost driver…

Non-interest expense is the key cost constituent for MFBs because of their business model. As they cater to the needs of people residing in remote and far-flung areas, they have to bear higher administrative costs (such as for credit administration). Therefore, non-interest expenses amount to more than two-third of the total expenses of MFBs (**Figure 3.3.7**).

Capital Adequacy Ratio of MFBs has adjusted downward…

Due to higher growth in loan portfolio, the Risk Weighted Assets have also increased, which has pushed the CAR down to 21.44 percent in CY17 from 23.7 percent in CY16. However, it is still well above the minimum requirement of 15 percent. If this growth trend continues, MFBs may have to strengthen their capital base by either injecting more capital or retaining profits.

Low financial literacy, AML CFT concerns and technological risks are major challenges to financial inclusion…

BB Account holders require some level of digital literacy to carry out transactions. However, according to a survey of 6,000 people, conducted by Financial Inclusion Insights, merely 16 percent people are financially literate and more than half of the adult population has low or no digital literacy (http://finclusion.org, 2018). This suggests that initiatives need to be taken to enhance the level of knowhow among BB users.

The number of BB Accounts has reached to 37 million, around half of which are active. With rising outreach and presence of BB services in distant areas, the risk of misuse of these channels by nefarious elements increases. In addition, technological risks related to cyber security, data and identity theft remain.

SBP is committed to increase financial inclusion…

SBP, in line with its Vision 2020, has taken a number of steps to increase the financial outreach in the country. In this regard, SBP has developed/adopted a broader National Financial Inclusion Strategy (NFIS), which aims to enhance formal financial access to 50 percent of the adult population by 2020.

SBP has increased maximum loan limit to PKR 1 million for microenterprises from PKR 0.5 million, which will help in meeting the needs of microenterprise segment[167].

During 2008-17 SBP supported wholesale funding by offering guarantees through the Microfinance Credit Guarantee Scheme. The scheme completed its term with the establishment of Pakistan Microfinance Investment Company (PMIC), which has started catering to liquidity needs of the industry[168].

To guard against AML/CFT concerns, SBP has instructed MFBs to use technological innovations like biometric identification machines and transactions monitoring system[169].

Further, to increase the outreach of Microfinance Industry, NFIS Sub-committee on MF is working on digitization of the Microfinance sector by linking the MF industry with digital platforms. In addition, to improve the microfinance outreach, development of Credit Scoring Model for Micro & Small Enterprises is in progress to help the MF institutions for better risk management, improve the loan approval processes and reduce operating costs.

Way forward…

After providing basic financial services through agents, the next step in financial inclusion is to make users self-sufficient in making transactions by their

[167] AC&MFD Circular No. 03 0f 2017 dated December 22, 2017
[168] AC&MFD Circular No. 01 0f 2017 dated April 13, 2017
[169] AC&MFD Circular No. 02 0f 2017 dated June 19, 2017

own BB Accounts. Owing to its flexibility and low operating cost as compared to traditional brick and mortar branches, BB has a huge growth potential. This is evident from the fact that there are 139 million registered cellular phone users in Pakistan, among which only 37 million have BB Accounts. Moreover, BB model has wide outreach when compared to traditional banks because, by using the vast network of cellular agents; MFBs could potentially increase their presence even in the remotest locations in the country.

Moreover, SBP has started various programs under National Financial Literacy Initiative including Student Ambassador Program, Financial Literacy Program for Youth and working with third parties on curriculum development to be included in schools. These programs will help in increasing financial literacy among masses.

With women comprising more than 28 percent of borrowers and 21 percent of BB Account holders, MFBs are promoting gender equality and women empowerment. This could help reach the NFIS target of 25 percent of women having formal accounts by 2020.