# 11 PERFORMANCE OF MICROFINANCE SECTOR

## 11.1 Introduction

The concept of microfinance has been present in rural and urban areas in the form of unsupervised cooperatives since a fairly long time. However, microcredit as a revolutionary social phenomenon was started by the Grameen Bank during the 1970s. Since then, the progress of microfinance in the world and especially in Asia has been inspired by the success story of the Grameen Bank. Established by Dr. Muhammad Younus to cater to the needs of the poor and the unprivileged segments of society on an experimental basis, Grameen Bank facilitated access of credit to the poor, especially women, with the aim of eradicating poverty and unemployment, the primary concern of any developing country. It not only provided funds to people generally considered to be financially unstable, but also proved that these people are credit-worthy, by a proven track record of recovery of loans at above 98 percent.

Pakistan, though a late starter in this industry, has also made considerable developments in Microfinance. Though Non-Government Organizations (NGOs) and Rural Support Programs (RSPs) have been providing micro-credit in the country since the 1980s, but the coverage and scope of their operations has generally been rather limited. The enhanced international focus on microfinance at the advent of the new millennium has accelerated the growth of the Microfinance sector in Pakistan. At present, six Microfinance Banks (MFBs) are operating in the country. Besides MFBs, there are 14 other microfinance institutions (MFIs) including Rural Support Programs (RSPs), Non-Government Organizations (NGOs) and Commercial Financial Institutions (CFIs), as detailed in **Box 11.1**.

**Box 11.1: Microfinance Institutions**

Microfinance Ordinance (2001) defines a Microfinance Institution (MFI) as a company that accepts deposits from the public for the purpose of providing microfinance services. MFIs in Pakistan include Microfinance Banks (MFBs) regulated by the State Bank of Pakistan, in addition to some NGOs, RSPs and CFIs as detailed below :

**Non-government Organizations (NGOs)**: These include NGOs operating as microfinance institutions as well as those running microfinance operations as part of their multi-dimensional development program. Specifically, Kashf, Sind Agricultural and Forestry Workers Coordination Organization (SAFWCO), Akhuwat, Orangi Pilot Project (OPP), and Asasah are operating as MFIs. Development action for mobilization and emancipation (DAMEN), Taraqee Foundation and Sungi are proving microfinance services as a part of their overall integrated development services.

**Rural Support Programmes (RSPs):** These programs are running microfinance operations as part of their multi-dimensional rural development programme. At present four RSPs are in operation, which include National Rural Support Program (NRSP), Punjab Rural Support Programme (PRSP), Sarhad Rural Support Program (SRSP) and Thardeep Rural Development Program (TRDP).

**Commercial Financial Institutions (CFIs):** These are financial institutions in the mainstream financial sector, providing microfinance services as a separate function within the broader organizational context. Two such CFIs are Orix Leasing and The Bank of Khyber.

Source : MFIs Ordinance (2001), Pakistan Microfinance Network Performance Indicators Report (2005).

Despite the existence of MFIs operating at various levels, the penetration of the sector is still low as the outreach of MFIs is only around 4 percent of the total potential market of 25-30 million borrowers. This low level of coverage is generally linked with the relatively recent focus on Microfinance as one of the viable components of the financial sector. Notwithstanding substantial progress made in this area, there are still some important issues that require particular attention for the future growth of this sector. Some of these issues include enhanced access of financial services to the poor, operational and cost efficiency, product diversification, and most importantly, the achievement of self-reliance through deposit mobilization to make this sector financially sustainable.

The Government of Pakistan (GoP) and the SBP are fully committed to the growth and development of the Microfinance Sector on a sound and sustainable basis. The policy makers' vision for the sector is to develop an enabling policy environment in which MFIs could flourish and grow, while providing a full range of financial services to the poor. In the budget for FY08, some constructive measures have been taken to promote the growth and expansion of this sector, which include the exemption of tax on income of MFBs for a period of five years.

### 11.2 Evolution of Policy Framework

Microfinance Banks are regulated by the State Bank of Pakistan (SBP). Pakistan is one of very few countries which have a separate legal and regulatory framework for microfinance banks (MFBs). This framework provides an enabling environment for the provision for microfinance services to deserving segments of the country. In recent years, SBP has taken various steps for the promotion and growth of this sector. Prudential regulations for MFBs are amended and upgraded from time to time in line with the market dynamics. SBP has also issued guidelines for commercial banks to undertake microfinance business (**Box 11.2**). Moreover, in order to expand microfinance outreach to 3 million borrowers by 2010, a strategy for 'Expanding Microfinance Outreach (EMO)' has been developed by the SBP which was approved by the Government in February 2007. The EMO strategy stresses on the fact that commercialization of the sector is key to financial and social sustainability. The strategy also sets forth recommendations on how the outreach can be increased beyond the target of 3 million people, which is the existing capacity of the sector. It emphasizes the need for instilling competition by allowing multiple and international players, encouraging all-encompassing financial services delivery, and launching innovative solutions for product delivery. The EMO strategy further stresses on strengthening the foundations of the microfinance sector for making it more efficient, diversified and sustainable so as to reach an aggressive target of 10 million borrowers in the next 5-6 years.

**Box 11.2- Guidelines for Commercial Banks to Start Microfinance Business**

In 2006, SBP has issued guidelines for commercial Banks to undertake microfinance business. These guidelines have been designed to facilitate those banks who want to diversify their assets portfolio into the microfinance business. Commercial Banks can now provide microfinance services under four different modes, which include:

i) Establishment of Microfinance counters in the existing branches,

ii) Designating standalone Microfinance branches either through conversion of existing branches or opening new microfinance branches,

iii) Establishing independent Microfinance subsidiary with independent and professional board and management under MFIs Ordinance 2001, and

iv) Developing linkages with MFBs licensed by SBP and NGO-MFIs that are not licensed by SBP to extend wholesale funds for onward lending.

Source: SMED Circular Nos. 10 dated June 27, 2006.

In the following section, a brief analysis of the entire Microfinance sector, including all the existing types of MFIs currently in operation in the country, is discussed.

### 11.3 Performance of the Microfinance Sector

The operations of MFIs have witnessed significant improvements during CY06, which is reflected in almost all aspects of the microfinance industry. Number of new MFBs branches has grown, total assets have increased, products are being gradually diversified, outreach is being extended, branch network is being expanded and growth has been achieved in the total number of borrowers and advances (**Table 11.1**).

To facilitate the poor by providing financial services in areas where they reside, more branches are being set up every year. In CY06, the branch network expanded to 992 branches across the country, with a growth of 79.4 percent over CY05. MFIs remained more progressive in terms of expanding the branch network. As a result, their share in total branch network has increased to 85.4 percent in CY06, as compared to 83.5 percent in CY05. This achievement is largely attributed to the fact that these institutions believe in community involvement, and to start a business in any new locality they seldom require elaborate infrastructure. This helps them in reducing their transaction and administration costs. MFBs are also learning from the experience of these institutions.

**Table 11.1: Outreach of Microfinance Institutions**

million Rupees

| | MFBs | | MFIs | | Total | | Change % |
|---|---|---|---|---|---|---|---|
| | CY05 | CY06 | CY05 | CY06 | CY05 | CY06 | CY06 over CY05 |
| Number of Branches | 91 | 145 | 462 | 847 | 553 | 992 | 79.4 |
| Advances | 2,258 | 3,444 | 3,344 | 4,907 | 5,602 | 8,351 | 49.1 |
| Borrowers('000') | 248 | 326 | 365 | 509 | 613 | 835 | 36.2 |
| Deposits/Voluntary savings | 680 | 1,420 | 675 | 929.5 | 1,355 | 2,350 | 73.4 |
| Depositors ('000') | 32 | 71 | 1,183 | 1,294 | 1,215 | 1,365 | 12.3 |
| Borrowings | 4,328 | 5,139 | 1,004 | 730.4 | 5,332 | 5,869 | 10.1 |

Source: OSED, State Bank of Pakistan and Pakistan Microfinance Network Annual Report 2006

Growing branch infrastructure is helping the microfinance sector in reaching a maximum number of potential clients, due to which the total active number of borrowers is also increasing rapidly. During CY03-06, total number of borrowers has reached 834,962, showing a growth of 150 percent in CY06 over CY03**.** Although the current share of MFIs is more than the MFBs, it is declining over time. Specifically, the share of these MFIs in total borrowers has declined to 61 percent in CY06 against 71 percent in CY03, indicating an increasing customer base of MFBs.

Customer-base of MFIs indicates that the total number of depositors/voluntary savers was 1.4 million in CY06 as compared to 0.8 million borrowers. However, the amount deposited by the depositors/voluntary savers was only Rs. 2.4 billion as compared to advances of Rs 8.4 billion. Importantly, these advances constitute only 47.6 percent of total assets for CY06, which is well below the international standards of 70 percent.[1]

### 11.3.1 Performance of Microfinance Banks

During CY06, assets of MFBs recorded YoY growth of 24.3 percent to reach Rs.10.5 billion. This asset growth was facilitated largely by the expanding outreach of MFBs. With the inception of Pak Oman Microfinance Banks Limited[2] during the year, the network of MFBs expanded to six banks.[3] Performance of MFBs in terms of growth in outreach and financial services can be termed satisfactory as: (1) MFBs are setting up 30 (on average) new branches every year since CY01; and (2) MFBs facilitated 231,408 new borrowers during CY04-06 compared to 95,000 during CY01-03 (**Table 11.2**). During CY06 alone, the total number of borrowers has reached 0.33 million as compared to 0.25 million in the previous year. On the other hand, the total loan portfolio, which is the major focus of MFBs, amounted to Rs 3.4 billion. However, despite the sharp rise in the total number of borrowers, the outreach is still far behind the total potential market of 25-30 million borrowers.

[1] Microfinance Performance in Pakistan: 1999-2005, USAID.

[2] Pak Oman Microfinance Bank Limited was incorporated on March 9, 2006 as a public limited company under the Companies' Ordinance, 1984. It received the certificate of commencement of business on April 18, 2006.

3 Currently four MFBs (Khushali Microfinance Bank Limited, First Microfinance Bank limited, Tamer Microfinance Bank Limited and Pak Oman Microfinance Bank) are working at the national level, while two MFBs (Rozgar Microfinance Bank Limited and Network Microfinance Bank limited) are providing financial services at the district level.

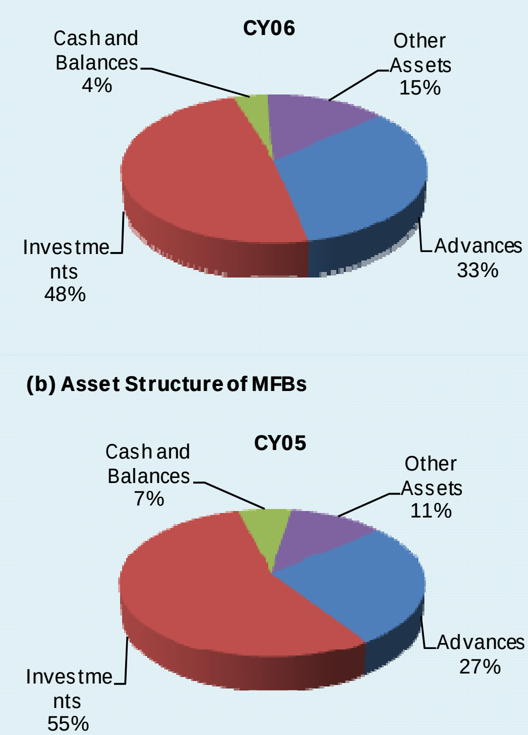
**Table 11.2: Outreach of Microfinance Banks**
million Rupees

| | CY03 | CY04 | CY05 | CY06 |
|---|---|---|---|---|
| Institutions age(years) | 3 | 4 | 5 | 6 |
| Number of Branches | 56 | 75 | 91 | 145 |
| Advances* | 736 | 1,537 | 2,258 | 3,444 |
| Borrowers('000') | 95 | 178 | 248 | 326 |
| Deposits | 392 | 469 | 680 | 1,420 |
| Depositors('000') | 10 | 19 | 32 | 71 |
| Borrowings | 1,403 | 2,601 | 4,328 | 5,139 |
| Average loan size | 7,969 | 7,340 | 9,450 | 8,721 |
| Average deposit size | 38,625 | 25,229 | 20,867 | 20,731 |

* Net of provision
Source: OSED, State Bank of Pakistan, PMN

In order to speed up the pace of attracting new borrowers, SBP has issued guidelines for identifying eligible borrowers and maximum loan size to their clientele. The purpose of these regulations is to ensure that MFBs serve their mandate and funds are channeled to the poor. The personal income criteria of Rs. 12,500 per month has been set for eligible borrowers and maximum loan size limit has been raised from Rs. 100,000 to Rs.150,000. However, individual loans size of upto 80 percent of the loan portfolio of the MFBs has to be up to Rs. 100,000. So far MFBs have been rather cautious in extending loans to their customers as the average loan size is about Rs. 8,721. This small average loan size is largely attributed to the borrower's low repayment capacity, which is around 30 percent of the monthly income i.e. Rs. 3,750 per month. However, some MFBs like Tamer Microfinance Bank Ltd are working on different models and their average loan size is Rs. 35,000. Further, MFBs are focusing more on financing working capital of microenterprises which have more capacity to take and repay loans which will ultimately raise the average loan size in the future.

**Figure 11.1 (a): Asset Structure of MFBs**




Source: State Bank of Pakistan

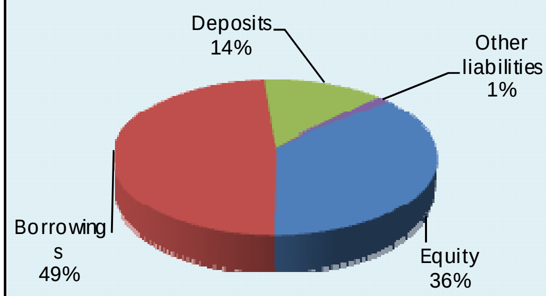
Although SBP has allowed MFBs to mobilize deposits, MFBs have yet to establish their own resource base for the long term sustainability of their business. During CY06, the total number of depositors grew by 115 percent, however in absolute terms the number of depositors and deposits remained low: 71,000 depositors hold Rs.1.4 billion of total deposits.

### 11.3.2 Asset & Liability Structure of MFIs and MFBs

Financial sustainability is the critical element for the continuous and smooth functioning of the sector. Asset composition of the MFBs shows that instead of advances, most of the surplus funds from credit lines are currently being placed in treasury assets. However over the period, the share of investments in total assets shows a declining trend and in CY06 it has reached 48.4 percent from 55.4 percent in CY05 (**Figure 11.1**). On the other hand, share of advances in the asset portfolio is growing and in CY06 it reached 32.8 percent[4] from 26.7 percent in the previous year. Even though the growth of advances is an encouraging development, the current level of advances is not sufficient for the commercial sustainability of the MFBs and there is a need to channelize surplus funds in advances which are the main source of revenue for any successful and commercially viable microfinance institution.

Funding structure of the MFBs shows that, on an average basis in the last five years, borrowing and equity together contributed around 85 percent in the total fund base of MFBs (**Figure 11.2**), as opposed to MFIs (**Figure 11.3**). During CY06, there has been a decline in the growth of borrowings to 18.8 percent from a fairly high growth rate of 66.4 percent in CY05. However, more then 95 percent share in borrowings is concentrated in Khushali Bank alone, reflecting its total dependency on the credit lines provided by the Asian Development Bank (ADB).

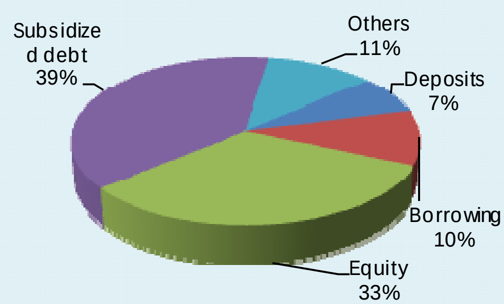
**Figure 11.2: Funding Structure of MFBs - CY06**




Source: State Bank of Pakistan

Deposit mobilization, which is supposed to be one of the main contributors in the total fund base of MFBs, remained weak, and during CY06 total deposits contributed only 13.5 percent in the total fund base of MFBs, which is an improvement over previous year's contribution of 8.0 percent. The present low share of deposits is largely attributed to the fact that the pioneer institution, Khushali Bank, has not started deposit mobilization as yet. Although some MFBs have started deposit mobilization activities, they are still lagging behind in developing their brand images and attracting the masses. In addition to that, MFBs are also facing competition from the conventional banking sector in urban as well as in rural areas. However, SBP in its EMO strategy has emphasized the need to diversify the funding structure of MFBs, from being largely concentrated in debt to self-reliance through deposit mobilization. This seems essential to reach the target of 3 million clients by 2010. And further, it is also stressed that MFBs should undertake market research for offering innovative savings products for their customers.

**Figure 11.3: Funding Structure of MFIs - CY06**




Source: Pakistan Microfinance Network

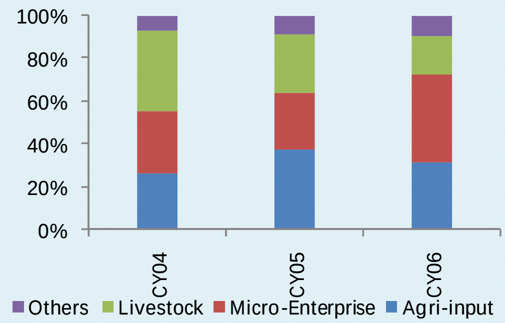
### 11.3.3 Activity-wise Distribution of Loans

Addition of new MFBs over the last two years has brought significant changes in the activity-wise loan disbursement. Some of these new banks largely focused on extending loans related to micro-enterprises, with no or little interest in agriculture and livestock related loans. As a result, the micro-enterprise loans emerged with the largest share of 40.4 percent in the total loan portfolio. This shows that the MFBs have started diversifying their loan portfolio, previously concentrated in agriculture and livestock sectors, by financing the micro-enterprises for their working capital needs. This diversification is clearly evident from **Figure 11.4** which shows decreasing shares of agriculture and livestock sectors at 32.1 percent and 18.0 percent respectively in CY06, from 37.4 percent and 27.2 percent in CY05. Product

[4] During CY06, TMFBL, FMFBL and KB contributed around 90 percent in the total assets of MFBs.

diversification is a healthy sign for the future growth of this sector and can potentially help this sector to reach it's potential market by serving its targeted segment of society. However this trend may weaken the growth potential of the MFBs in the rural areas which are largely dependent on agriculture and livestock for earning their livelihood. The prospective addition of experienced commercial banks and NGOs into the microfinance business is expected to maintain the balance of advances between both peri-urban and rural areas.

**Figure 11.4: Activity-wise Distribution of MFBs Loans - CY06**




Source: State Bank of Pakistan

### 11.3.4 Gender-wise Distribution of Loans

Gender-wise distribution of advances is quite important as one of the main objectives of microfinance is to empower women by making them financially sustainable. However, MFBs in Pakistan are not very successful in fulfilling this objective, as the share of female borrowers in the total number of bowers has been declining, and during CY06 it declined further to around 19 percent as compared to 24 percent in CY05 (**Table 11.3**). One of the most apparent reasons for this declining share of women is that mostly microcredit is being given to those clients who are economically active. Despite their involvement in the agriculture sector, women in remote areas are not actively participating in business activities due to cultural constraints. In this regard the experience of MFIs is very encouraging as more than 54 percent of their clientele is female. Their successful experience is attributed to their more frequent community interaction and involvement.

**Table 11.3: Gender-wise Distribution of Loans**
percent

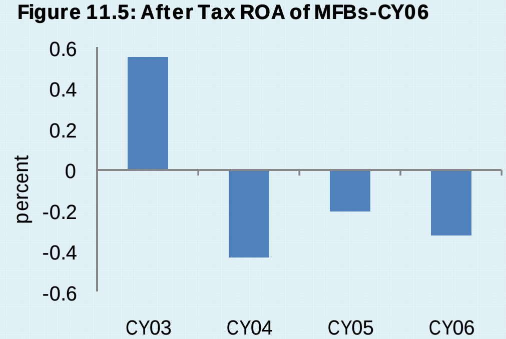
| | MFBs | | MFIs | | Total | |
|---|---|---|---|---|---|---|
| | CY05 | CY06 | CY05 | CY06 | CY05 | CY06 |
| Male | 76 | 81 | 47 | 46 | 41 | 60 |
| Female | 24 | 19 | 53 | 54 | 59 | 40 |

Source: OSED, State Bank of Pakistan, PMN

### 11.3.5 Financial Health of MFBs

Most of the MFBs are still in the initial stages of establishing their businesses, and are not mature enough to earn reasonable profits for their own sustainability. **Figure 11.5** shows that MFBs have accumulated losses in the post-CY03 period. These losses are largely due to the high operational and administrative costs in the wake of expansion activities of the new MFBs. Although the overall profitability of this sector is negative but individually, older MFBs like KB and FMFBL have started making reasonable profits which is a positive sign for the sustainability of this sector and therefore it could be expected that in the coming years the other banks, after establishing themselves, would also start making profits.

**Figure 11.5: After Tax ROA of MFBs-CY06**




Source: State Bank of Pakistan

The loan portfolio of MFBs is growing rapidly, while the delinquency rates of microfinance clients and the number of bad loans written-off are low and declining. MFBs, in term of loan recovery, proved themselves more efficient which is mainly attributed to close and efficient monitoring system of MFBs. As a result, non performing loans (NPLs) of MFBs declined by 38.5 percent to reach Rs.63.5 million in CY06 (**Table 11.4**). NPLs form only 1.8 percent of total advances which does not indicate any serious threat to the future growth of

MFBs as these NPLs have been adequately provisioned. During CY06 net NPLs turned negative by Rs. 30.4 million, indicating the higher amount of provisioning is being done against NPLs. As a result, provisioning to NPL ratio improved further to reach 148 percent in CY06 from 84.1 percent in the same period last year.

**Table 11.4: Asset Quality Indicators of MFBs**

million Rupees

| | CY05 | CY06 |
|---|---|---|
| NPLs | 103.3 | 63.5 |
| Net NPLs | 16.4 | -30.4 |
| NPL/Gross Loans (percent) | 4.4 | 1.8 |
| NPL/Net Loans (percent) | 4.6 | 1.8 |
| Prov/NPLs (percent) | 84.1 | 147.9 |
| Net NPLs/Capital (percent) | 0.5 | -0.8 |

Source: OSED, State Bank of Pakistan

### 11.4 Sustainability Issues

The growth in the Microfinance sector of Pakistan is being led largely by those institutions which are heavily subsidized in terms of cost of operations, and yet most of the MFBs have not achieved the requisite self sustainability level and are unable to generate revenues sufficient to cover their costs. At present, MFBs are incurring 32-36 percent recovery costs, whereas in contrast, they are charging interest rates of around 18 percent, creating a revenue gap which indicates unsustainability of future operations. In terms of financial self sufficiency (expense to revenue ratio), MFIs in Pakistan are far behind at 62 percent, in comparison with regional benchmarks of 109 percent and 101 percent in South/East Asia and Sub Saharan Africa respectively.[5]

In order to extend the outreach to 3 million borrowers by 2010, there is a need to improve access to finance through financially sustainable, low cost models, as the existing model will only require provision of more subsidies. Growth can only be achieved through sustainable microfinance operations. For this purpose the microfinance sector needs to employ the cost-covering concept, develop low cost alternate delivery channels, diversify their products and services, and consider mechanisms for re-pricing of products and services which could be determined in line with the respective transaction costs.

### 11.5 Should MF Sector be subsidized?

Subsidies have played an important role in the promotion and growth of the microfinance sector in Pakistan.[6] As MFIs are positioning themselves to enter into the growth phase, there is a need to change the role of subsidies in order to promote healthy competition. Going forward, subsidies should be allowed only to build the efficiency and financial sustainability of the institutions. MFIs have been providing their services in both rural as well as in urban areas. Subsidies should be restricted for those MFIs who intend to provide microfinance services in the poorer and resource deficit regions (i.e. Rural Sind and Baluchistan, barani areas of Punjab and NWFP), enhance capacity, innovate and grow rather than just finance their normal operational costs. SBP in its strategy has also recommended that Pakistan Poverty Alleviation Fund (PPAF) should define specific eligibility criteria to provide concessionary financing to MFIs.

### 11.6 Conclusion

With the efforts of the government and the SBP's active role to streamline the business of MFIs, the microfinance sector has started gaining momentum in terms of expanding its outreach. As of end-June CY07, MFIs (including MFBs) are serving approximately 1.28 million active borrowers. However, despite this progress in terms of outreach, there are some important issues related to the sustainability of microfinance operations on commercial terms. At present, almost all market participants heavily rely on grants and subsidies in one way or another, and even then are incurring losses. The funding structure of MFBs suggests that these institutions lack their own resource base through deposits mobilization, which is of vital importance for the long term sustainability of these institutions.

[5] Based on information from "Microfinance Performance in Pakistan: 1999-2005" published by USAID, 2006.

[6] According to the USAID report on "Microfinance Performance in Pakistan: 1999-2005", from 1999 to 2005, total investment from international donor agencies in the microfinance sector of Pakistan amounted to at least US$ 400 million which is mainly from the World Bank's support to PPAF and the Asian Development Bank's Microfinance Sector Development program.

For an efficient utilization of subsidies, their amount must be linked to the operations of MFIs in resource deficient areas, or for the MFIs involved in capacity enhancement, innovation and growth rather than financing their normal cost of operations.

Keeping the expanding microfinance outreach strategy in view, it is expected that MFIs will be further strengthened in coming years and their role in employment generation, empowerment of women and eradicating poverty will become more significant.