5 Financial Deepening: Role of Islamic and Microfinance Institutions

The establishment of Islamic banking and microfinance institutions is one of the major highlights in Pakistan's financial sector development in recent years. These specialized institutions are expected to enhance deepening of financial services in the country through offering services to two major segments of the society that had remained outside the coverage of the existing financial system. First, those who are not using the existing system due to its non-conformity with the Islamic rules of law; and second, the poor people, who do not have access to the conventional financial system.[1] Both the Islamic banking and microfinance institutions have registered rapid growth during the last couple of years, although they have covered only a small portion of the available market.

The process of Islamizing the financial system in Pakistan was first started in 1979 through efforts to transform the loans and deposits products of the banking sector into non-interest bearing activities.[2] It was completed by the mid-1990s, as banks shifted to Profit and Loss Sharing (PLS) deposit schemes and started giving loans on mark-up based system. However, this non-interest based banking was declared un-Islamic by the Council of Islamic Ideology at the initial stages and by the Federal Shariah Court in 1991. As a result, a significant portion of the society willing to use banking facilities compatible with Islamic rules and regulations stayed away from the existing interest-based banking system. Real impetus to Islamization came after the establishment of the Commission for Transformation of Financial System to comply with the directions given by the Supreme Court of Pakistan in its judgment of December 23, 1999. Following the recommendations of the Commission and the supporting tasks force, separate rules and regulations for Islamic banking parallel to interest-based banking activities have been formulated. As a result, the Islamic banking sector has registered a rapid growth during the last four years.

The history of microfinance institutions in the formal sector in Pakistan dates back to 2000, when the first ever microfinance bank was established under 'Khushhali Bank Ordinance 2000' in a bid to alleviate poverty by providing credit facilities to the poor segment of the society.[3] Subsequently, the Microfinance Institutions Ordinance 2001 was promulgated to specify detailed rules and regulations for the operations and procedures of the microfinance banks. Since then, this sector has made substantial progress, which is evident from the increasing number of microfinance institutions and their clientele. However, the focus has largely remained on credit-extension, as microfinance banks, in particular the Khushhali Bank,[4] is solely relying on credit line from international financial institutions and has not yet started mobilizing deposits. In order to sustain growth in future and also to optimize the social objectives, there is a need for microfinance institutions to provide whole range of financial services; including loans extension, deposit mobilization, and insurance services to their clienteles.

In this backdrop, the performance of the Islamic banking system and the microfinance institutions during 2001-2005 has been analyzed in this chapter.

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[1] Prior to the establishment of microfinance banks, the microfinance activities, in particular micro-credit, were performed by the moneylenders, merchants, non-governmental organization (NGOs), and friends and relatives as a considerably large proportion of population in rural areas often does not have access to the conventional banking system. While microfinance banks have made rapid progress, still the informal channel is dominating this sector.

[2] The government also facilitated Shariah compliant financial activities of Leasing and Modaraba companies by establishing rules and regulation during 1980s.

[3] In fact, worldwide recognition of MFIs as one of the effective tools to alleviate poverty following the role model of Grameen Bank of Bangladesh, various countries established MFIs to extend credit facilities to the poor people.

[4] The largest microfinance bank in Pakistan.

5.1 Islamic Financial Services

In the last three decades, Islamic Financial Services have made a considerable progress at the global front.[5] Especially, during the previous ten years the Islamic Financial Sector (IFS) has registered a robust growth (between 15 to 20 percent per annum); making it one of the fastest growing segments of the overall financial system. As a result, today the Islamic financial industry is comprised of across-the-board financial institutions including: onshore and offshore commercial banks, non-bank financial companies, housing cooperatives, microfinance institutions, venture capitals, mutual funds, insurance companies, etc. Moreover, there are dedicated regulatory, legal and academic institutions at the international level that are providing support in establishing the IFS.[6]

Since 2002, the Islamic financial sector, in particular Islamic banking, has made rapid progress in Pakistan. Unlike the earlier attempt of Islamizing the banking system when the entire banking sector was required to implement Islamic banking principles, in the recent effort a three-pronged approach has been adopted. Specifically, financial institutions were allowed to choose among three alternatives: (i) establish a full-fledged Islamic Bank (IB) in the private sector; (ii) set up a subsidiary of the existing commercial bank; and (iii) start stand-alone Islamic banking branches of existing commercial banks.

Table 5.1: Number of Islamic Banks & Branches

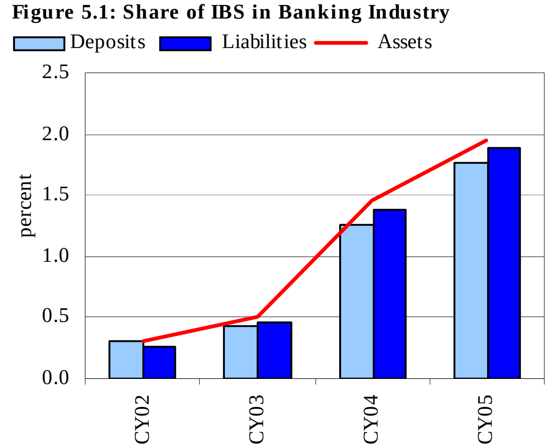
numbers

	Jun-02	Jun-03	Jun-04	Jun-05	Jun-06
IBs	1	1	2	2	4
Branches of IBs	6	10	23	37	60
Stand alone branches	0	7	25	33	40
Total branches	6	17	48	70	100

Source: IBD, SBP

As a result, the network of Islamic banking has increased manifold (see **Table 5.1**).[7] By the end of June 2006, four full-fledged Islamic banks, with a network of 60 branches, and, 40 stand-alone branches of commercial banks were providing Islamic banking services in the country.[8] Moreover, recently license has been issued to two more banks,[9] which are expected to start their business soon.

Figure 5.1: Share of IBS in Banking Industry



5.1.1 Performance of Islamic Banking System

In aggregate, the Islamic Banking System (IBS) depicted a tremendous growth as assets surged from 6.9 billion in CY02 to 71.5 billion in CY05, growing at an average annual rate of above 100 percent. Growth in assets was well supported by a sharp increase in deposit base; which increased from Rs 5.0 billion in CY02 to Rs 50.0 billion in CY05. This rapid growth allowed IBS to increase its share in the overall banking industry from only 0.3 percent in CY02 to around 2 percent in CY05 (see **Figure 5.1**). The momentous growth of the sector in its relatively

[5] Broadly, an Islamic financial system can be defined as a financial system that follows basic Islamic principles (Tawhid, Vicegerency and Justice). Islam prescribes rules for Halal and Haram specifically, prohibiting *riba* (interest); *Gharar* (excessive uncertainty); and *Maysir (*speculation) and encourages alms giving, i.e. *Zakat*.

[6] For details on development of IFS see **Box 5.1**.

[7] The first and third options have been exercised so far and none of the commercial bank has set up a subsidiary for Islamic banking.

[8] Among commercial banks, the Muslim Commercial Bank Ltd (MCB) has the largest network of standalone Islamic Branches.

[9] Emirates Global Islamic Bank & First Dawood Islamic Bank Limited.

initial stage demonstrates the existence of a significantly large potential market for Islamic banking in Pakistan.

Box: 5.1: Islamic Financial Services- International Developments

Presently, Islamic Financial Institutions (IFIs) exist all around the world operating either in a complete Islamic regulatory regime (Iran, Sudan) or in an environment where they coexist along the conventional financial services (Pakistan, United Arab Emirates, Saudi Arabia, Malaysia, and Indonesia). The big players of the banking industry based in United States and Europe have also introduced Islamic financial services. However the preference still remains to have a clear separation between Islamic and conventional financial services.

According to the estimates of the General Council for Islamic Banks and Financial Institutions, there are about 284 Islamic financial institutions (IFIs), operating in 38 countries, and managing funds to the tune of US $ 178.5 billion. In addition, Islamic windows operated by the conventional banks have US $ 200 billion under their management. The estimated size of non-banking financial institutions was estimated to be around US $ 9-12 billion in 2005.

Regulating the Islamic Financial Services Industry

In order to establish standards and design prudential regulations for the IFS various international institutions have been set in place. Islamic Financial Services Board (IFSB) is one of the key initiatives in this regard. IFSB has been established in Malaysia with the collaboration of Central Banks of Islamic countries and the International Monetary Fund (IMF). In 2005, IFSB has produced some valuable documents with a focus on Corporate Governance, Risk Management, and Capital Adequacy standards for Non-Takaful Islamic Financial Institutions (IFIs). IFSB is also working towards developing regulations for a smooth transition to Basel II accord.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is another important organization complementing IFSB in issuing standards for the Islamic financial industry. AAOIFI has issued over 50 accounting, auditing, governance and Shariah standards since its inception in 1991. AAOIFI is currently working on four new standards focused on (i) Governance Principles, (ii) Independence of Shariah Supervisory Board, (iii) Takaful and Re Takaful, and (iv) Financial Market Indices.

Other important institutions include the Islamic Development Bank (IDB), Liquidity Management Centre of Bahrain (LMC), International Islamic Rating Agency (IIRA), the Council of Islamic Banks and Financial Institutions (CIBFI) and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCFI).

Capital Markets

Most of the Islamic countries have a sizable presence of shariah compliant stocks listed on their stock exchanges. Investments in this area were facilitated by the establishment of Dow Jones Islamic Market Index (DJIMI) and Financial Times Islamic Indices. According to The Islamic Banker London there are more than 250 Shariah compliant mutual funds managing about US$ 300 billion in assets.

Islamic securities have captured significant attention from both public and private enterprises as means of raising funds. Issuance of Sukuks has diversified liquidity management options for Islamic investors. By the end of 2005 Sukuk market was estimated to be worth US $ 10 billion with 54 issues. Most of the Sukuks are attractive to the conventional investors since they carry an implicit government guarantee with them. The most recent Development in Sukuk Market is the launch of a benchmark index for Islamic bonds by the Dow Jones Citi Group.

Takaful

According to IFSB there are around 78 Takaful companies functioning around the world and IFSB estimates the Takaful industry to be at US $ 10 billion providing a cover to an estimated US $ 20 billion of assets. Most of the companies are situated in Malaysia, Bahrain and Sudan with new ones coming in different parts of the world including the Gulf Region, and Pakistan.

Source: Ten-Year Master Plan (2006 – 2015); A joint initiative of the Islamic Research & Training Institute, Islamic Development Bank & Islamic Financial Services Board.

Similar to the conventional banking system, as well as international practice, *financing* has the largest share in overall assets of IBS (see **Table 5.2**). However, in sharp contrast to both the practices, *investment* share is very miniscule; for instance at end CY05 investment comprised of only 2.6 percent of total assets.[10] This difference can be explained by the lack of Shariah compliant investment avenues in the country. In fact, lack of investment opportunities for IBS put these institutions at a relative disadvantageous position compared to the other commercial banks in fulfilling the Statutory Liquidity Requirement (SLR). Specifically, until the issuance of WAPDA-Sukuk bond in November 2005, there was no approved security for meeting SLR and IBS was required to hold the entire SLR in cash (at zero return) with the Central Bank.[11] In order to partially compensate, SLR for IBS was set at 6 percent (against 15 percent for other banks).[12] As the WAPDA-Sukuk bond has been considered the approved security,[13] IBS is required to maintain SLR at 8 percent (in the form of investment in WAPDA-Sukuk not exceeding 5 percent of their time and demand liabilities and remaining in the shape of cash balance with SBP)[14].

Table 5.2: Asset and Liability Structure of IBS

Share in percent

	CY02	CY03	CY04	CY05
Assets				
Cash and balances with treasury banks	9.5	10.0	17.9	14.4
Balances with other banks	15.2	5.3	9.1	12.6
Investments	12.3	9.6	4.5	2.6
Financings	50.7	67.0	62.4	64.0
Operating fixed assets	0.5	0.7	2.1	1.6
Other assets	11.7	7.4	3.9	4.8
Total assets (billion Rs)	7.0	12.9	44.1	71.5
Liabilities				
Bills payable	0.9	1.6	1.2	1.0
Deposits	94.3	76.9	77.4	78.4
Due to financial institutions	0.2	9.1	11.5	7.1
Borrowings from head office	0.0	8.3	5.3	7.0
Other liabilities	4.6	4.1	4.2	6.0
Total liabilities (billion Rs)	5.1	10.9	39.0	63.7

Source: IBD, SBP

Product-wise break-up suggests that financing by IBS has largely been concentrated in debt-based financing schemes,[15] in particular *Murabaha* and *Ijarah*.[16] The former category, though, saw a sharp decline in share, continued to hold the largest proportion of overall financing by IBS (see **Table 5.3**). Ijarah financing, on the other hand, registered a rapid growth during CY02-CY05 and consequently the share of this category in the overall financing jumped from 17.4 percent in CY02 to 31.8 percent in CY05. Investment related participatory mode of financing, which generates a variable return and are of a relatively high-risk category than debt financing, registered a strong growth from CY04 onwards. In particular *Diminishing Musharaka* grew at the compound growth rate of above 240 percent over the period (CY03-CY05). At the end of CY05, Musharaka, including both general and diminishing, constituted around 10 percent of overall IBS financing compared to below 1 percent in CY02.

Table 5.3: Financing Products by IBS

Share in percent

	CY02	CY03	CY04	CY05
Murabaha	76.9	79.4	57.1	42.5
Ijarah	17.4	16.5	24.8	31.8
Musharaka	0.0	0.0	1.0	1.2
Diminishing Musharaka	0.0	1.2	5.9	8.9
Salam	0.0	1.6	1.0	0.6
Istisna	0.4	0.0	0.4	3.0
Others	5.3	1.3	9.8	12.1

Source: IBD, SBP

[10] In contrast, in CY05 investment shared around 22 percent of total assets of scheduled banks in Pakistan.
[11] This also explained a relatively higher share of *cash and balances with treasury bank* for IBs than the other commercial banks.
[12] This was in addition to 5 percent Cash Reserve Requirement (CRR).
[13] Vide Para-8 of the Government's Notification dated November 28, 2005.
[14] The SLR was increased w.e.f. February 15, 2006 (for details see BSD Circular No. 3 of 2006).
[15] This is in accordance with general practice in other Islamic countries.
[16] Definition of various Islamic financing schemes is given in **Annexure 5**.

Financial Health of Islamic Banks

It is encouraging to note that the rapid growth of Islamic Banks is accompanied by good financial performance as well. This can be deduced from looking at financial indicators of Islamic Banks both in absolute as well as in relative terms. As shown in **Table 5.4**, at the end of CY05, the capital to risk-weighted ratio at 14 percent was significantly above the 8 percent required level. Similarly, both gross and net NPLs to financing ratios at 1.7 percent and 0.6 percent, respectively, are considerably low and showing good quality assets of Islamic Banks. Also, *ROA (after tax)* at 2.0 percent was significantly higher than the generally acceptable level of 1.5 percent.

Table 5.4: Financial Indicators of Islamic Banks in CY05
percent

	IBs	All Banks
Capital Section		
Total capital to total risk weighted assets	14.0	11.3
Core capital (Tier 1 capital) to total RWA	13.8	8.3
Total capital (free of net NPLs) to total assets	11.5	6.7
Assets Quality Ratio		
NPLs to advances	1.7	8.3
Net NPLs to net advances	0.6	2.1
Provisions to NPLs	66.4	76.7
Earning asset to total assets	78.1	85.9
Earnings and Profitability Section		
ROA before tax	2.7	2.8
ROA after tax	2.0	1.9
Liquidity & Sensitivity Section		
Loans to deposits ratio*	68.2	66.4
Liquid assets to total assets	30.5	33.7

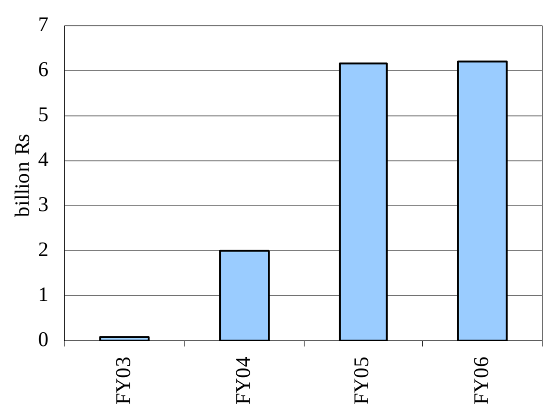
*: Net of Export Refinance Borrowings
Source: State Bank of Pakistan

Moreover, comparing indicators for financial performance of Islamic Banks with the overall banking system suggests that at the end of CY05 Islamic Banks were enjoying a relatively better financial health. As shown in **Table 5.4**, Islamic Banks were relatively better capitalized, enjoying high quality assets and earning better returns than the overall banking sector. However, the liquidity indicators suggest that Islamic Banks were relatively less liquid than the overall banking sector.

5.1.2 Islamic Export Refinance Scheme (IERS)

Similar to the refinance facility available to conventional banks, in 2002 SBP started a Musharaka-based export refinance scheme for Islamic banks and stand-alone Islamic branches operating in the country. Accordingly, IBS can avail refinance from SBP against its export financing operations to eligible exporters. In this regard, the IBS is required to have a Musharakah pool of minimum 10 export companies. SBP has set a very stringent eligibility criterion for exporters and only blue chip-export companies meeting four conditions, defined by SBP, are allowed to be on the Musharaka pool. Specifically, the company should have (i) good track record on stock exchange; (ii) credit rating of minimum B+ or equivalent; (iii) higher value of ROE during the previous three years than the rates of financing prescribed by SBP for conventional export finance scheme; and (iv) no adverse CIB report.

Figure 5.2: Disbursement under IERS



During the initial three years, the disbursement under IERS has increased tremendously (see **Figure 5. 2**). Specifically, annual disbursement under IERS has reached to Rs 6.1 billion in FY06 from only Rs 65 million in FY03. It is interesting to observe that up till 2005 only Meezan Bank Limited was availing this facility for their clients. However, in

FY06, Al-Baraka and Islamic branches of the Bank Al-Falah have also started tapping this source.[17]

5.1.3 Islamic Non-Banking Financial Institutions

Modarabas and Islamic mutual funds together constitute to form Islamic NBFIs.[18] The latter is a type of *equity mutual fund*, which is bound to invest either in equity market or Shariah compliant Bonds and Term Finance Certificates (TFCs). During FY01-FY05 the assets of Islamic-NBFIs grew at an annual average rate of 12.0 percent, which was significantly lower than the overall NBFIs growth in this period. As a result, the share of Islamic NBFIs declined by more than 100 basis points reaching at 6.3 percent in FY05 (see **Table 5.5**).

However the slower growth of Islamic NBFIs was primarily because of relatively poor showing by Modarabas. As discussed in the previous chapter, a large number of Modarabas have been merged or acquired by other financial institutions. As a result, a part of Modarabas' assets has been shifted to non-modarabas' financial institutions slowing down the growth of the sector. Islamic Mutual Funds, on the other hand, registered a strong growth of above 250 percent per annum during FY03-FY05 driven by healthy returns in stock markets. As shown in **Table 5.5**, the share of Islamic mutual funds in overall Islamic NBFIs' assets has jumped from 3 percent in FY03 to 12.4 percent in FY05.

Table 5.5: Assets of Islamic NBFIs
million Rupees

	FY00	FY01	FY02	FY03	FY04	FY05
Modarabas	15.3	15.6	17.5	16.0	18.0	21.4
Islamic mutual funds	-	-	-	0.5	2.0	3.0
Total	-	-	-	16.5	20.0	24.4
share in percent						
Modarabas	100.0	100.0	100.0	97.0	90.1	87.6
Islamic mutual funds	0.0	0.0	0.0	3.0	9.9	12.4
as percent of NBFIs						
Islamic NBFIs	6.4	7.6	8.2	6.3	6.1	6.3

Source: SECP

5.1.4 Islamic Capital Markets

While the overall domestic bond market has made some progress, the Islamic bond market has almost been a neglected area in Pakistan.[19] The first Islamic Term Finance Certificate (TFC) of Rs 360 million was issued in June 2002 by Sitara Chemicals Industries Ltd. The TFC was a Musharaka-based certificate of 5 years tenor and offering expected 12 percent return on the first Rs 100 million and 2 percent incremental return on each additional Rs 100 million investment. The certificate was rated AA- (double A minus) by the JCR-VIS. Later on, in December 2003, Al-Zamin Leasing Modaraba also issued Musharaka-based TFC of 5 years tenor and offering expected 8 percent return on profit and loss sharing basis. Despite over-subscription of this TFC, reflecting a demand for Shariah Compliant investment avenues, no other Islamic instrument has been launched until WAPDA issued its Sukuk bond on November 28, 2005.

The WAPDA bonds were issued for a tenor of 7 years and were allowed to trade in the secondary markets. The six month KIBOR with a positive spread of 35 basis points has been used as the reference rate to compute the return. IBS has shown a strong interest in the bond, as out of the total issue size of Rs 8 billion,[20] IBS has purchased almost 50 percent of the total issue. This was expected as the WAPDA bonds were considered as approved security for IBS to meet SLR. In fact, the IBS

[17] Moreover, recently Islamic branches of Standard Chartered Bank Ltd have been assigned a limit of Rs 300 million.
[18] In addition, Investment Finance Companies (IFCs) are also offering Islamic products, in particular Mudaraba and Musharaka, but their share of these products is not very significant in overall business of IFCs. For instance in FY05 the Islamic products shared only 2.0 percent in overall assets of IFCs.
[19] The difference between a conventional bond and Islamic bond is that Islamic bond is assed backed and is in accordance with Shariah principle. For details see publication "Pakistan Financial Sector Assessment 2004" page 71-72.
[20] The bond is issued in denominations of Rs 5.0 thousand.

has categorized its entire purchase of the bond into held-to-maturity, thus only a small amount is left to be potentially traded in the secondary market.

Pakistan Islamic Bond in International Market

In order to raise funds from the international market, the Government of Pakistan for the first time launched a Shariah compliant Ijara Sukuk of US$ 600 million in January 2005.[21] Initially, it was planned to raise US$ 500 million, but the amount was increased in response to overwhelming offerings by investors. Specifically, the total amount offered was US$ 1.2 billion. After Malaysia, Qatar and Bahrain, Pakistan was the fourth sovereign nation to issue an international Sukuk. As an Islamic bond has to be backed by a real asset, the Pakistan Sukuk bond has been issued against the 400-kilometer Islamabad-Lahore motorway. The bond is offering a return of 220 basis points over the six-month LIBOR. At the time of issue, Standard and Poor's rated the bond as B+, which has been maintained so far.

5.2 Microfinance Banks-MFBs

Worldwide reorganization of microfinance activities as an effective tool of poverty alleviation paved the way for the creation of the Pakistan Poverty Alleviation Fund (PPAF) in 1999. Besides others, one of the key objectives of the PPAF is to improve access of communities to financial services. To achieve this end, the government established the 'Khushhali Bank'(KB) under 'Khushhali Bank Ordinance 2000' to carry out microfinance activities in Pakistan. The bank was envisaged to strengthen community-based lending activities in collaboration with the existing well-functioning NGOs and by expanding its own branch network. Subsequently, these activities were further formalized by promulgating the Microfinance Institutions Ordinance, 2001. Based on this legal infrastructure, the SBP played a vital role by issuing detailed prudential regulations for safe and sustainable operations of microfinance banks and institutions. Furthermore, the SBP has also developed on-site and off-site surveillance manuals for MFIs with an elaborated consultation process. Recently, government has amended and refined the Microfinance Institutions Ordinance, 2001 through Finance Bill 2006 aimed to increase the business viability, diversity, and financial sustainability of microfinance banks (for more detail, see **Box 5.2**).

Box 5.2 Major Amendments and Refinements of MFI Ordinance 2001 Introduced in Finance Bill 2006

In order to improve the corporate governance and strengthening the regulatory power of the SBP by introducing the flexibility both at the regulatory cum supervisory level, several amendments and refinement were made in MFI Ordinance 2001 through Finance Bill 2006. These amendments aimed at increasing the business viability, diversity, and financial sustainability of microfinance banks. Among others, the major amendments are:

- To empower SBP to introduce flexibility and broadening of Microfinance Institutions to include Microfinance Banks,
- To give SBP flexibility in the determination of CRR and SLR with a flexible monitoring system
- To provide SBP the option of determining the definition/threshold income level of the poor
- To strengthen provisions to introduce explicit clauses regarding licensing of new MFIs, separate licensing requirements for existing NGO-MFIs, new start-up MFBs as well as improving provisions related to suspension of licenses, and
- To bring in line with SECP guidelines on corporate governance, the terms of external auditors and extending period of submission of accounts.

5.2.1 Growth and Outreach of MFBs

The conducive environment, in terms of legal and financial infrastructure, resulted in creating the fundamentals of the formal sector for microfinance. Since the inception of Khushhali Bank (KB) in

[21] For details on the Pakistan Sukuk bond see SBP publication "Pakistan Financial Sector Assessment 2004" page 72.

2001, the formal sector of Microfinance has developed a network of five institutions[22] consisting of 130 branches at end year 2005.[23] Realizing the special nature of microfinance, SBP has also allowed mobile banking to facilitate the institutions to enhance their access to their special target group concentrated in the unbanked areas of the country.

This expanded network has resulted in expanding the outreach of MFBs as indicated by an increase of 0.23 million in the number of borrowers during CY02-CY05 (see **Table 5.6**). By the end of CY05, MFBs were covering around 3.5 percent of estimated potential market of 7.0 million against only 0.2 percent in CY02.[24] Asset base of MFIs is depicting an increasing trend from Rs.1.9 billion in CY01 to Rs 7.9 billion in CY05 (see **Table 5.6**) making it 0.22 percent of the assets of the whole commercial banking industry. Though the share is still very small but the rising trend may be indicative of the favorable environment that can result in making MF as one of the essential part of the financial sector of the country. This can be substantiated by the very recent permission granted by the State Bank of Pakistan to commercial banks to start operations of microfinance through stand-alone branches or separate counters.[25]

Table 5.6: Outreach of Microfinance Banks

	Units	CY01	CY02	CY03	CY04	CY05
Institutions	numbers	1.0	2.0	2.0	2.0	5.0
Branches	numbers	10	49	71	107	130
Assets	million Rs	1,886	3,066	4,335	5,687	7,909
Advances*	million Rs	110	493	736	1,537	2,258
Borrowers	thousands	15	57	95	178	248
Deposits	million Rs	0	64	392	469	680
Depositors	thousands	0	3	10	19	33
Borrowings	million Rs	77	402	1,403	2,601	4,328

* Net of provision
Source: SME & Micro Finance Department, SBP

5.2.2 Composition of Assets and Liabilities

As expected, composition of MFBs' asset saw drastic changes during CY01-CY05 period. In the initial years of operations, a significantly large proportion of MFBs' assets was concentrated in investment; mainly in short-term government securities. However, as business of MFBs expanded, the share of *investment* in total assets declined from above 80 percent in CY01 close to 19 percent in CY05. A*dvances* to general clientele, and *lending and placements* in the interbank market have largely replaced the fall in investment share (see **Table 5.7**).[26] At end CY05, the former constituted almost 27 percent of total assets against only 6 percent in CY01.[27] However, this share of advances is still very low and is expected to increase further as MFBs are trying to increase their outreach.

In order to fund their assets base, MFBs are mainly relying on borrowing and their own equity. For instance, in CY05, together these two sources funded around 91 percent of the total asset. It is important to note that KB, the largest MFB, has not started mobilizing deposit yet. The institution is mainly dependent on credit-line provided by the Asian Development Bank (ADB). FMFBL, on the other hand, registered a sharp annual growth of above 300 percent (on average) in deposits base. As a

[22] Three MFBs (Khushali Microfinance Bank Limited, First Microfinance Bank Limited, Tameer Microfinance Bank Limited) are working at national level while two MFBs (Rozgar Micro Finance Bank Limited & Network Micro Finance Bank Limited) are operational at district level.
[23] By end June 2006 the number of MFBs increased to six as Pak Oman Microfinance Bank Limited has started operations since April 14, 2006.
[24] Including NGOs and Rural Support Programmes (RSPs) outreach of the microfinance sector was more than 17 percent of total potential market in CY05.
[25] Vide SMED Circular No. 11 dated June 27, 2006.
[26] Moreover, share of *other assets*, including *fixed operating assets*, has also increased from 6.4 percent in FY01 to 11.4 percent in FY05.
[27] It may be noted that the share of advances slightly declined in FY05 (by 0.4 percentage points), this was primarily due to entry of three new MFBs in this sector during the year.

result, the *deposit to total asset* ratio for FMFBL has increased from only 7.4 percent in CY02 to 44.5 percent in CY05. The experience of FMFBL suggests that poor people in Pakistan have the capacity to save. KB should also make efforts to tap on these resources. This is vital for sustainability of the sector, as relying primarily on credit lines may hinder the growth of MFBs in case this source is not available in future.

Table 5.7: Asset and Liability Structure of MFBs

Share in percent

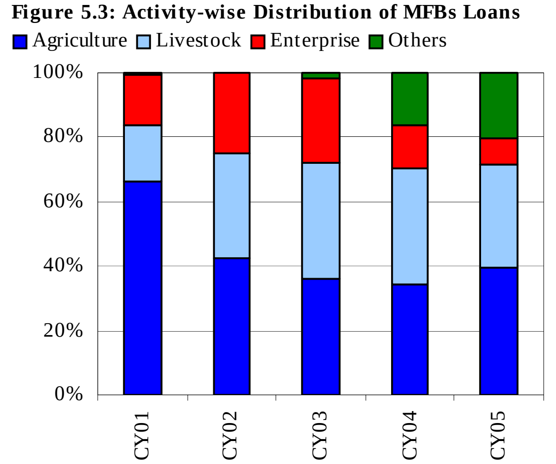
	CY01	CY02	CY03	CY04	CY05
Assets					
Cash & balances with treasury banks	5.7	6.8	15.9	12.6	6.5
Balances with other banks	1.7	3.5	14.6	15.2	20.1
Investments	80.3	63.7	43.1	21.7	18.5
Advances	5.9	16.0	16.6	27.1	26.7
Operating fixed assets	4.7	3.8	2.8	3.5	3.6
Other assets	1.7	6.1	7.0	19.8	24.5
Total assets (billion Rupees)	1.9	3.1	4.4	5.7	8.5
Liabilities					
Deposits	0.0	12.1	21.0	15.0	13.3
Borrowings	70.0	75.6	75.2	83.3	84.7
Other liabilities	30.0	12.3	3.7	1.6	1.9
Total liabilities (billion Rs)	0.1	0.5	1.9	3.1	5.1

Source: Microfinance Unit, SMED, SBP

5.2.3 Activity-wise Distribution of Loans

At present, the operations of MFBs are largely concentrated in rural areas and most of the loans are being extended to agriculture and live-stock sectors. At the end CY05, these two sectors together constituted above 70 percent of total loans. This distribution can be justified given a majority of the labor force and poor segment of the society is attached with these two professions. However, it is important for the sustainability of MFBs and also socially desirable that these institutions diversify their loan portfolio. Some diversification has been observed during CY01-CY05 (see **Figure 5.3**). Recently in January 2006, the Tameer Microfinance Bank Limited has started its operations; initially the bank is focusing on targeting the un-banked people in urban areas.

Figure 5.3: Activity-wise Distribution of MFBs Loans



5.2.4 Gender-wise Distribution of Loans

In contrast to a general trend in other countries and notwithstanding the objectives of microfinance, as defined in the Microfinance Sector Development Programme (MSDP), distribution of loans, extended by MFBs, is highly skewed towards male borrowers. In fact, the share of female borrowers in total loans extended by MFBs has further declined to 24 percent at the end of CY05, from an already low level of 30 percent in CY01 (see **Table 5.8**). This was largely an outcome of MFBs' efforts to increase their outreach to remote areas, as people in these areas of Pakistan generally have strong views on women's participation in economic activities. However, it may be important to note that NGOs and RSPs are quite successful in attracting female clientele, as in aggregate terms their female coverage ratio is above 50 percent.[28] As SBP has allowed

Table 5.8: Gender-wise Distribution of MFBs Loans

percent

	CY01	CY02	CY03	CY04	CY05
Male	70.0	70.0	70.6	71.7	75.8
Female	30.0	30.0	29.4	28.3	24.2
Total	100	100	100	100	100

Note: Data pertains to KB & FMFBL

Source: KB and FMFBL

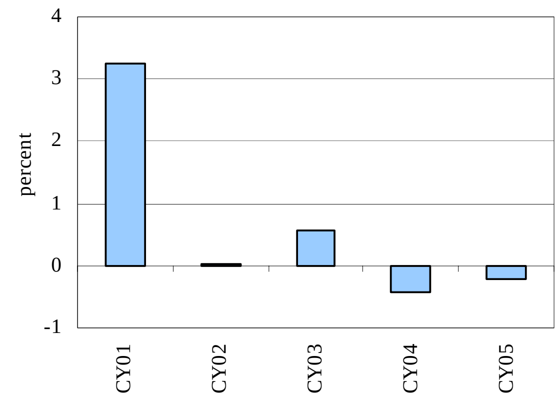
[28] Some of the NGOs, such as KASHF and DAMEN, are extending loans only to female group.

NGOs to transform into MFBs, it is expected that the overall coverage of the female would increase in coming years. Moreover, in order to enhance their activities to the female section of the society, MFBs should take the guidance and assistance from the network of the unregulated sector.

5.2.5 Profitability and Asset Quality of MFBs

As MFBs have recently started to expand their business network, it may be too early to analyze the profitability of this sector. Nevertheless, in aggregate terms, MFBs have failed to earn significant amount of profits so far, except in CY01 (see **Figure 5.4**).[29] In fact, MFBs have registered losses during CY04 and CY05. However, this was mainly attributed to large administrative expenses stemming from expanding the network. Going forward, as the MFBs attain an adequate size, it is expected that these institutions will start booking profits. This can be supported by the fact that KB & FMFBL, which have already expanded their business network to an extent, have earned positive (after tax) profits of Rs 13.1 million in CY05**.**

Figure 5.4: After Tax ROA of MFBs



The Pakistan experience with microfinance loans, so far, also confirms that the poor have the ability to repay loans. This can be seen by below 4 percent value of NPLs to total loans ratio in CY05 (see **Table 5.9**). These NPLs are adequately provisioned, thus do not pose any serious concern at this stage. Specifically, at the end of CY05, provisioning to NPLs ratio was close to 84 percent and consequently net NPLs to net loans ratio was below one percent. However, it may not be appropriate to draw strong conclusions on the asset quality of MFBs in their early stage of operations. It is essential for the sustainability of this sector that MFBs should continue with the high repayment and provisioning ratios.

Table 5.9: Asset Quality Indicators of the MFBs

	Units	CY02	CY03	CY04	CY05
NPLs	million Rs	5.7	57.3	93.9	103.3
Net NPLs	million Rs	-62.3	-126.4	20.4	16.4
NPL/loans(gross)	percent	1.0	6.2	5.8	4.4
NPL/loans(net)	percent	--	--	1.3	0.7
Prov/NPLs	percent	--	--	78.3	84.1
Net NPLs/capital	percent	-2.5	-5.1	0.8	0.5

Source: Microfinance Unit, SMED, SBP

5.3 Conclusion

The establishment of Islamic banking and the Microfinance institutions was among the most important features of the financial sector development during the last five years. These institutions helped in the deepening of the financial sector by offering services to the un-banked segments of the society. Although at present both the sectors are at the very initial stages and capturing a very small portion of the available market, their momentous growth indicates a great potential of these sectors to be the essential parts of the financial system of the economy in coming years.

The Islamic banks are enjoying a relatively better financial health than the overall banking industry (on average). Despite the fact that IBS does not have avenues for investment and holds a significantly higher cash with SBP at zero return to meet SLR, the ROA of Islamic banks was consistently higher

[29] During CY01, KB, the only MFB at that time, earned a profit of Rs 60 million.

than average of banking system during the last three years. Moreover, with the recently issued Islamic bond by WAPDA, it is likely that profitability of IBS would further improve.

Although the MFBs have recently started business in Pakistan, their rapid growth and high performing assets so far has confirmed the fact at the international level that the poor do have the ability to meet their debt obligations and can save a part of their income, as well. However, at present, focus in Pakistan is only in extending credit facilities, as MFB, in particular the KB, is solely relying on credit line from ADB and has not yet started mobilizing deposits. However, in order to sustain growth in future and to optimize the social benefits, it is important for MFBs to increase focus on deposit mobilization, as well. Further, there is a need that microfinance institutions should provide insurance services to the poor segment of the society, which is more prone to adverse shocks and often has limited capability to mitigate negative fallouts.

It is encouraging to note that recently the commercial banks have also been allowed to start microfinance operations. Moreover, in order to provide flexibility to the SBP both at the regulatory and supervisory level, recently, Microfinance Institutions Ordinance 2001 was amended and refined through Finance Bill 2006. These developments would not only accelerate the development of this sector but also improve the efficiency of MFBs through increased competition.