3.3 Risks to the Microfinance Banking Sector

Pakistan has been endeavoring to increase financial inclusion in the country and the National Financial Inclusion Strategy has been a milestone in this context. Over the past decade and a half, Microfinance Banks (MFBs) have been playing their part towards enhancing financial inclusion. The sector has flourished well in recent times; though asset quality has somewhat worsened. Profitability has been high and deposit base has been growing at a significant pace. Most of the credit is extended to enterprises, agriculture and livestock with majority of the customers belonging to the under-served rural areas. The penetration has been limited though, as the client base stands at 1.9 million in a country of around 126 million adults; pointing to huge potential ahead. Encouragingly, women comprise around one-fourth of the clientele. Future of MFBs seems bright though careful supervision is required especially in the area of branchless banking.

SBP has been taking a number of steps and initiatives to increase the outreach of financial services to a wider range of populace. In fact, the goal of Financial Inclusion has been accorded strategic importance and is an integral part of SBP's Strategic Plan 2016-2020. Under this plan, SBP is aiming to implement the National Financial Inclusion Strategy (NFIS) and promote alternative channels for delivery of financial services.

Table 3.3.1

Access Strand in Pakistan

Percent of adult population	A2FS 2008	A2FS 2015
A. Bank Accounts	11	16
B. Other formal	1	7
Formally served (A+B)	12	23
C. Informally served	32	24
Financially served (A+B+C)	44	47
Financially excluded	56	53

Source: Acces to Finance Survey (A2FS) 2008 and 2016, SBP

The reason for focusing on financial inclusion is that despite considerable growth of the banking sector in recent times, the overall financial inclusion in the country remains on the lower side. Access to Finance Survey (A2FS) 2015 indicates that access to formal financial services has increased from 12 percent of the adult population in CY08 to 23 percent in CY15. The adult population with a bank account has increased from 11 percent in CY08 to 16 percent in CY15. Particularly, women's access to financial services has expanded considerably, as 11 percent now have access to a bank account, compared with merely 4 percent in CY08 (**Table 3.3.1**).

Microfinance banks better placed to cater to financial inclusion…

MFBs in Pakistan present immense opportunities for increasing financial inclusion. Although their asset base stands at just 1.08 percent of the total assets of the banking sector as of end CY16, MFBs, because of their alternative lending technology, outreach in remote areas and their clientele at lower end of income distribution, are better positioned to serve the purpose.

Given the fact that more than half of the population of Pakistan lives in rural areas, access to financial services through conventional banks is difficult for them. MFBs, on the other hand, with their focus on rural areas could provide the solution. MFBs, generally, offer small loans with minimal paper work, which is better suited to meet the needs of an underserved population.

Unlike commercial banks, one of the strengths of microfinance banks is the "Group lending (GL)" technology. The GL consists of the attribution of a loan to each person within the group. However, the loans are not renewed to anyone in the group even if one borrower defaults. Consequently, through social pressure, the GL gives individuals incentives to be financially disciplined and to repay their loans[111].

MFBs have shown prolific growth over the last few years…

Microfinance banking in Pakistan dates back to CY00, when the first MFB was incorporated. By CY08, the number of MFBs increased to six; and currently there are eleven MFBs operating in Pakistan (**Table 3.3.2**).

Table 3.3.2

Number and Major Financial Soundness Indicators of MFBs

	CY12	CY13	CY14	CY15	CY16
Number of MFBs	10	10	10	10	11
	Percent				
CAR	47.48	43.11	37.57	28.95	23.38
NPLs to Advances	1.04	1.02	1.16	1.32	1.57
Net NPLs to Net Advances	(0.68)	0.11	0.13	0.16	(0.56)
ROA (After Tax)	(0.03)	1.20	2.12	4.75	4.72
ROE (After Tax)	(0.14)	5.28	9.76	23.41	27.77
Cost / Income Ratio	86.95	83.68	81.20	77.32	73.28
Liquid Assets to Short-term Liabilities	87.98	70.93	70.58	59.37	66.45
Advances to Deposits	85.00	83.60	85.43	86.73	73.04

Source: SBP

Financial health of the MFBs has been encouraging despite tremendous growth. Over the period of last four years, total assets of the industry have expanded nearly four times. During CY16 alone, the industry has expanded by 74.65 percent. More than half of the assets of MFBs are loans and advances while share of investments stands at 19.64 percent. The government's focus on achieving the goals of the NFIS is partly responsible for the prolific growth of MFBs during CY16.

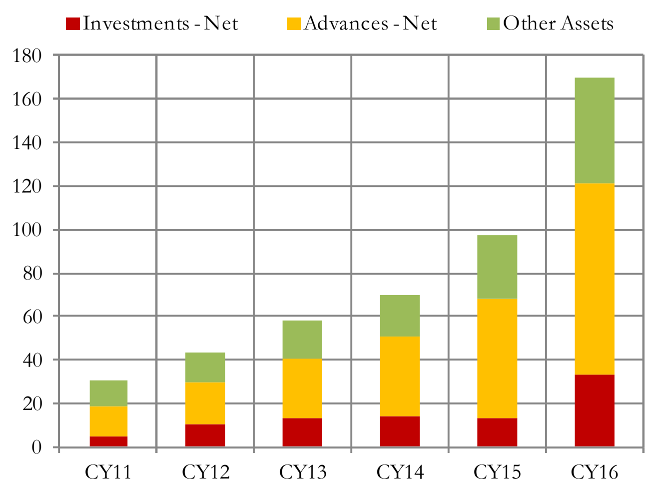
It is noteworthy that a substantial amount of assets of MFBs are parked as interbank balances, which is mainly for meeting the liquidity requirements since MFBs are not entitled to the SBP's discount window facility (**Figure 3.3.1**). Currently, MFBs are catering the credit needs of around 1.9 million people, mostly in the remote areas.

Figure 3.3.1

MFBs have shown prolific growth over the last few years

Assets of Microfinance Banks

(PKR billion)



Source: SBP

Asset quality shows some signs of worsening…

Gross loans of MFBs have increased by more than four folds over the past four years with around 60 percent growth during CY16 alone. At the same time, the volume of NPLs has also increased from PKR 208.5 million as of end CY12 to PKR 1.4 billion as of end CY16. Portfolio at Risk for greater than 30 days (PAR30), which is a popular measure of asset quality specifically for MFBs, also stands at the same level as the NPLs.[112] Consequently, both

[111] Ugur, Z. (2006). Commercial Banks and Microfinance. CUREJ - College Undergraduate Research Electronic Journal. Retrieved from http://repository.upenn.edu/cgi/viewcontent.cgi?article=1042&context=curej

[112] Portfolio at Risk (PAR) is defined as the outstanding balance of all loans with arrears over 30 days, plus all refinanced (restructured) loans (Damian von Stauffenberg, 2003), while NPLs are defined as the

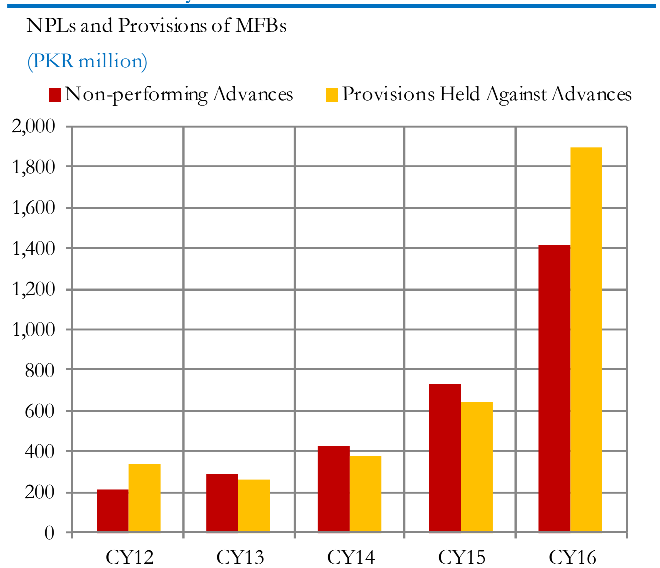
infection ratio and PAR30 to gross loans ratio has risen to 1.57 percent as of end CY16 from 1.04 percent as of end CY12.

The credit riskiness of MFBs is amplified by the fact that a sizeable proportion of 87.13 percent of the advances is non-collateralized. However, higher rate of return and GL somewhat dilute this risk.

Generally, expansion of operations and growth in loan portfolio are accompanied by a rise in NPLs. However, MFBs need to exercise caution by reviewing and tightening/strengthening credit standards as the absolute amount of NPLs has nearly doubled over the course of CY16 alone.

Figure 3.3.2

Provisions held by MFBs are well above the level of NPLs



Source: SBP

...while provisions held by MFBs are well above the level of NPLs

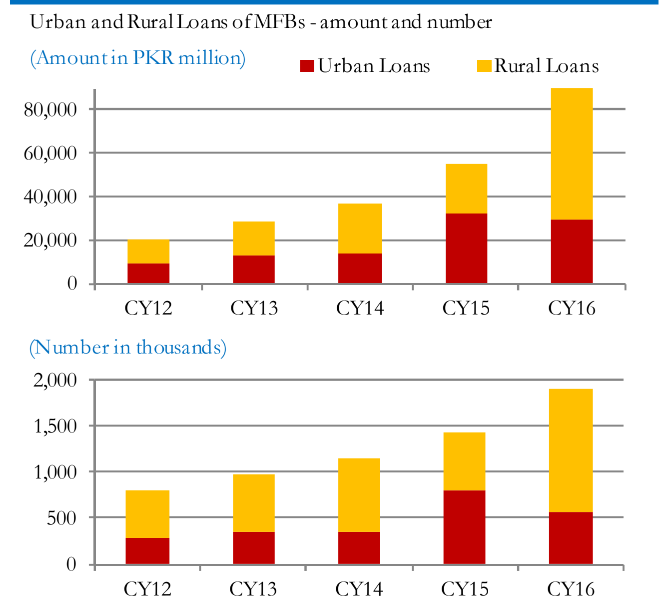
Although NPLs are rising, infection is being adequately covered. The provisioning coverage ratio of the MFBs has reached 134.57 percent as of end CY16. Given the rise in NPLs, the industry booked PKR 1.2 billion of provisions during the year under review (**Figure 3.3.2**). Hence, MFBs have already taken the impact of the classified loans on their books.

Rural areas remain key beneficiary of microfinance...

Encouragingly, during the year under review, there has been a remarkable increase in loans provided to the rural areas of the country (**Figure 3.3.3**). Both the amount and the number of rural loans have more than doubled during CY16. Moreover, this rise has been spread across the major segments of the industry (**Figure 3.3.4**).

Figure 3.3.3

Both amount and number of rural loans have risen during CY16



Source: SBP

...with loans mainly extended for Agriculture and Livestock

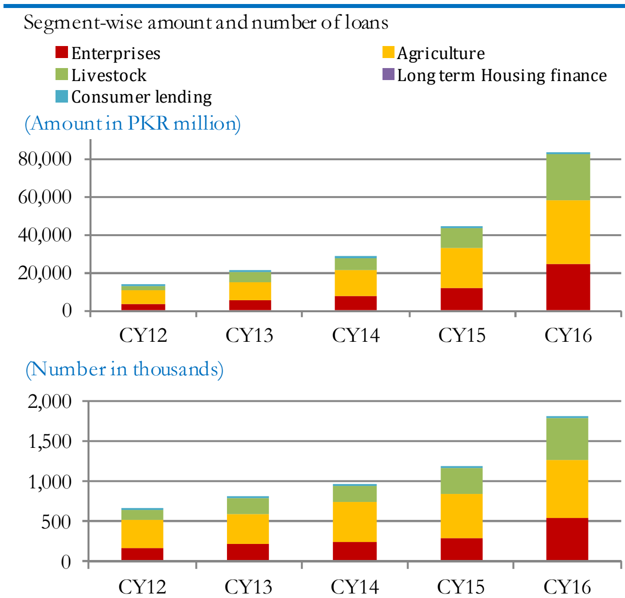
Understandably, as the MFBs are catering more to the rural customers, the exposure in Agriculture and Livestock loans dominates. As of end CY16, more than 60 percent loans are disbursed in these two segments as most of the rural population is associated with these two businesses.

outstanding principal and mark-up of the loans and advances, payments against which are overdue for 30 days or more as per Prudential Regulations for Microfinance Banks (R-8): http://www.sbp.org.pk/acd/2014/C3-Annex.pdf

With the introduction of Crop Loans Insurance Scheme, the risks associated with natural calamities like floods and droughts have been hedged to a greater extent. In contrast, housing and consumer finance continue to remain lower priority as MFBs have shown minimal interest in these areas (**Figure 3.3.4**). Given the level of outreach of MFBs compared with their conventional counterparts, there is a sizeable potential in both categories of lending in rural areas that can be tapped.

Figure 3.3.4

Lending remains concentrated in three major segments



Source: SBP

NPLs in Enterprise sector have increased…

Despite having only 26.94 percent share in total advances, enterprise[113] sector has almost half of the NPLs of the industry. As such, infection ratio of the sector stands at 2.96 percent, which is higher than industry's average of 1.57 percent.

Funding risks are minimal since the deposit base of MFBs has continued to expand…

Advances to deposit ratio has dropped to 73.04 percent as of end CY16 from 85 percent four years ago. This is primarily due to more than five folds increase in deposit base over the past four years, increasing by 90.43 percent in CY16 alone. Moreover, 50.81 percent of the deposits are fixed-term deposits while the remaining are CASA deposits. This exponential growth in deposits has been supported by increasing use of branchless banking in addition to healthy growth in lending activity.

Concentration in deposits has, however, increased over the last four years. Contribution of top 10 depositors in total deposit base has increased to 25 percent which was 16 percent four years ago.

Due to prolific growth over the past four years, the key liquidity ratios have come down significantly, though they are still at comfortable levels: liquid assets to total deposits, liquid assets to short term liabilities, and liquid asset to total assets ratios have all declined from 75.42 percent in CY15 to 45.99 percent in CY16, 87.98 percent to 66.45 percent and 40.03 percent to 32.46 percent, respectively.

…nevertheless, liquidity management can be a tricky business for MFBs

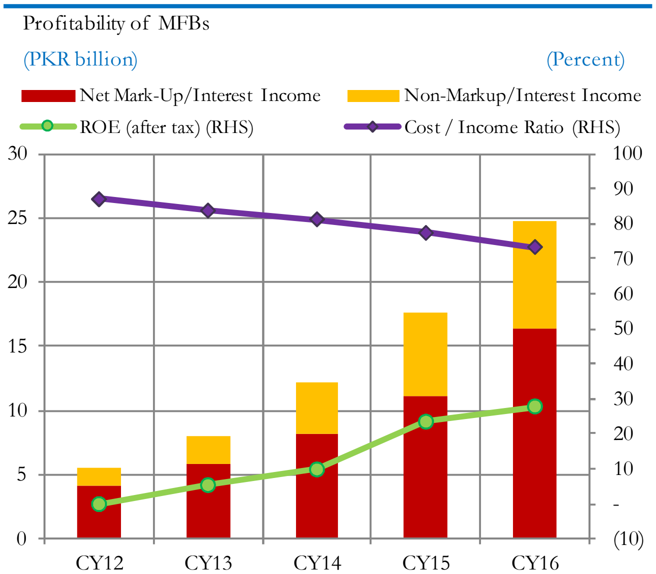
Since MFBs cannot avail SBP discount window facility, managing liquidity can be a challenge. As mentioned before, in order to efficiently manage liquidity, 12.34 percent of assets of MFBs constitute interbank balances and another 12.69 percent are invested in MTBs. One of the major challenges for the MFBs lies in finding the 'right' amount of funds to be placed in liquid assets without hindering extension of credit.

113 Enterprise means loans extended to "Microenterprises" defined as projects or businesses in trading, manufacturing, services, or agriculture that lead to livelihood improvement and income generation. Moreover, these projects/businesses are undertaken by micro entrepreneurs who are either self-employed or employ few individuals not exceeding 10 (excluding seasonal labor). For further details, please see Prudential Regulations for Microfinance Banks: http://www.sbp.org.pk/acd/2014/C3-Annex.pdf

Profitability of MFBs has been rising

The profitability of MFBs has risen by 28.43 percent during CY16. Around two-third of the income has come from interest based products. Consequently, the profitability indicators have been improving. For instance, ROE (after tax) has surged to 27.77 percent as of end CY16 from negative 0.14 percent as of end CY12 (**Figure 3.3.5**).

Figure 3.3.5
Profits of MFBs continue to rise



Source: SBP

While administrative costs remain high…

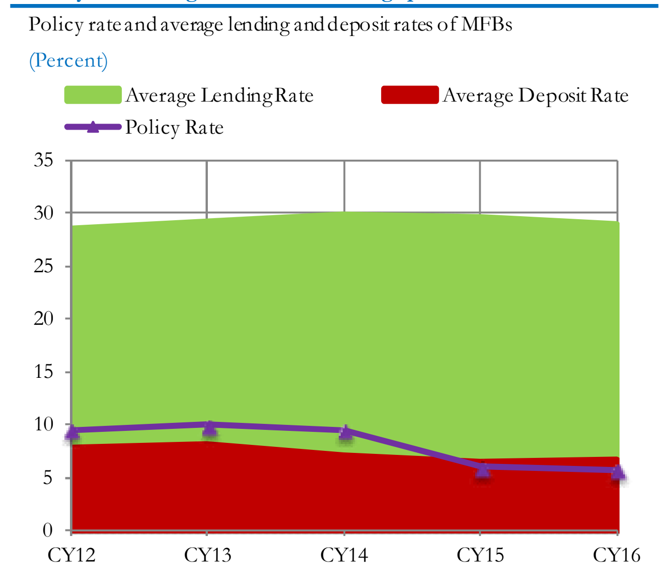
The level and depth of outreach and expansion of asset base by MFBs entails substantial costs since microfinance services involve frequent face to face interaction between banks' staff and the target clients. Resultantly, a point of concern for MFBs is the higher cost to income ratio. The ratio, though has dipped by 13.67 pps from its level in CY12, yet still stands at 73.28 percent in CY16.

Given the significant growth pattern of the MFBs, such higher expenses are understandable. Recently, MFBs have tried to reduce the prices of their lending products; nevertheless, their administrative costs have either risen or remain unchanged.

…that lead to relatively higher lending spreads

SBP has reduced the policy rate by more than 4 pps during the last three years. Ideally, this decline should impact the average lending and deposit rates of MFBs. However, the aforementioned higher administrative costs mean that MFBs have to maintain a certain lending spread in order to stay profitable. Therefore, despite some dip in the average deposit rate, there has not been a pronounced reduction in average lending rates of MFBs. As a result, lending spread of MFBs has remained steady over the last few years (**Figure 3.3.6**).

Figure 3.3.6
Policy rate has neglible effect on lending spread of MFBs



Source: SBP

Increasing lending portfolio has improved capital utilization

Lending portfolio has substantially increased over the past four years due to which Risk Weighted Assets have also shown considerable growth. This has pushed the CAR down to 23.38 percent in CY16 from 47.48 percent in CY12. CAR is, however, still higher than the minimum requirement of 15 percent. Nevertheless, if MFBs continue to follow the present growth pattern of their lending activity, the strengthening of the capital base may be needed either through plough back of profits or fresh capital injection.

Inclusion of third parties in branchless banking may raise issues related to operational risk

Core Banking Systems and branchless banking systems are using different platforms; their untimely integration may raise reconciliation issues. In case of branchless banking, super agents in the form of telecom companies are involved that may lead to financial information leakage and confidentiality risks. These risks have become all the more important since three MFBs are now subsidiaries of telecom companies. Moreover, retailers involved in OTC branchless banking transactions may split large transactions which raise money laundering concerns. Cognizant of their importance, Prudential Regulations for MFBs comprehensively address these risks vide "Section M: Money Laundering, Terrorist Financing and other Unlawful Activities" and "Annexure F: Guidelines on Internal Control and Risk Management".[114]

Though increasing, the outreach of MFBs is below potential…

Although number of people benefiting from the MFBs has risen to 1.9 million as of end CY16 from 0.8 million four years ago, penetration is still low when compared with the total adult population of the country (around 126 million). [115]As per the Pakistan Microfinance Network, the potential microfinance market is 20.5 million[116], which means that less than 10 percent of this market has been covered by MFBs.

Gender-wise, though women comprise a significant 26 percent of this headcount, the share has been hovering around this mark since CY12. Moreover, the share of outstanding amount of loans to women customers is even lower, sticking around 18 percent since CY12.

Although MFBs have grown significantly in recent times, further growth of the sector would facilitate access to finance, reduce poverty and also help existing small businesses to grow and foster employment. As mentioned before, NFIS will continue to facilitate growth in microfinance since it aims at bringing attention of GoP, regulators, and private sector to the microfinance sector. Moreover, with women accounting for a significant portion of the client base, MFBs are promoting gender equality and women's empowerment and can help reach the NFIS target of 25 percent of women having formal accounts.

114 Prudential Regulations for Microfinance Banks: http://www.sbp.org.pk/acd/2014/C3-Annex.pdf
115 Pakistan economic Survey 2015-16 - http://www.finance.gov.pk/survey/chapters_16/12_Population.pdf

116 Pakistan Microfinance Network - http://www.microfinanceconnect.info/assets/articles/d34305e0acc6d13f591fa0ddf120445e.pdf