7 Financial Inclusion and Financial Stability

Pakistan has come a long way in financial inclusion as today branchless banking and m-wallet accounts have expanded the access to far-flung areas of the country. The Microfinance banking sector, the key actor in financial inclusion landscape, continues to perform exceedingly well even in the face of general slowdown in the economy in CY18. MFBs asset base, deposits, advances have shown promising growth and the CAR has improved. From the financial stability perspective, growing financial inclusion poses limited concerns.

Pakistan re-launched the National Financial Inclusion Strategy with renewed commitment during 2018…

Pakistan is one of the pioneers in providing an enabling and conductive policy and regulatory framework for financial inclusion. Considering the benefits associated with enhanced financial inclusion (See Box 6), its longstanding commitment to inclusive finance was stepped up into a comprehensive National Financial Inclusion Strategy (NFIS) in 2015.

NFIS is based on four drivers: (i) promoting digital transaction accounts and reaching scale through bulk payments, (ii) expanding and diversifying access points, (iii) improving capacity of financial service providers, and (iv) increasing levels of financial awareness and capability. Under each category, a set of targets have been identified that are to be achieved by the year 2020. With the renewed commitment of the new government, the magnitude of various targets of NFIS have been revised during 2018, under the 100-days agenda, and the deadline has been extended to 2023 (See Exhibit)

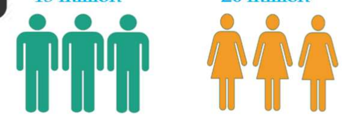
Exhibit: Revised Targets under NFIS

Enhance Usage of Digital Payments

65 million active accounts

Active Digital Transaction Accounts

45 million　20 million



Enhance Deposit to GDP ratio

55 percent

Increase share of Islamic Banking

25 percent of banking industry

Increase share of Islamic Banking Branches

30 percent of banking industry

Promote SME Finance

Financing 700,000 SMEs

Increase share of SME financing

17 percent of Total Private Sector Credit

Promoting Agri Finance through Digitalized Solutions

Serving 6 million farmers

Enhance Annual Disbursement

NFIS envisages utilizing all possible channels…

A common misconception is that only Microfinance institutions are responsible for banking the unbanked. However, all financial institutions including banks and non-banks have their role to play in enhancing financial depth and breadth. This is the reason that NFIS has envisaged utilization of all possible channels for increasing access.

Commercial banks facilitating in Financial Inclusion agenda, though at a slower pace …

To achieve the targets set under NFIS, the banks are also aiding by expanding the branch network, deposit base and financing to SME, Housing and Agriculture sectors. During CY18, banks have increased their branch network by 5 percent to 15,346.[243] Under SME financing, the number of borrowers have increased by 8.7 percent to 177,796 while financing has grown by 12.39 percent.

Housing finance, however, has decelerated recording a growth of 21.62 percent in CY18 compared to an increase of 31.85 percent in the previous year. Among others, the challenging economic environment seems to be having an impact on housing finance. Nevertheless, the number of borrowers have inched up by 9 percent to reach 16,320 in CY18. Agriculture financing, on the other hand, has reduced by 2.44 percent in CY18 (**See Chapter 3.1**).

SBP, cognizant of the need to keep up the pace of NFIS, has taken several measures to promote priority sector financing. It has provided indicative targets to the banks & DFIs to achieve the goal of SME financing equivalent to 17 percent of total private sector credit by 2023. In case of low cost housing, SBP has announced "Financing Facility for Low Cost Housing for Special Segments" at concessional rate.[244] Further to its efforts, a National Financial Literacy Program (NFLP) has been launched.

The Microfinance sector is the biggest player of financial inclusion landscape in Pakistan…

Microfinance Banks (MFBs) remains a pivotal player in the financial inclusion landscape in Pakistan. MFBs constitute almost 70 percent of the total loan portfolio of the microfinance sector followed by Microfinance Institutions (MFIs) with 20 percent share. [245]

The assets of MFBs have increased by 32.7 percent during the CY18 compared to a 7 percent increase in assets of commercial banks (**Table 7.1 & Chart 7.1**). Accordingly, share of MFBs' assets in the total banking sector assets has reached to 1.62 percent in CY18 from 1.31 percent in CY17 (0.57 percent in CY14).

Table 7.1: Financial Soundness Indicators

	CY14	CY15	CY16	CY17	CY18
	Key variables (PKR Billion)				
Total Assets	70	97	170	247	328
Investments (net)	15	13	33	49	55
Advances (net)	37	55	88	134	185
Deposits	43	63	120	186	239
Borrowings from FIs	9	11	14	14	21
Lending to FIs	1	3	2	5	11
Equity	15	18	24	33	49
Profit Before Tax	2	3	4	8	8
Profit After Tax	1	2	3	5	5
NPLs	0	1	2	2	5
NPLs (Net of Provsions)	0	0	0	(1)	0
	Key FSIs (Percent)				
NPLs to Loans (Gross)	1.16	1.32	2.45	1.50	2.52
Net NPLs to Net Loans	0.13	0.16	0.34	(0.38)	0.20
Net NPLs to Capital	0.34	0.47	1.20	(1.49)	0.74
Provision to NPL	88.72	88.26	86.36	124.60	92.06
ROA (After Tax)	1.74	2.45	2.08	2.60	1.40
ROE (After Tax)	7.97	11.99	12.51	18.81	9.42
CAR	37.70	29.12	23.71	21.44	22.65
Advances to Deposit Ratio	85.4	86.7	73.0	72.0	77.69

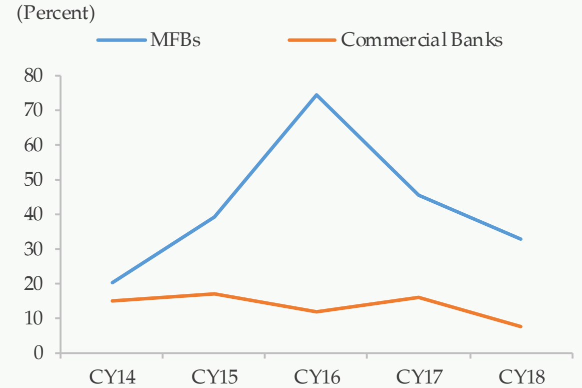
Source: SBP

[243] As per SBP branch licensing policy, the required composition of the branches is 49 percent in Big Cities, 29 percent in other than big cities, 17 percent in rural and underserved areas and 5 percent in un-banked areas. BPRD Circular No. 04 of 2016 available at : http://www.sbp.org.pk/bprd/2016/C4.htm

[244] IH&SMEFD Circular No. 5 of 2019 available at:: http://www.sbp.org.pk/smefd/circulars/2019/C5.htm

[245] Microfinance connect quarterly review 2018

Chart 7.1: Growth in MFBs versus commercial banks' assets



Source: SBP

Advances of MFBs have recorded a healthy growth of 38.6 percent during CY18, while number of loans have increased by 40 percent to 2 million. As a result, the share of MFB loans has increased to 2.25 percent of banking sector loans in CY18 as compared to 1.99 percent in CY17.

MFBs are effectively playing the intermediary role as the ADR improved by 5.7 percentage points to 77.7 percent in CY18. This improvement, among other factors, has come on the back of 20 percent growth in the number of MFBs clients, which have increased to 3,169,785 in CY18.

The microfinance banking sector is maturing…

The MFBs started their business with group lending model. Over the years, the financing model has shifted from the solidarity groups to individual lending. At the end of CY18, the share of individual financing in total financing has reached to 71.76 percent from 65.14 percent in CY17. This increase is attributed to maturity attained by microfinance industry and the development of effective borrower assessment criteria. The adoption of technology by MFBs and increase in financial literacy among the lower income strata is also helping MFBs to focus on individual lending rather than group lending.

The deposit growth momentum accelerates helping MFBs attain self-sufficiency in funding…

The deposit base of MFBs has been expanding helping them achieve self-sufficiency in their funding requirements (Table 7.1). During CY18, the deposits have increased by 28.37 percent in comparison to 54 percent in CY17. Encouragingly, the composition of deposits is tilting towards individuals who now have 58 percent share in total deposits, while the institutions account for about 36 percent. The increase in deposits from individuals has recorded another increase of 23 percent during CY18. This high growth trend has facilitated in providing a more stable and steady funding to MFBs.

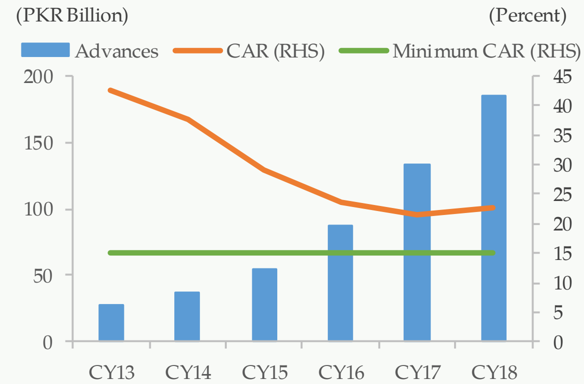
…though concentration in deposits is still relatively high

The healthy growth in deposits as well as the change in its composition is encouraging because it is supporting the asset growth. However, the concentration in deposits of MFBs remains relatively high as the top 25 depositors constitute around 35 percent of the total deposits.

Despite some dip in profitability, capital adequacy of MFBs has improved ….

The profitability of the MFBs has observed some decrease during CY18 despite rise in earning assets. This is mainly due to increase in provision expense resulting from high defaults in MFBs' exposure to sugar sector. As a result, the profitability indicators have dipped during CY18 (Table 7.1). The CAR of MFBs has, however, improved by about 1 percentage point to 22.65 percent in CY18. Injection of fresh capital and rise in retained earnings and reserves contributed to the improved CAR. (Chart 7.2).

Chart 7.2: Growth in advances and reduction in CAR



Source: SBP

Expansion in Digital Financial Services (DFS) is changing the financial landscape…

With the advancements of new technologies, the scale of disruption in the banking industry is unprecedented across markets, distribution channels and product lines. Significant penetration of digital channels like mobile phone, smart cards, internet, and other technologies are resulting in new innovative business models that deliver financial services at lower prices, efficiently and with broader customer reach.

SBP has taken various initiatives in recent past for promotion of digital payment channels in the country. Some of the measures include: development of a strong legal and regulatory framework; robust payment systems infrastructure; Real Time Gross Settlement (RTGS) system; fully interoperable ATM switches; fast growing internet, mobile and branchless banking services along with plastic cards (ATM only, Debit, Credit and Pre-Paid cards). All these initiatives are opening new areas of possibilities in the Business-to-Business (B2B), Business-to-Customer (B2C), Government-to-Person (G2P) payments and Person-to-Government (P2G) payments. Because of these efforts, the share of digital payments is trending upward in Pakistan. **(See Chapter 6)**. Currently, the share of e-Banking channels i.e. real time online branches (RTOB), ATMs, e-Commerce, Internet, Mobile Phone and Call Centers/ IVR Banking in total transactions processed is around 8 percent.

In order to foster innovation in the payments industry and promote financial inclusion, SBP has issued the regulations for 'Electronic Money Institutions'.[246] Under these regulations, SBP has decided to license non-banking entities as E-Money Institutions (EMIs). Likewise, an "Innovation Challenge Facility" has been launched in May 2019 to facilitate stakeholders to develop innovative digital solutions[247].

Branchless Banking, the core of DFS, is continuing its growth momentum…

With the advent of Branchless Banking (BB) and M-wallet accounts, MFBs have gradually leveraged the potential of reaching to masses without physical outreach through brick and mortar branches. Rapid outreach and lower operational costs have accelerated the growth of branchless banking. Especially, the launch of the Asaan Mobile Account (AMA) Scheme will further enable account opening and usage of financial services through an interoperable platform for the low income demographic.[248] A look at the performance of BB during the CY18 reveals that the positive momentum of growth in the number of accounts has continued recording 26.58 percent growth and reaching to 47 million during the year. Similarly, the BB deposits have grown by 12 percent during the year **(Table 7.2)**.

[246] PSD Circular No. 01 of 2019 available at:: http://www.sbp.org.pk/psd/2019/C1.htm

[247] ACMFD Guidelines of 2019 available at: http://www.sbp.org.pk/Guidelines/ACMFD/2018/DFS-Guidelines.pdf

[248] ACMFD Guidelines of 2019 available at: http://www.sbp.org.pk/Guidelines/ACMFD/2018/DFS-Guidelines.pdf

Table 7.2: Branchless Banking Indicators

	CY17	CY18	YoY Growth (Percent)
Number of Agents	405,673	425,199	4.81
Number of Accounts	37,260,215	47,164,779	26.58
Deposits (Rupees in Million)	21,139	23,678	12.01
Number of transactions (No. in 000's)	647,615	955,044	47.47
Value of transactions (Rupees in million)	2,804,008	3,659,075	30.49
Average number of transactions per day	1,798,929	2,652,902	47.47

Source: SBP

On the usage front, the number of transactions during the period and the average number of transactions per day have shown growth of 47 percent and 41 percent, respectively, during CY18.

SBP cognizant of its responsibilities has put in place a robust risk-based customer due diligence approach to ensure that the integrity of the branchless banking channels. Based on the category of account, the Customer Due Diligence (CDD) requirements include verification of customer particulars from NADRA, biometric verification, transaction limits and maximum balance limits.[249]

There is still untapped potential for the BB players….

Despite the sustained growth in BB sector there is still a plenty of untapped potential to expand further the BB services in the country. Creation of an interoperable digital ecosystem, enhanced financial literacy, promotion of products and registration of new users, expanding the value added services in the product offerings are some of the challenges that BB players need to overcome to maximize true positive impact of digital financial services.

The expanding financial inclusion poses limited financial stability concerns…

There is growing evidence in the literature that financial inclusion can have mixed effects on the financial stability of the system. Some of the positive effects include broadening of banking industry's assets, diversifying its depositor base and better transmission of monetary impulses etc.[250] On the contrary, risk level may rise from rapid credit growth associated with new financial inclusion institutions and instruments, and from inadequate or lack of regulations especially in view of rapid acceleration in digital financial services.

Since in Pakistan, the strategy for financial inclusion is supported by a well-defined regulatory and supervisory architecture and the risk-based customer due diligence (CDD) the negative externalities arising from the increase in depth and breadth of financial services are limited.

Way forward…

The revised NFIS targets, including the gender balance, set under the 100-day agenda of the current government require concerted efforts of all stakeholders. Therefore, there is a need to remain engaged with them to achieve the common goals.

[249] BPRD Circular No. 9 of 2016; http://www.sbp.org.pk/bprd/2016/C9.htm

[250] Mehrotra, Aaron, and James Yetman. "Financial Inclusion - Issues for Central Banks." The Bank for International Settlements, 18 Mar. 2015, www.bis.org/publ/qtrpdf/r_qt1503h.htm.