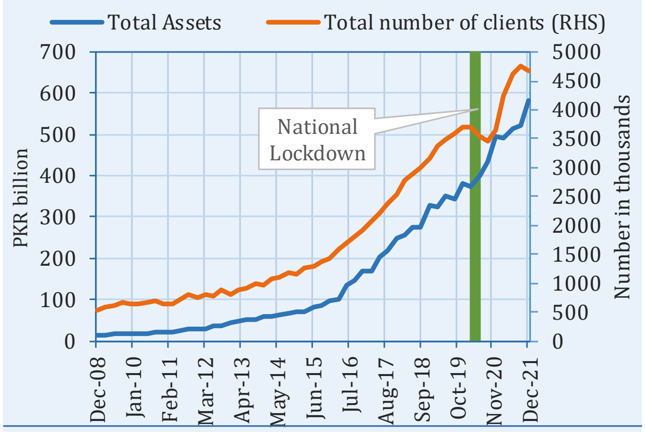
Chapter 5. Performance & Risk Analysis of Microfinance Banks (MFBs)[115]

In the second year of the pandemic, the MFB sector expanded asset base on the back of increases in advances and investments. However, asset quality indicators somewhat deteriorated due to the repayment capacity of borrowers and disruptions in institution-customer relationships which were caused by the pandemic- related lockdowns. Nevertheless, SBP's interim regulatory debt relief and support measures enabled the sector to ward off the buildup of risk, as the MFBs were able to maintain both their solvency and flow of credit and services during the pandemic. The sector posted losses due to higher provisions and administrative expenses. While various institutions are striving to improve their performance by rationalizing their business models, the overall performance and soundness indicators of the sector will be subject to the pandemic-induced challenges and implementation of IFRS-9

MFB sector plays a key role in the social and economic uplift though has nominal share in the financial sector ……

In Pakistan, MFBs' growth trajectory of recent years indicated that the sector may still be in the growth phase of its lifecycle: over last five years it grew with compound annual growth rate (**CAGR**) of 27.9 percent. Although they hold a small share in the financial sector i.e. 1.5 percent of total assets in CY21, the number of MFBs' borrowers at 4.7 million surpassed the 3.9 million loan borrowers served by banks in CY21 (in CY20, MFBs = 3.65 million borrowers, Banks = 3.8 million borrowers) (**Chart 5.1**).

Chart 5.1: Growth in MFB Sector



Source: SBP

Moreover, the sector was the driving force behind financial inclusion holding 83.3 percent of the total mobile banking accounts in the country. These statistics emphasized the growing importance of the MFB sector in the intermediation process as well as its role in the economic and social uplift of the financially excluded segments of the society.

MFB's growth during CY21 remained lower than the recent trend, due to pandemic related uncertainties …

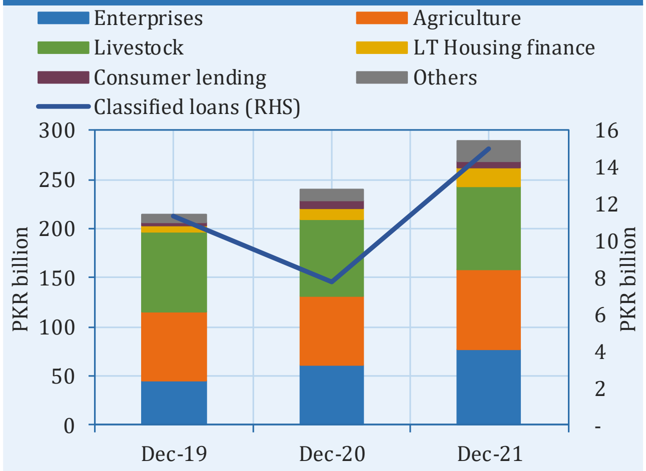
The asset base of MFB sector grew by 17.8 percent to PKR 582 billion in CY21, showing signs of slackness compared to the trend of recent years as the challenges posed by the pandemic impacted the performance of the MFBs and created uncertainties.

The growth during CY21 mainly came on the back of increases in advances and investments, which increased by 20.5 percent and 37.9 percent, respectively. The MFB sector particularly increased its holding of low-risk government papers capitalizing on the government's demand to meet budgetary needs from domestic resources. The growth in asset base was well supported by PKR 50 billion (13.4 percent) increase in deposits. However, some increase in borrowings was also necessary to finance the assets' growth; borrowings increased by PKR 32 billion (119.3 percent) over the year.

[115] Assets of MFBs are not part of the banking sector

Most segments showed an uptick in advances …

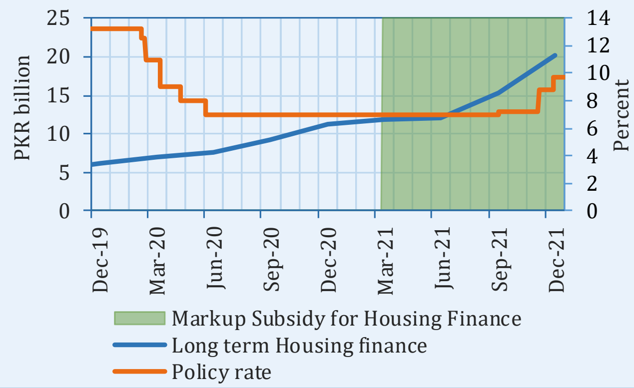
Chart 5.2: Breakup of Advances



Source: SBP

Detailed analysis of advances showed that barring consumer lending, all other segments recorded positive growth with a sizeable increase in enterprise loans, followed by Agriculture and Long-term Housing Finance (**Chart 5.2**).[116]

Chart 5.3: Impact of Government's Markup Subsidy for Housing Finance on MFBs' Housing Portfolio

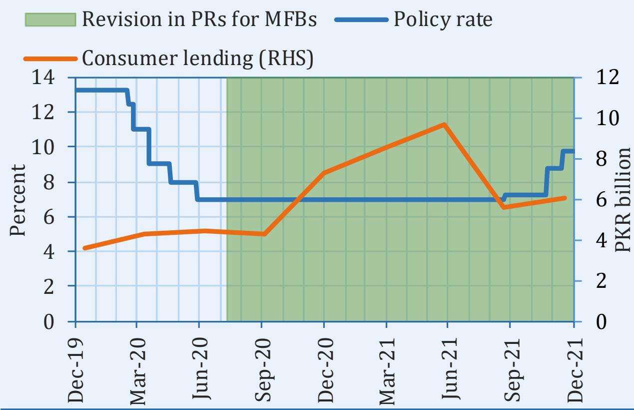


Source: SBP

Long-term housing finance's increase of 80.2 percent in CY21 was partly due to the Government's Markup Subsidy for Housing Finance introduced in Oct-20. The scheme was revised in Mar-21 to include MFBs as agents, subsequently the sector was also allocated mandatory targets (**Chart 5.3**).[117, 118]

In addition, financing to Enterprises and Housing surged due, in part, to revisions in PRs for MFBs, which enhanced the limit of loan size for microfinance borrowers.[119] Similarly, revision in borrowers' eligibility criteria facilitated lending against gold for consumption.[120]

Chart 5.4: MFBs' Consumer Lending Portfolio



Source: SBP

These revisions, along with the accommodative monetary policy that prevailed during most part of the year under review, also facilitated surge in the consumer finance portfolio which increased by 126.8 percent between Sep-20 and Jun-21 before declining steeply in Sep-21 quarter due to change in SBP's forward guidance and increase interest rates (**Chart 5.4**).

Repayment capacity of microfinance borrowers was affected by the pandemic related disruptions …

The onset of the pandemic particularly affected microfinance providers (**MFPs**) across the globe as the pandemic impaired both earning capacity of clients as well as the strong repayment culture on which microfinance providers depend. In

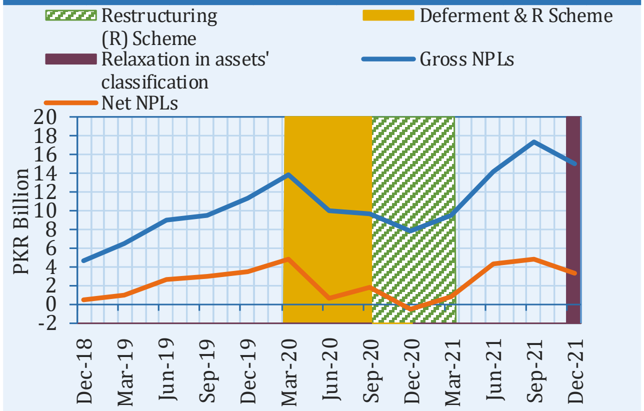
[116] Loans to Enterprises rose by PKR 17 billion to PKR 77 billion, to Agriculture by PKR 10 billion to PKR 82 billion, and to Long-term Housing Finance by PKR 9 billion to PKR 20 billion, respectively.
[117] IH&SMEFD Circular No. 11 of 2020- Markup Subsidy for Housing Finance
[118] IH&SMEFD Circular No. 03 of 2021-Government's Mark-up Subsidy Scheme for Housing Finance
[119] For example the limits for Housing Finance and Microenterprise have been enhanced to PKR 3 million from PKR 1 million
[120] AC&MFD Circular No. 02 of 2020-Revision in Prudential Regulations for Microfinance Banks

response, MFPs around the world deferred and restructured loans, which eventually became difficult to collect. As repayments dried up, the MFP's reserves began to deplete as operational expenditures continued, which, in turn raised liquidity concerns.[121,122]

Over the last two years or so, the asset quality of the MFB sector came under stress in Pakistan also as the pandemic affected the repayment capacity of some borrowers and caused disruptions in the institution-customer relationships in the wake of social distancing and mobility restrictions. Any sudden increase in loan losses had the potential to cause solvency issues for MFBs that in turn could have affected the flow of credit and thus further added to the delinquencies.

SBP's debt relief scheme helped in thwarting the asset quality concerns and facilitating the flow of credit ...

Chart 5.5: NPLs and Debt Relief Scheme



Note: While the validity of the Deferment and Restructuring schemes have expired on 30-Sep-2020 and 31-Mar-2021, respectively, loans under the two schemes can exist beyond the validity period as loan principals could be deferred for up to twelve months and loans could be restructured for more than twelve months. This means that loans under deferment could exist till 30-Sep-2021 and loans under restructuring could exist beyond 31-Dec-2021.
Source: SBP

In order to prevent the pro-cyclical effects of the deterioration in the repayment capacity of micro borrowers and bolster the solvency of the MFB sector, SBP introduced a regulatory debt relief scheme (**DRS**) which comprised payment holidays (principal amount) and easy restructuring of advances. This scheme provided interim forbearance by delaying the recognition of loan losses and thus preserving both the solvency of MFBs as well as the flow of credit to borrowers. Under the scheme introduced in Mar-20, the principal repayment of performing loans were allowed to be deferred for one year and restructuring of COVID stricken loans was allowed with a relief that the loan can be treated as regular[123]. Under this scheme, MFBs extended relief of PKR 135 billion to over 1.8 million small borrowers, which enabled them to weather the harsh impacts of the pandemic and facilitated the MFBs in maintaining their capital cushions and sustaining the flow of credit and services (**Chart 5.5**). Accordingly, the NPLs remained in check and the NPLs ratio clocked in at 3.3 percent at the end of CY20.

However, the asset quality indicators remained under stress...

As compared to the borrowers of commercial banks, the impact of pandemic was relatively more enduring on MFBs' borrowers as their resources depleted over the course of the pandemic, which pushed certain borrowers further into poverty. Accordingly, the NPLs of the MFB sector started to witness increase in CY21 as the DRS also started to expire. Realizing the prevailing stress among the MFB borrowers, SBP amended the criteria for classification of assets and provisioning requirements in Dec-21 for the deferred and restructured portfolio[124]. This measure helped in checking the flow of fresh NPLs. Accordingly, the NPLs after peaking in Sep-21 (PKR 17 billion) again declined to PKR 15 billion by the end of CY21 and the NPL ratio fell to 5.2 percent.

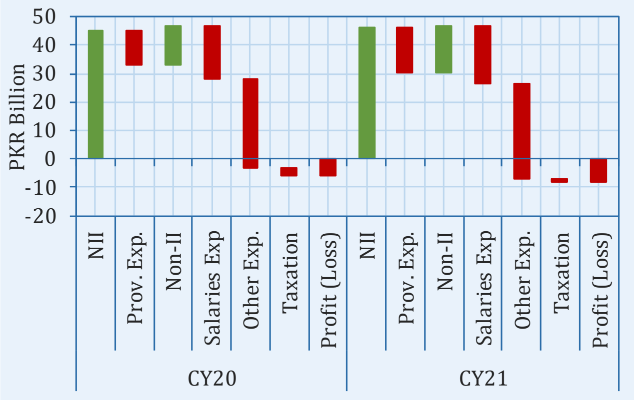
[121] CGAP's (2019) The Menace of COVID-19 for Microfinance. October. Accessed on April 15, 2022
[122] Meagher, P. (2020). Microfinance in the COVID-19 crisis: A framework for regulatory responses. *Insights for Inclusive Finance. CGAP, June*. Accessed on April 15, 2022
[123] COVID-19: Loan Extension and Restructuring Package of SBP
[124] That is, timeline for the classification of loans was extended by 30 days; please see: AC&MFD Circular Letter No. 1 of 2021-Regulatory Relief to Dampen the Effects of Covid-19

The business model of a typical microfinance bank generally involves higher financial risk which can be effectively managed through prudent and socially appropriate lending models ...

The MFB sector has provided more than 75 percent of its loans to the borrowers without collateral e.g. loans secured through personal guarantees. Though this feature contributed to financial inclusion and improvements in the economic conditions of the impoverished segments of the society, it also involved relatively higher credit risk for MFBs. Furthermore, the concept of solidarity group lending – an important aspect of microfinance internationally which has an inbuilt check of moral suasion and community pressure for timely repayment of advances – has gradually lost ground within MFBs in Pakistan. Group lending has several advantages such as having internal rules of conducts (e.g. peer selection) on repayment performance.[125] It helps enhance informational symmetry by making it possible to co-manage risk with greater possibilities of offering credit to individuals previously thought to be non-bankable.[126] However, the solidarity loans' share in total loans has gradually come down over the years to only 10.2 percent in CY21 – it was 15.2 percent in CY20, 28.2 percent in CY18, and 48.8 percent in CY14. In value terms too, group lending has shown a decline since CY18. One reason for the decline is that it is considered onerous for borrowers[127] as well as the MFB to structure the solidarity loans. Moreover, due to relative flexibility in extending other forms of loans and the experience gained over the years, MFBs are focusing relatively less on the solidarity loans.

MFB sector on overall basis posted loss due to high provisioning and administraive expenses, though concentrated in a few institutions ...

Chart 5.6: Composition of Profit and Loss for MFBs



Source: SBP

Despite healthy growth in assets, the bottom line of the MFB sector on aggregate basis has been in the red since CY19 as the sector continued to face increased risk of delinquencies. The aggregate loss before tax stood at PKR 6.85 billion for CY21 (loss of PKR 3.4 billion in CY20). Consequently, overall ROE (before tax) of the sector deteriorated from -7.1 percent in CY20 to -12.7 percent in CY21, while Operational Self Sufficiency (i.e. ratio of financial revenues to all expenses) declined from 81.9 percent in CY20 to 76.8 percent in CY21 (**Charts 5.6 & 5.7**).

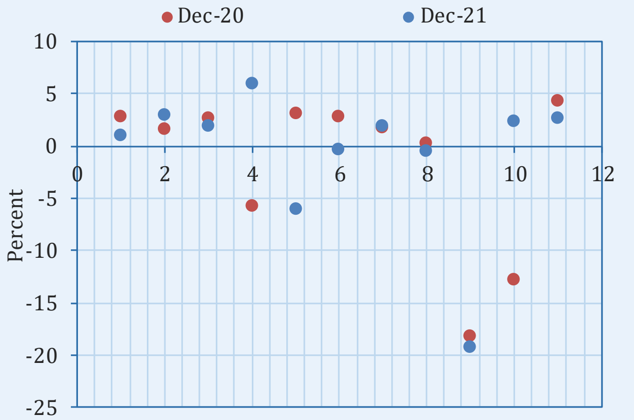
Incidentally, this loss was concentrated in a few institutions while majority of the MFBs posted profits. These loss-making institutions face higher incidence of delinquencies (due to some idiosyncratic factors and the pandemic)) accounting for 51.3 percent of Gross NPLs.

[125] Zeller, M. (1998). Determinants of repayment performance in credit groups: The role of program design, intragroup risk pooling, and social cohesion. *Economic development and cultural change*, 46(3), 599-620

[126] Marconatto, Diego & Barin Cruz, Luciano & Gressler Teixeira, Emidio & Moura, Gilnei. (2017). Why the microfinance institutions exist: lending groups as a mechanism to enhance informational symmetry and enforcement activities. *Organização & Sociedade*, 24, 633-654

[127] Attanasio, O., Augsburg, B., De Haas, R., Fitzsimons, E., & Harmgart, H. (2013). Group lending or individual lending? Evidence from a randomized field experiment in rural Mongolia. *Forthcoming in the American Economic Journal: Applied Economics, CentER Discussion Paper Series*, (2013-074)

Chart 5.7: MFB-wise ROA (before tax)



Source: SBP

The MFB sector also increased its share in investments – mainly government papers which carry relatively lower return vis-à-vis advances – as a percent of assets from 19.6 percent in CY20 to 22.9 percent in CY21. Furthermore, to cater to the growth of assets, reliance on borrowing increased towards the end of the year.

However, due to the accommodative monetary policy that prevailed during most of CY21, Return on Investments (**ROI**) and NIM declined in CY21. Similarly, the Cost of Funds (Deposits and Borrowings) ratio for the sector declined in CY21. These dynamics contributed to slower growth in both the interest income and expenses, resulting in a moderate increase in net interest income of 3.4 percent (10.5 percent growth in CY20). The non-interest income, which witnessed a contraction in CY20 due to economic lockdowns, posted an appreciable growth of 27.3 percent during CY21. However, the increase in provisioning expenses caused a drag on earnings.

Loan loss provisioning expenses increased over the last few years. These expenses[128] remained at an elevated level of PKR 12 billion in CY20 and PKR 16 billion in CY21. They dipped slightly in CY20 as the SBP's principal payment holiday and loan restructuring scheme stemmed the flow of fresh NPLs and associated provisioning expense. The provisioning expense again rose by 40.3 percent during CY21 as the MFBs increased their lending portfolio and part of the scheme's applicability lapsed during the year.
Administrative expenses – despite posting a contained growth this year-- remained at an elevated level during CY20 and CY21. Due to the pandemic induced slowdown in opening of new branches and curtailment of operations, administrative expenses remained almost stable in CY20 at PKR 49 billion, and despite relatively high rate of inflation in CY21, these expenses showed only a modest increase of 7.6 percent to PKR 53 billion in CY21.

MFBs continued to effectivley fund their liquidity needs despite slackness in liquidity indicators ...

Due to the faster increase in the asset base (including the extension of longer-term loans), a significant part of which was financed from borrowings, the liquidity indicators of MFB sector slightly deteriorated and the average maturity of the loan portfolio increased during CY21. The share of loans with maturity of more than 1 year increased from 18.9 percent in CY20 to 37.6 percent in CY21 of total loan portfolio (maturity) while Liquid Assets to Total Deposits decreased from 47.3 percent in CY20 to 43.1 percent in CY21. However, the MFBs continued to effectively manage their asset-liability positions because of the ample liquidity available in the market due to the accommodative monetary policy stance and ample fund-based liquidity cushions available with the MFBs (**Table 5.1**).

[128] Provisioning expenses jumped from PKR 4 billion in CY18 to PKR 13 billion in CY19; from thereon, they have remained at an elevated level.

Table 5.1: Financial Soundness Indicators (FSIs) of MFBs

Description	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21
	Percent				
Capital					
Total Capital to Total RWA	21.4	22.6	20.9	19.0	18.3
Tier 1 Capital to Total RWA	19.5	20.2	17.8	15.3	14.3
Asset Quality					
NPLs to Total Loans	1.5	2.4	5.3	3.3	5.2
Provision to NPLs	124.6	92.1	70.0	106.5	78.1
Net NPLs to Net Loans	-0.4	0.2	1.7	-0.2	1.2
Net NPLs to Capital	-1.5	0.7	6.5	-0.9	5.4
Earnings					
ROA before Tax	4.3	2.9	-1.7	-0.8	-1.3
ROE before Tax	29.4	20.7	-12.4	-7.1	-12.7
Operational Self Sufficiency (OSS)	78.4	89.5	75.8	81.9	76.8
Liquidity					
Liquid Assets to ST Liabilities	45.2	37.0	47.5	50.9	42.4

Source: SBP

Solvency indicators of the MFB sector slightly declined, but still stayed well above the minimum requirement ...

The aggregate CAR of the MFB sector marginally declined from 19.0 percent in CY20 to 18.3 percent in CY21 due to faster growth in asset base (including growth in the lending portfolio) as compared to eligible capital. However, the ratio still remained well above the minimum regulatory requirement of 15.0 percent (**Table 5.1**). Incidentally, the sponsors of the few loss-making institutions continued to show their commitment by injecting further equity to meet the capital requirements and support their operations.

The results of the latest stress tests indicate that there is sufficient cushion available with MFBs to absorb the impacts of severe shocks to key risk factors, thus indicating that the sector and loss-making MFBs in general have ample opportunity to realign their business models to control losses and improve earnings to ward off stresses in the macro environment and maintain long-term sustainability.

Despite their minute share in the financial sector, MFBs lead the branchless banking segment, which has driven the policy initiative on financial inclusion ...

Microfinance banks have been instrumental in promoting Branchless Banking **(BB)**, as they hold more than 80 percent of the total BB accounts. Incidentally, these accounts provide the benefit of scalability and potential to reach the unbanked and underserved masses. Since their introduction, the numbers of BB accounts increased at a phenomenal rate to surpass conventional bank accounts.

During CY21, the number of active BB accounts recorded a significant increase (of 21.3 percent) to reach 45 million, and most key indicators recorded robust double-digit growth, which bodes well for enhancing financial inclusion in the country, and encouraging digital modes of payments and documentation of the economy (see **Table 8.3**).

Continuation of stresses and disruptions created by the pandemic and introduction of IFRS-9 may pose challenges on the asset quality and earnings front for MFBs ...

Going forward, the performance of the sector will be dependent upon the MFBs' ability to cope with the stresses and disruptions created by the pandemic in relation to the repayment capacity of their borrowers and institution-borrower relationships. Successful recovery of outstanding loans which were deferred and restructured under the SBP's DRS will be a key determinant of MFB sector's soundness and performance indicators. Besides, ongoing efforts by a few institutions to recapitalize and improve their performance will also be important.

Furthermore, given the increase in credit risk in CY21, MFB sector needs to monitor on a continual basis to address any solvency concerns in a timely manner.

IFRS-9 (which addresses recognition, classification, measurement, and de-recognition of financial assets and liabilities) involves new impairment model which requires realization of losses on prospective basis – instead of incurred basis. The applicability of this standard may add some burden to the earning and solvency position of MFBs in future.