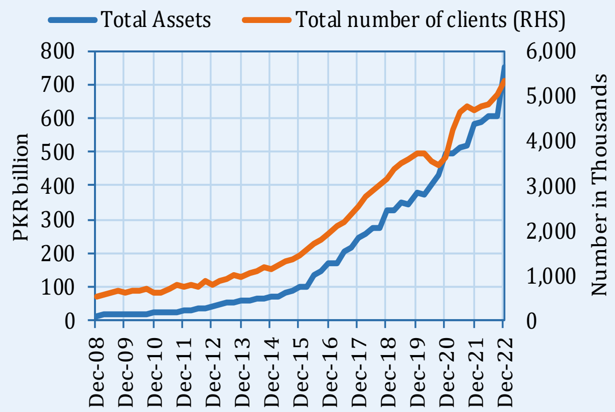
# Chapter 5: The Performance and Risk Analysis of Microfinance Banks (MFBs)[125]

*Due to its large customer base that surpasses that of commercial banks, MFB sector holds a special significance from the financial inclusion perspective. The asset base of the Microfinance Banks (MFBs) expanded at an accelerated pace as a result of a significant increase in investments and advances. Nevertheless, asset quality indicators remained under stress owing to the lingering effects of COVID-19 pandemic that were compounded by flooding which severely compromised the repayment capacity of micro borrowers. As a result, MFBs' losses increased during the year. Accordingly, the aggregate capital adequacy ratio of the sector came down significantly. However, sponsors of the institutions continued to show their support; further, SBP maintained enhanced supervision of the sector and provided policy support to withstand the impacts of massive flooding.*

*Despite having a nominal share in the financial sector's asset base, MFBs remain crucial from financial inclusion perspective…*

Microfinance Banks (MFBs) play an important role in serving a large number of microcredit borrowers and depositors, contributing to the economic empowerment of low-income families and microenterprises. Although the sector only accounts for 1.6 percent of the total financial sector assets, nonetheless, the number of borrowers has risen to 5.3 million in CY22 (4.7 million in CY21) or around 55 percent of the combined borrowers of banks and MFBs.[126] This shows that MFBs are the key driver towards financial inclusion by providing financial services to the financially underserved segments of the population (**Chart 5.1**).

Chart 5.1: Growth in MFB Sector




Source: SBP

*MFBs recorded an accelerated growth, which was driven by investments in government securities and advances …*

The asset base of the MFBs reached PKR 753.0 billion after recording an accelerated growth of 29.4 percent in CY22 (17.8 percent in CY21). The growth was largely driven by higher investments (especially in government securities) followed by advances, which increased by 71.0 percent and 23.0 percent, respectively. MFBs capitalized on the government's budgetary needs - by making hefty investments in low-risk government securities (PIBs) - as well as availability of funding from the banking sector which aimed to improve ADR.

[125] Statistics of MFBs are not part of the banking sector's data set.

[126] As per the latest available data (SBP – Statistical Bulletin), the number of bank borrowers stood at 3.9 million at end of Jun-22 vis-à-vis 4.9 million borrowers of MFBs.

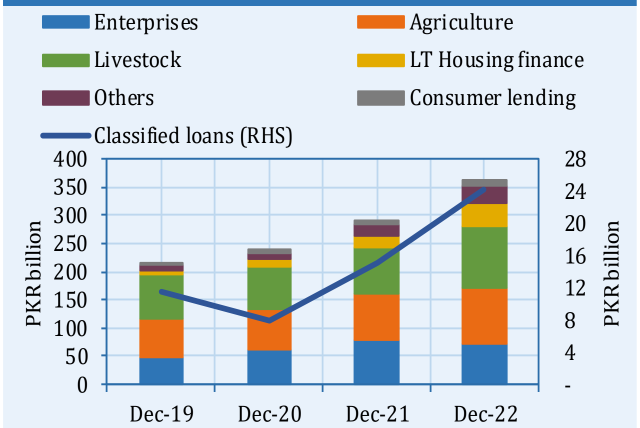
*While deposits remained the main source of funding, reliance on borrowings also increased ...*

Although deposits remained the key source to finance the expansion in asset base – growing by 21.9 percent to reach PKR 515.8 billion at end CY22, reliance on borrowings also increased as they grew by 132.2 percent to reach PKR 137.0 billion.

*Advances posted accelerated growth which was relatively broad-based in terms of flow to different sectors ...*

Apart from enterprise lending, all other sectors received higher advances from MFBs as compared to the last year. With an overall increase of PKR 71.4 billion in advances, the livestock sector constituted the highest share with PKR 26.2 billion followed by long-term housing (PKR 22.8 billion) and agriculture (PKR 18.4 billion) (**Chart 5.2**).

Chart 5.2: Breakup of Advances




Source: SBP

Higher loan disbursement under long-term housing finance was partly due to the government's Mark-up Subsidy for Housing Finance. The scheme was introduced for MFBs in March 2021 but further approval of loans under the scheme were kept on hold from end of June2022 in the light of macroeconomic developments.[127]

Agriculture financing rose due, in part, to the revisions in Prudential Regulations for MFBs, which allowed enhancement in the unsecured financing limit as well as in the exposure limit. Another possible aspect was the revision of Indicative Credit Limits for Agriculture Financing.[128] Indicative limits were increased to allow farmers greater access to credit in order to enhance agriculture productivity.

It is important to note that a large part of the country was affected by torrential rains and flooding during H2CY22, causing heavy human and economic losses. Agriculture sector in southern part of Punjab, Sindh and Baluchistan were severely affected. To facilitate the affected farmers, government and SBP actively introduced various policy measures. For instance, to provide relief to the farmers severely affected by torrential rains and flooding, government of Pakistan provided mark-up waivers and financing schemes under the Kissan Package 2022.[129] Further, SBP not only encouraged the MFBs to extend fresh financing but also relaxed the eligibility criteria by allowing loans against gold as collateral.

To facilitate the borrowers of MFBs and align the regulatory standards with changing market dynamics, prudential standards for MFBs were reviewed to increase the maximum size of different microfinance loans, enhance the limit of clean loans and rationalize the provisioning requirements for delinquent loans.[130]

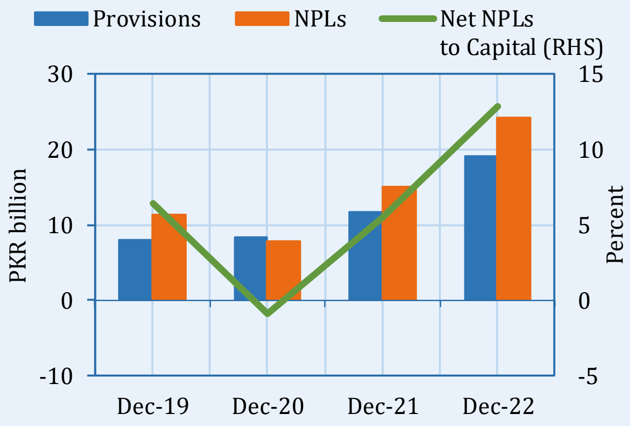
*Asset quality indicators further deteriorated ...*

MFB sector has faced severe asset quality challenges particularly since the outbreak of the COVID-19 pandemic, which not only affected the incomes of the micro borrowers but also disrupted the institution-customer relationship due to social distancing and lockdown measures. This year's torrential rains and flooding further compounded the challenges for MFBs. During CY22, gross NPLs further rose by PKR 9.3 billion to PKR 24.2 billion. Accordingly, non-performing loans ratio (NPLR) of

[127] IH&SMEFD Circular No. 09 of 2022.
[128] AC&MFD Circular No. 01 of 2022.
[129] AC&MFD Circular No. 03 of 2022.
[130] AC&MFD Circular No. 02 of 2022.

MFBs sector increased to 6.7 percent by the end of CY22 (5.2 percent in CY21). Since additional provisioning was relatively lower, the Net NPLR increased to 1.5 percent (1.2 percent in CY21) and impairment (net NPLs to capital) ratio increased to 12.9 percent (5.4 percent in CY21), indicating increase in risks to capital position from delinquent loans. (**Chart 5.3**).

Chart 5.3: Asset Quality Indicators

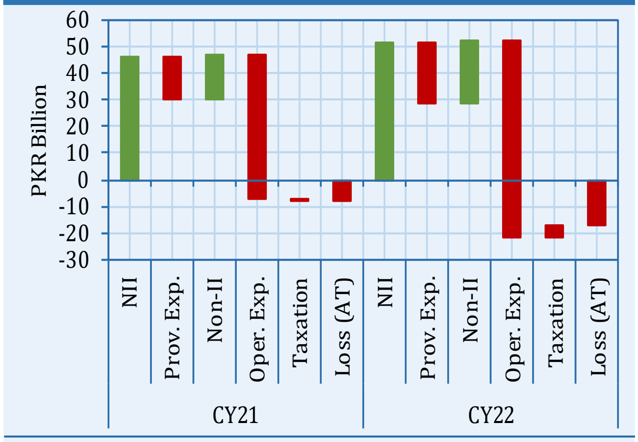



Source: SBP

*Overall profitability of the sector remained in red as marginal growth in incomes was more than off-set by strong increase in administrative expense and provisioning charges…*

Aggregate profitability of the sector remained in losses for the fourth consecutive year. Pre-tax loss of the sector reached PKR 21.6 billion in CY22 as compared to last year's loss of PKR 6.9 billion. Accordingly, ROE (before tax) dropped to -42.9 percent (-12.7 percent in CY21). Similarly, Operational Self Sufficiency (i.e. ratio of financial revenue to all expenses) also dropped from 76.8 percent in CY21 to 69.8 percent in CY22.

Chart 5.4: Composition of MFBs Income & Expenses

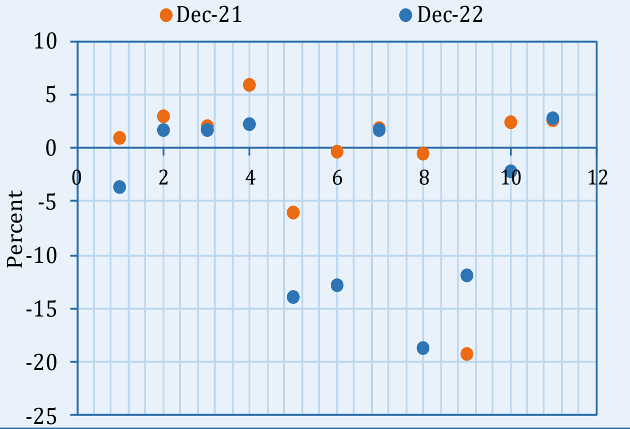



Source: SBP

Detailed analysis shows that despite hefty increase in earning assets, net-interest income grew by a relatively slower pace of 10.6 percent to reach PKR 51.3 billion for CY22. This slow pace of growth can be attributed to the rising interest rates during the last quarter, allowing interest expenses to outpace incomes. Accordingly, net interest margin (NIM) slightly fell to 10.1 percent in CY22 (11.2 percent in CY21). Due to the resumption of economic activities after COVID-19, non-interest income posted encouraging recovery during the year under review, surging by 42.0 percent (27.3 percent growth in CY21) to PKR 24.0 billion. On the other hand, admin expenses that remained muted during last couple years following the COVID-19 related lockdowns witnessed pent up growth in CY22, surging by 33.6 percent. Similarly, provisioning charges also remained high due to deterioration in asset quality and lapse of COVID-19 related loan deferment and restructuring policy. Accordingly, aggregate bottom line of the sector turned red for the fourth year in a row (**Chart 5.4**).

Further, cross sectional analysis shows that number of loss-making institutions increased to six in CY22 from four in CY21 (**Chart 5.5**). These loss-making entities incurred heavy provisioning against bad debts as they account for around 75 percent of the overall increase in the sector's NPLs.

Chart 5.5: MFB-wise ROA (before tax)




Source: SBP

*Liquidity indicators slightly dropped due to relatively higher growth in asset base vis-à-vis liquid assets …*

During CY22, liquidity indicators experienced slight contraction. Although MFBs made large investments in risk-free government securities, a substantial part of this was financed by rebalancing the asset mix away from bank balances; thus, the overall liquid assets of the sector reported a relatively slow growth of 9.2 percent (3.5 percent in CY21) vis-à-vis growth in asset base and fund base. Accordingly, the share of liquid assets in total assets fell to 26.5 percent by end CY22 from 31.3 percent in CY21 while the liquid assets to short-term liabilities ratio fell to 31.9 percent in CY22 (42.4 percent at end CY21) (**Table 5.1**).

Table 5.1: Financial Soundness Indicators (FSIs) of MFBs

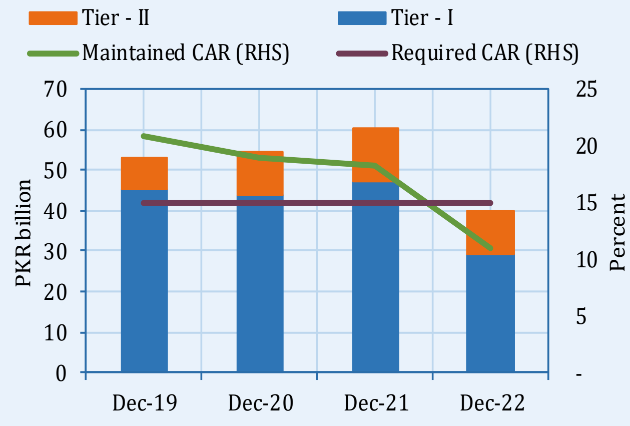
| Description | Dec-19 | Dec-20 | Dec-21 | Dec-22 |
|---|---|---|---|---|
| | Percent | | | |
| **Capital** | | | | |
| Total Capital to Total RWA | 20.9 | 19.0 | 18.3 | 10.9 |
| Tier 1 Capital to Total RWA | 17.8 | 15.3 | 14.3 | 8.1 |
| **Asset Quality** | | | | |
| NPLs to Total Loans | 5.3 | 3.3 | 5.2 | 6.7 |
| Provision to NPLs | 70.0 | 106.5 | 78.1 | 78.8 |
| Net NPLs to Net Loans | 1.7 | -0.2 | 1.2 | 1.5 |
| Net NPLs to Capital | 6.5 | -0.9 | 5.4 | 12.9 |
| **Earnings** | | | | |
| ROA before Tax | -1.7 | -0.8 | -1.3 | -3.4 |
| ROE before Tax | -12.4 | -7.1 | -12.7 | -42.9 |
| Operational Self Sufficiency (OSS) | 75.8 | 81.9 | 76.8 | 69.8 |
| **Liquidity** | | | | |
| Liquid Assets to Short Term Liabilities | 47.5 | 50.9 | 42.4 | 31.9 |

Source: SBP

*Solvency indicators dropped below the minimum requirement …*

Due to overall losses and growth in asset base, the overall CAR of the MFB sector dropped from 18.3 percent in CY21 to 10.9 percent in CY22, below the minimum regulatory requirement of 15 percent for an individual institution (**Table 5.1**). At the start of the year under review, overall CAR of the sector was well above this minimum requirement, however, with the recognition of loan losses pertaining to COVID-19 related interim relief and deterioration in profitability, the CAR of the sector came under significant stress by the end of the year (**Chart 5.6**).

Chart 5.6: Capital Adequacy Ratio




Source: SBP

Although the sector remained severely affected by the pandemic and recent flooding, the sponsors continued to show their commitment to meet capital requirements and support operations by injecting further equity – paid up capital of the sector increased by PKR 5.6 billion to PKR 42.2 billion. In addition, realizing the externality of the recent flooding and importance of the MFB sector for financial inclusion, SBP continued the enhanced supervision of the sector. In order to mitigate the impact of the floods, MFBs were also allowed to reschedule/ restructure loans of their flood-affected borrowers for up to one year.

*MFBs continue to dominate branchless banking...*

MFBs play a crucial role in branchless banking (BB) in Pakistan as they account for more than 80 percent of BB accounts. The increased use of BB has significantly contributed in the policy objective of financial inclusion. Being an easily accessible and cost-effective delivery channel of financial services, BB accounts have grown at an exponential rate exceeding the total banking accounts.

During CY22, the number of BB accounts recorded a growth of 23.2 percent (25.6 percent in CY21) reaching 97 million accounts. However, the number of active accounts declined by 5.4 percent (a growth of 21.3 percent in CY21) reaching 42.5 million (**Table 8.4**). While the pandemic might have contributed to strong growth in active BB accounts in the past couple of years, conversely, the calamities caused during this year's flooding, which impacted around 33 percent of the population might have disrupted this growth momentum.[131]

*The sector's outlook hinges upon the macroeconomic dynamics and recovery efforts in the flood affected areas ...*

The performance of MFBs during CY23 will be contingent upon their ability to tackle the disruptions caused by the flooding. Successful recovery of the outstanding loans previously deferred/ restructured under SBP's new relief scheme will also be a key determinant for the sector's performance and soundness going forward.

During CY22, SBP has proactively assisted the MFBs to continue servicing small-scale borrowers. However, the recent monetary tightening does pose increased credit risk for the sector, which needs proactive monitoring and management of underlying risks.

[131] Ministry of Planning Development & Special Initiatives – "Pakistan Floods 2022 Post-Disaster Needs Assessment"