5

Microfinance Banks

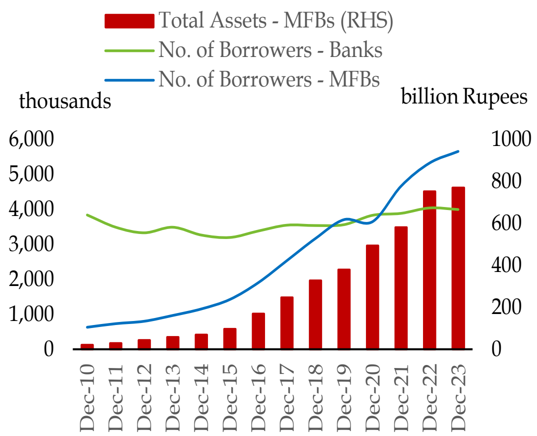
In line with the overall macro environment that has been particularly stressful for Microfinane Banks (MFBs), CY23 remained a challenging year for the sector. Asset quality indicators deteriorated during the first half of the year as the infection ratio reached its historic high; however, the ratio recovered and stabilized by the year-end. Nevertheless, weak repayment capacity of the borrowers persists amid challenging macroeconomic environment and disruptions caused by the rain/flooding of 2022 and 2023. MFBs' aggregate earnings remained in red for the fifth year in a row, though the losses halved in CY23 compared to the previous year. Accordingly, the sector's overall solvency further deteriorated. Although MFBs are facing challenges, they pose a low risk to the financial stability due to their smaller share in the total financial sector assets and contained inter-sectoral exposures. However, from financial inclusion and grass root development perspective, MFBs hold significance, as they provide financial services to the under-served, low-income segments and micro borrowers. In view of the stressed macro environment, SBP continued enhanced supervision of MFBs to ensure solvency of the sector and smooth provisioning of credit to the under-served segment of the population.

5 Microfinance Banks

MFBs are instrumental for the financial inclusion of low-income urban and rural customers, although their share in the financial sector asset base is nominal.

Despite challenging macroeconimc conditions, Microfinance Banks (MFBs) continue to expand their outreach of financial services to the low-income segment of the population. MFBs pose relatively low systemic risk as they represent only 1.3 percent of the total financial sector assets. Nonetheless, given its broad customer base that exceeds the banking sector in terms of number, MFBs are crucial for achieving the objectives set under the National Financial Inclusion Strategy **(Figure 5.1)**.[1]

Growth in MFB Sector **Figure 5.1**



Source: State Bank of Pakistan

Stressed macroeconomic environment, however, resulted in dampened balance sheet growth.

Over the last five years, MFBs, on average, grew by 19.1 percent (YoY); however, during CY23, the sector expanded by a meager 2.4 percent (YoY), which is the lowest level ever recorded. The growth was mainly generated by advances, which increased by 11.0 percent during CY23.

percent and were the leading cause of the slowdown in asset growth. Overall investments fell, as the MFB sector reduced its investments in mutual funds, while investment in government papers slightly grew by 3.8 percent reaching Rs 152 billion. This is in contrast to the scheduled banks whose investment portfolio increased by 41.4 percent in CY23 due to strong growth in government securities.

Asset mix of the MFBs further inclined towards advances during CY23 as it's share in the total assets rose to 49.3 percent (45.5 percent in CY22). This strategy can be attributed to the sector's effort to improve its net interest income and reduce its overall losses.

… which is mainly financed by deposits…

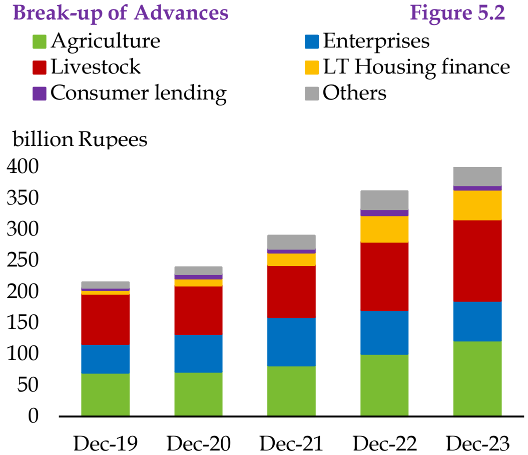
The growth in the asset base of MFBs was supported by a 15.8 percent (Rs 81.3 billion) increase in deposits from CY22. Meanwhile, borrowings by MFBs fell by 57.3 percent (Rs 78.6 billion) from the previous year due to lower investment activity.

Most of the segments experienced an uptick in advance.

A detailed analysis of growth in advances by segements reveals that most of the segments recorded an increase in advances during CY23. In particular, loans to agriculture and livestock rose by Rs 21.6 billion and Rs 20.8 billion, respectively. On the contrary, loans to enterprises and consumer segments fell by Rs 6.4 billion and Rs 1.8 billion, respectively **(Figure 5.2)**.

[1] By end of CY23, the number of bank borrowers stood at 4.0 million, whereas, borrowers of MFBs stood at 5.7 million.

Break-up of Advances **Figure 5.2**



Source: State Bank of Pakistan

The financing for agriculture and livestock rose, in part, due to the Prime Minister's Youth Business and Agriculture Loan Scheme (PMYB&ALS) that started in December 2022. The objective of this scheme was to ensure the provision of loans to the agriculture and SME sector. Under this scheme, a new tier of interest-free microloans was introduced. [2]

In addition Government of Pakistan (GoP) introduced three more schemes under the Kisan Package-2022 to provide relief to the farmers of rain/flood-affected areas.[3] Under the schemes, GoP provided a Mark-up Waiver Scheme (MWS) for subsistence farmers against agricultural loans. In contrast, the GoP Mark-up Subsidy Scheme (GMSS) was used to revive the agriculture and livestock sectors. Moreover, interest-free loans and the risk-sharing mechanism for landless farmers (IF&RSLF) in flood-affected areas were also introduced.

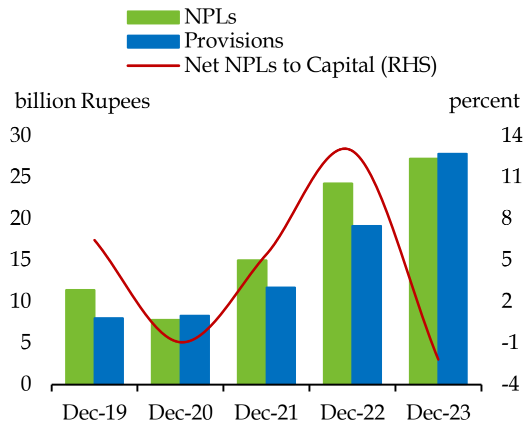
Asset quality that was under pressure due to severe and prolonged macroeconomic and exogenous shocks stabilized by the end of CY23.

MFBs continued to face the challenging situation that started in the wake of the COVID-19 pandemic and further compounded by the 2022 floods and their continued impact in 2023, prolonged stress in macroeconomic conditions, and consequent tightened economic policies to address the high inflation.[4] The infection ratio that had consistently increased over the last few years remained at 7.8 percent by June 2023, the highest level ever recorded. However, during the second half of CY23, the total NPLs of the sector began to drop, allowing asset quality positions to improve. By end of the year, total NPLs reached Rs. 27.2 billion after an addition of Rs 2.9 billion in CY23 (9.3 billion in CY22). As a result, the infection ratio moderated to 6.7 percent in CY23.

Provisioning standards remained higher during CY23, as the MFBs raised their provisioning by Rs 8.8 billion to reach Rs 27.8 billion. The improvement in provisioning coverage also reflects the implemtation of IFRS-9 with effect from January 01, 2024. Additional provisioning has further improved the MFB's ability to absorb potential losses, as evidenced by other asset quality ratios. For instance, the provisioning coverage ratio rose to 102.3 percent in CY23 (78.8 percent in CY22), net NPLR improved to -0.2 percent in CY23 (1.5 percent in CY22), and capital impairment ratio (net NPLs to Capital) also enhanced to -2.2 percent in CY23 (12.9 percent in CY22), suggesting muted credit risks to solvency from the delinquent portfolio, which is adequately provided for **(Figure 5.3)**.

[2] For details see SBP's IH&SMEFD circular no. 12 of 2022
[3] For details see SBP's AC&MFD Circular No. 3 of 2022
[4] For details on losses caused by 2022 floods, see Chapter 2 in The State of Pakistan's Economy Half Yearly Report (2022-2023), State Bank of Pakistan

Asset Quality Indicators **Figure 5.3**



Source: State Bank of Pakistan

The business model of microfinance banks is generally associated with higher financial risk

MFBs have provided around 58 percent of their total loan portfolio without any collateral, i.e. loans secured through personal guarantees and expected cash flows. While this feature has helped rise in usage of financial services, it also involves relatively higher credit risk for MFBs. Various factors, such as a lack of data-driven credit models, high susceptibility of the borrowers to economic shocks, and exposure to an agriculture sector that is vulnerable to climate risk, mainly drives the overall credit risk of the MFBs.

One of the critical concepts in microfinance banks is group lending. It involves providing micro-loans to a group of individuals who are from low-income backgrounds. This approach has several advantages when applied adequately, such as group guarantees rather than individual guarantees, social pressure within the group to repay loans, internal group monitoring and support to repay loans, and risk diversification in multiple groups within a community. During CY08, group lending comprised 80.4 percent of the total lending of the MFBs. However, this form of lending lost its ground over the years, and during CY23, it accounted for only 3.3 percent of total lending (5.0 percent in CY22).

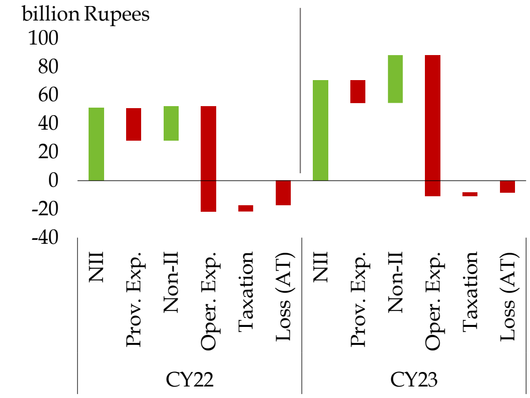
The sector's profitability remained in the losses for the fifth consecutive year; however, the magnitude of losses remained lower than the previous year.

The aggregate profitability of the MFBs remained in losses for the fifth year in a row. The sector's pre-tax losses by the end of CY23 stood at Rs 10.8 billion, lower than last year's loss of Rs 21.6 billion. Consequently, the ROA (before tax) reached -1.5 percent (-3.4 percent in CY22), and ROE (before tax) stood at -26.4 percent (-42.9 percent in CY22). Operational Self Sufficiency (i.e., the ratio of financial revenue to all expenses) stood at 78.8 percent in CY23 (69.8 percent in CY22). Although the sector posted losses during the year under review, it is worth mentioning that the incurred losses were lower than last year. This indicates some signs of recovery, possibly because of the fading impact of the COVID-19 pandemic and the rain/flooding in 2022 and 2023.

Further investigation of the MFB's profitability indicates a substantial increase in the net interest income (NII), which almost doubled, reaching Rs 54.8 billion by the end of CY23 **(Figure 5.4)**.[5] This strong growth can be attributed to the rising interest rates in CY23, allowing interest income to outpace expenses. The net interest margin (NIM) rose to 12.2 percent in CY23 (10.1 percent in CY22). The sector's income level was further supported by the non-interest component, which expanded 39.7 percent (42.0 percent in CY22) to reach Rs 33.6 billion.

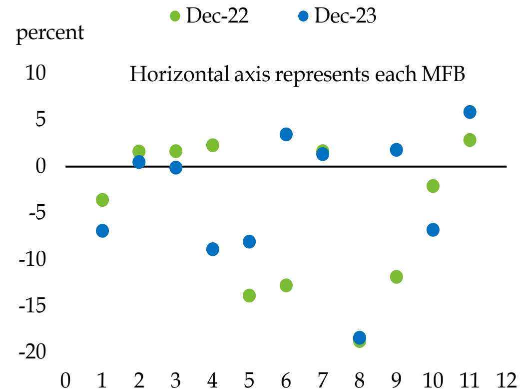
[5] Growth in NII is attributed to growth in average yield that significantly outpaced the growth in average cost.

Composition of MFBs' Income and Expenses **Figure 5.4**



Source: State Bank of Pakistan

MFB-wise ROA (before tax) **Figure 5.5**



Source: State Bank of Pakistan

Administrative expenses, which surged in CY22, grew by 5.7 percent in CY23, reaching Rs 74.8 billion **(Figure 5.4)**. Most of these expenses were incurred due to branch expansion carried out by several MFBs. Higher administrative expenses are a universal phenomenon for microfinance banks due to their unique business model that involves a vast number of borrowers and the need to maintain continuous interaction. However, emerging technological advancements are offering opportunities that banks can leverage to reduce their operating costs.

The number of loss-making institutions in the sector remained the same as the previous year. Most loss-making MFBs experienced higher administrative expenses in CY23, whereas, in CY22, higher provisioning against bad debts drove overall losses **(Figure 5.5)**.

Liquidity indicators improved because of higher investments in risk-free government securities.

In the year under review, liquidity indicators improved due to higher accumulation of liquid assets and lesser reliance on borrowing from other financial institutions. The overall liquid assets of the sector experienced a relatively strong growth of 13.9 percent (9.2 percent in CY22) when compared with the growth of 2.4 percent in asset base. Accordingly, the share of liquid assets in total assets increased to 29.4 percent by the end of CY23 (26.5 percent in CY22) **(Table 5.1).** Liquid assets rose on the back of higher investments in government securities particularly in MTBs – though overall investments declined due to contraction in mutual funds holding.[6]

During CY23, MFBs were less reliant on borrowings and instead mobilized deposits to finance their asset base. This led to 9.8 percent drop in MFB's exposure to short-term liabilities, thereby, increasing the proportion of liquid assets to short-term liabilities to 42.1 percent in CY23 (31.9 percent in CY22) **(Table 5.1)**.

[6] Treasury investments increased from Rs 146.4 billion in December, 2022 to Rs 152.0 billion in December, 2023.

Financial Soundness Indicators (FSIs) of MFBs **Table 5.1**

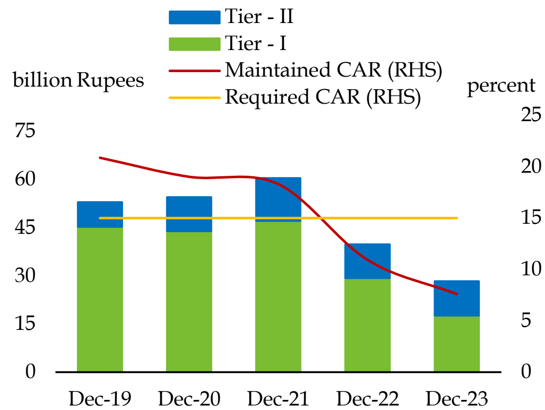
				percent
	Dec-20	Dec-21	Dec-22	Dec-23
Capital				
Total Capital to Total RWA	19.0	18.3	10.9	7.6
Tier 1 Capital to Total RWA	15.3	14.3	8.1	4.7
Asset Quality				
NPLs to Total Loans	3.3	5.2	6.7	6.7
Provision to NPLs	106.5	78.1	78.8	102.3
Net NPLs to Net Loans	-0.2	1.2	1.5	-0.2
Net NPLs to Capital	-0.9	5.4	12.9	-2.2
Earnings				
ROA before Tax	-0.8	-1.3	-3.4	-1.5
ROE before Tax	-7.1	-12.7	-42.9	-26.4
Operational Self Sufficiency (OSS)	81.9	76.8	69.8	78.8
Liquidity				
Liquid Assets to Short Term Liabilities	50.9	42.4	31.9	42.1

Source: State Bank of Pakistan

Solvency indicators dropped further below the minimum required level.

In the wake of continued stressful credit risk and earning conditions, MFB's solvency indicators remained under pressure during CY23 as the aggregate capital adequacy ratio (CAR) of the sector dropped to 7.6 percent by end CY23 from 10.9 percent at end-CY22 – against the minimum regulatory requirement of 15 percent. The realization of loan losses triggered by the COVID-19 pandemic and flash floods of 2022 absorbed a sizeable portion of the sector's capital base. Although the sector has witnessed a significant amount of equity injection by several institutions over the last few years, however, due to losses emanating from severe exogenous shocks, the capital base remained low vis-à-vis asset base (**Figure 5.6**). However, within the sector, only a few institutions with a market share of 28.3 percent have CAR below minimum regulatory requirements. Excluding these institutions, the overall CAR of the MFBs sector rises to 17.2 percent. Keeping in view the solvency issues of the MFBs and their importance from the financial inclusion perspective, SBP continued enhanced supervision of the sector and engagement with individual institutions.

Capital Adequacy Ratio **Figure 5.6**



Source: State Bank of Pakistan

MFBs continue to lead financial inclusion objectives through branchless banking.

Despite their small share in the financial sector, MFBs have been instrumental in widening financial inclusion through Branchless Banking (BB). BB accounts provide easy access and a cost-effective way of delivering financial services to the unbanked and underserved population.

MFBs account for around 80 percent of the total BB accounts of banks and MFBs combined. During CY23, the number of BB accounts rose by 18.1 percent (23.2 percent in CY22), reaching 114 million accounts. The number of active accounts reached 64.1 million depicting significant growth of 50.9 percent in CY23, as opposed to last year's decline of 5.4 percent.

Continued macroeconomic stress that has been regularly compounded by severe exogenous shocks remains the determinant of MFB's financial performance and standing.

Stress in the MFB sector is a continuation of disruption that started during the pandemic, compounded by the flash floods of 2022 and worsened by the deteriorating macro-financial conditions afterward. Continued stress in CY24 might add further pressure to the sector's credit risk and funding cost. Moreover, the sector's portfolio vulnerability to climate risks (e.g flooding) is another significant source of risk that may adversely impact the sector's already stressed solvency level.

Going forward, the MFBs' performance will depend on their ability to build buffers to withstand such disruptions, especially reestablishing the institution-borrower relationship that was severed during the post-pandemic period. Tackling these issues is crucial for enhancing loan recoveries and lowering the credit risk thus protecting their already stressed solvency position.

MFBs also need to revisit their business models to rationalize and curb operating costs that have hauled their profits during the past several years. In addition, given the increase in credit risk due to high inflation and consequent stabilization policies, MFBs need to manage the underlying risks preemptively by enhancing their risk management capacities and strengthening capital buffers. MFBs need to focus on raising funds through stable sources for profit generation and supporting the policy objective of financial inclusion in a sustainable manner.