5

Microfinance Banks

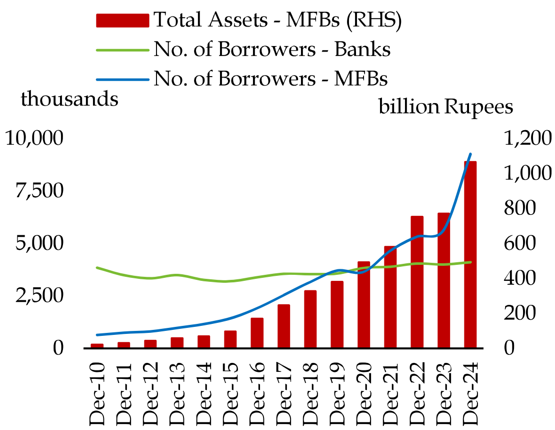
The Microfinance Banks (MFBs) experienced a significant growth in asset size, primarily driven by substantial increase in investments in government securities in CY24. Advances also grew, though at a slower pace, with increased financing to enterprise, livestock, and housing sector. The expansion in the asset base was financed by both borrowing followed by deposit mobilization. The sector's financial soundness, however, remained under stress due to prolonged challenges. Rising infection ratio and decline in provisioning coverage signaled increased credit risk. The sector posted aggregated losses for the sixth consecutive year, thereby raising solvency concerns as the aggregate Capital Adequacy Ratio (CAR) fell further and remained below the applicable minimum regulatory requirement. Nonetheless, from financial inclusion standpoint, the MFBs hold importance as they are key to providing financial services to the under-served segments and low-income micro-borrowers. While SBP remains engaged via enhanced supervision to support the sector's stability and its role in financial inclusion, the sector also needs to focus on improving loan recoveries, optimizing operations, and strengthening capital buffers to ensure long-term sustainability.

5 Microfinance Banks

MFBs are instrumental in the financial inclusion of low-income, under-served urban and rural customers...

Despite challenging macroeconomic conditions, Microfinance Banks (MFBs) continue to play a crucial role in expanding financial inclusion by providing services to the low-income segment of the population. While MFBs account for only 1.5 percent of total financial sector assets and pose relatively low systemic risk, their broad customer base—surpassing that of the commercial banking sector—makes them essential for achieving the goals of the National Financial Inclusion Strategy **(Figure 5.1)**. However, their exposure to a predominantly low-income clientele carries heightened credit risk, posing challenges to portfolio quality and financial sustainability.[1]

Growth in MFB Sector **Figure 5.1**



Source: State Bank of Pakistan

The sector experienced sizeable expansion in its balance sheet footing…

During CY24, the asset base of the sector experienced a sizeable expansion of 38.5 percent (YoY), as compared to 2.4 percent during CY23. The growth was mainly generated by hefty investments, which increased by 136.9 percent during CY24. Investment in government papers almost tripled to reach Rs 376 billion. Support also came from advances, which increased by 10.9 percent.

… which is mainly financed by both borrowings and deposits…

The growth in the asset base of MFBs was supported by a 249.3 percent (Rs 146 billion) increase in borrowings and a 22.8 percent (Rs 136 billion) increase in deposits in CY24.

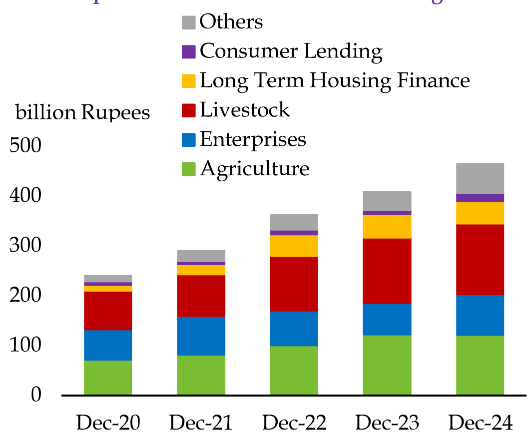
Almost all segments experienced an uptick in loans from MFBs...

Sector-wise breakdown of advances reveals that barring agriculture and housing, all other sectors received more funds from MFBs than the previous year. Amongst these sectors, enterprises availed Rs 81 billion during CY24, which was Rs 18 billion more than last year. Similarly, livestock financing reached to Rs 142 billion during CY24, which is Rs 11 billion more than the previous year **(Figure 5.2)**. Higher livestock financing can be partly attributed to the issuance of interest-free loans to farmers under the Livestock Card Scheme by the Government of Punjab.[2]

---

[1] By end of CY24, the number of domestic bank borrowers stood at 4.4 million, whereas, borrowers of MFBs stood at 9.2 million.
[2] For further information, see https://punjab.gov.pk/cm-punjab-livestock-card

Break-up of Advances **Figure 5.2**



Source: State Bank of Pakistan

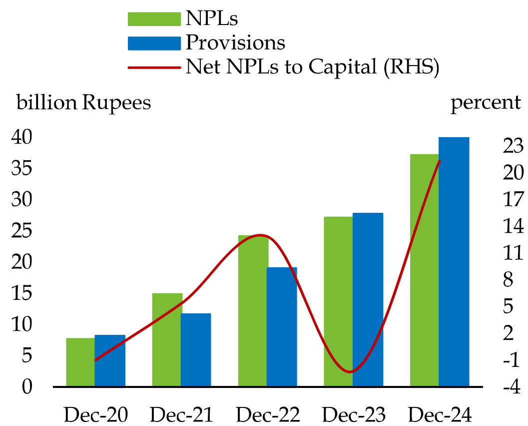
Asset quality further deteriorated during CY24...

The soundness of MFBs was further stressed during CY24. The infection ratio that has consistently increased over the last few years, peaked at 10.5 percent by June 2024, the highest recorded level. However, by the end of CY24, the ratio slightly lowered to 9.7 percent due to fast growth in advances, but was still considerably higher than the 6.7 percent recorded at the end of CY23. By the end of CY24, total NPLs reached Rs 45 billion after an addition of Rs 18 billion in CY24 (Rs 27 billion in CY23).

Due to legacy issues, MFBs continue to face asset quality concerns, especially since the onset of COVID-19 pandemic, which were further compounded by the floods in the summer of 2022 and tighter financial conditions during CY23 and H1CY24.

Provisioning coverage also remained slightly lower during CY24. Although the MFBs raised their provisioning to Rs 43 billion during CY24 (Rs 28 billion during CY23), their provisioning coverage fell to 95.3 percent (102.3 percent in CY23). Similarly, net non-performing loans to total loans ratio (NPLR) dropped to 0.5 percent in CY24 (-0.2 percent in CY23), and capital impairment ratio (net NPLs to Capital) also deteriorated to 21.4 percent in CY24 (-2.2 percent in CY23), depicting an increase in credit risks to solvency from the delinquent portfolio **(Figure 5.3)**.

Asset Quality Indicators **Figure 5.3**



Source: State Bank of Pakistan

The sector's profitability remained in red for the sixth consecutive year…

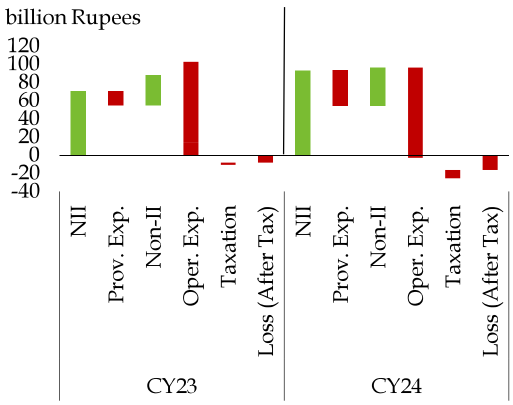
The profitability of the MFBs posted losses for the sixth year in a row. The sector's pre-tax losses more than doubled in CY24 to Rs 25 billion from Rs 11 billion by the end of CY23. As a result, the sector's before tax ROA reached *negative* 3.0 percent (*negative* 1.5 percent in CY23), and ROE stood at *negative* 77.9 percent (*negative* 26.4 percent in CY23). Operational Self Sufficiency (i.e., the ratio of financial revenue [markup income] to all expenses) also deteriorated slightly to 75.2 percent in CY24 (78.8 percent in CY23). Although the MFBs were able to generate higher interest and non-interest-based revenues, elevated administrative expenses pulled the sector into losses.

Further analysis of the MFB's profitability indicates an increase of 31.7 percent (YoY) in the net interest income (NII), which reached Rs 93 billion by the end of CY24 **(Figure 5.4)**.[3] The current growth in NII was lower as compared to

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

CY23 due to monetary easing in CY24.[4,5] Nonetheless, the net interest margin (NIM) rose to 13.9 percent (YoY) in CY24 (12.2 percent in CY23). Similarly, growth in non-interest income also remained relatively lower during CY24 at 25.7 percent (YoY) when compared to 39.7 percent during CY23. Though growth in income was lower than last year, the deceleration (YoY) in expenses helped improve the cost to income ratio to 89.8 percent from 95.0 percent in CY23.

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



Source: State Bank of Pakistan

Non-interest expense grew by 22.7 percent (YoY) in CY24, driven by a Rs 46 billion rise in administrative costs and a Rs 23 billion increase in provisioning expense against non-performing loans.[6] As a result, the number of loss making institutions rose to eight (out of 12) during CY24 from six (out of 11) in CY23. In CY23, MFBs faced losses primarily due to elevated administrative expenses, however, this year, while administrative expenses remain significant, the additional burden of higher provisioning expenses has further amplified their losses.

Higher administrative expenses are inherent to the microfinance banking model, given their extensive borrower base and the need for a continuous engagement with their customers. However, technological advancements present opportunities for MFBs to enhance their efficiency by streamlining their operations and reducing costs.[7]

Liquidity indicators improved on the back of significant investments in government securities...

Liquidity indicators saw a significant improvement on the back of a 105.2 percent increase in liquid assets during CY24 (13.9 percent in CY23). Hefty investments in government securities allowed improvement in their overall liquidity. Against this backdrop, the share of liquid assets in total assets increased to 43.6 percent by the end of CY24 (29.4 percent in CY23) **(Table 5.1)**.

During CY24, MFBs relied on borrowings followed by deposits to finance expansion in assets. This led to further accumulation of short-term liabilities, witnessing 15.4 percent growth during CY24. Encouragingly, the sector's liquid assets to short-term liabilities rose to 61.2 percent in CY24 (42.1 percent in CY23), indicating a sizeable improvement in the sector's ability in meeting short-term withdrawal of funds **(Table 5.1)**.

[4] During CY24, NII rose by 31.7 percent as compared to 37.9 percent during CY23.
[5] During CY24, SBP cut the policy rate by 900 basis points cumulatively across eight MPC meetings.
[6] Administrative expenses rose because of increase in salaries and allowances, and due to commission to a related party by one of the institutions.
[7] Globally, Kenya's M-Pesa and Bangladesh's "Cashless Bangladesh" campaign are few global examples of how leveraging technology can alleviate the efficiency of MFBs.

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

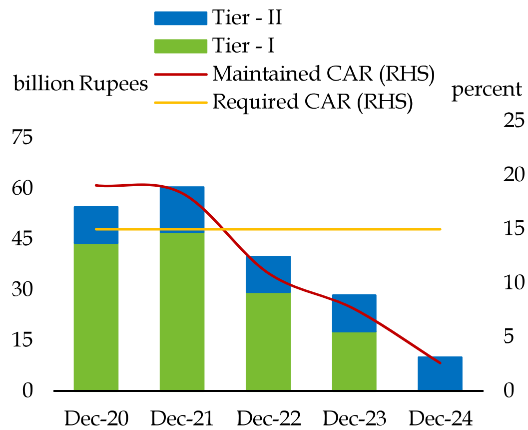
				percent
	Dec-21	Dec-22	Dec-23	Dec-24
Capital				
Total Capital to Total RWA	18.3	10.9	7.6	2.6
Tier 1 Capital to Total RWA	14.3	8.1	4.7	0.1
Asset Quality				
NPLs to Total Loans	5.2	6.7	6.7	9.7
Provision to NPLs	78.1	78.8	102.3	95.3
Net NPLs to Net Loans	1.2	1.5	-0.2	0.5
Net NPLs to Capital	5.4	12.9	-2.2	21.4
Earnings				
ROA before Tax	-1.3	-3.4	-1.5	-3.0
ROE before Tax	-12.7	-42.9	-26.4	-77.9
Operational Self Sufficiency (OSS)	76.8	69.8	78.8	75.2
Liquidity				
Liquid Assets to Short Term Liabilities	42.4	31.9	42.1	61.2

Source: State Bank of Pakistan

Solvency indicators dropped further below the minimum required level…

The MFB sector's solvency remains a point of concern, as the aggregate capital adequacy ratio (CAR) of the sector dropped to 2.6 percent by the end of CY24 from 7.6 percent at the end of CY23 – against the minimum regulatory requirement of 15 percent. Although the sector witnessed a significant amount of equity injection by several institutions during CY24, the capital base remained low vis-à-vis asset base due to losses emanating from infected portfolio (**Figure 5.5**). More importantly, within the sector, the market shares of the institutions that have CAR below the minimum regulatory required level rose to 49.9 percent (28.3 percent in CY23). Keeping in view the solvency issues of the MFBs and their importance from the financial inclusion perspective, SBP continued its enhanced supervision of the sector and engagement with individual institutions.[8]

Capital Adequacy Ratio **Figure 5.5**



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). The 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 CY24, the number of BB accounts rose by 10.7 percent (18.1 percent in CY23), reaching 122 million accounts.

Legacy issues remain the primary driver of MFB's financial performance and stability…

The stress in the MFB sector is a continuation of the disruptions that began during the pandemic, exacerbated by the 2022 flash floods and further intensified by deteriorating macro-financial conditions in CY23. Additionally, the sector's exposure to climate-related risks, such as floods, remains a major concern that, if materialized, may further strain its already weakened solvency position.

Going forward, MFBs' performance will largely depend on their ability to build resilience

[8] MFBs collectively injected Rs. 17 billion additional eligible capital in their balance sheet during CY24, significantly higher than Rs. 183 million eligible capital injected during CY23.

against such disruptions, improving loan recoveries, mitigating credit risk, and safeguarding their solvency position.

Furthermore, there is a need that MFBs reassess their business models to optimize their operations, reduce costs, strengthen their risk management frameworks and build necessary capital cushions. In this connection, leveraging the technological advancements can help in achieving the economies of scale and scalability, strengthening of risk management capabilities, and operational efficiencies.