RATING REPORT

FINCA Microfinance Bank Limited (FINCA MFB)

REPORT DATE:
April 30, 2022

RATING ANALYST:

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RATING DETAILS

	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	A	A-1	A	A-1
Rating Outlook	Negative		Rating Watch-Developing	
Rating Date	*April 30, '22*		*April 30th, '21*	

COMPANY INFORMATION

Incorporated in 2008	**External auditors:** M/S KPMG Taseer Hadi & Co Chartered Accountants
Public Limited Unlisted Company	**Chairman of the Board**: Mr. Florin Lila
	CEO: Mr. Jahanzeb Khan
Key Shareholders (with stake 5% or more):	
FINCA Microfinance Cooperatief U.A -- 86.4%	
Kashf Holding (Private) Limited – 5.2%	

APPLICABLE METHODOLOGY(IES)

VIS Entity Rating Criteria: Microfinance Banks (September 2021)
https://docs.vis.com.pk/docs/Microfinance202109.pdf

FINCA Microfinance Bank Limited (FINCA MFB)

OVERVIEW OF THE INSTITUTION

FINCA Microfinance Bank Limited (FINCA MFB) previously Kashf Microfinance Bank Limited, was incorporated in June, 2008 as a public limited company under Companies Ordinance 1984 (now Companies Act 2017). The bank obtained the Microfinance banking license from SBP in August 2008 under the provisions of Microfinance Institutions Ordinance, 2001. The ultimate holding company of FINCA MFB is FINCA Impact Finance, a not-for-profit corporation incorporated in Washington, DC, USA.

Profile of Chairman

Mr. Florin Lila joined the Board in March, 2021. He holds a Master's degree in Economics for Business Analysis from Staffordshire University, United Kingdom. He has over two decades of experience in the banking and microfinance sector including multiple roles at the Executive Management and Board of Directors level in Europe, Africa and Asia.

Profile of CEO

Mr. Jahanzeb Khan joined as CEO of the bank in June, 2021. Mr. Khan has over 24 years of global experience in financial services. Most recently he had worked as Chief Strategy and Transformation officer at Telenor Microfinance Bank Limited. He has also worked at JPMorgan Chase & Co. and Deloitte Consulting. Mr. Khan holds a Bachelor of Science in Electrical Engineering from the University of Texas at Austin, Masters in Business Administration from University of Delaware,

RATING RATIONALE

The ratings assigned to FINCA MFB incorporate association of the bank with FINCA Impact Finance., a global microfinance organization operating in 20 subsidiaries, including Pakistan. Majority shareholding (86.4%) of the bank is vested with FINCA Microfinance Cooperatief U.A. FINCA MFB continues to receive support from its parent through transfer of technical expertise emanating from FINCA's global experience. Overall performance indicators of the banks have remained under pressure mainly on account of impairment in loan portfolio transpired due to regulatory relief provided during the pandemic, which shrouded the worsening portfolio quality at that time. Decline in markup income mainly on account on contraction in microcredit portfolio along with sizeable provisioning charge have depressed the profitability profile of the bank. Resultantly, the bank incurred sizeable losses in the outgoing year. In addition, equity base eroded while CAR reached the minimum regulatory threshold by end-Dec'21. However, the latest revision in prudential regulations pertaining to provisioning coverage and write-offs of certain lending products have provided a breather for the sector. Accounting for the same, the bank booked profit in 1QFY22 while CAR showed slight improvement. In order to avoid potential breach of the regulatory threshold of CAR as growth momentum in lending is pursued, the bank is actively working to raise capital. As per management, equity injection is expected by end-July' 22. VIS will continue to monitor the bank's CAR while timely injection of fresh equity and positive trend in performance indictors is likely to ease pressure off ratings, going forward. In addition, the ratings do take into account uncertainty pertaining to timely achievement of capital injection plans.

Key Rating Drivers

Decline in gross loan portfolio amidst write-offs and subdued disbursements: The lending activities were largely curtailed given the bank remained focused on portfolio consolidation amidst surge in non-performing loans and write-offs. The gross loan portfolio (GLP) of the bank decreased to Rs. 19.7b (FY20: Rs. 21.6b) by end-FY21. Loans amounting Rs. 19.2b (FY20: Rs. 21.6b) were disbursed against the target of Rs. 21.5b during the outgoing year. During FY21, the bank's focus remained towards microenterprise and secured lending. The bank's exposure in agriculture and livestock sectors stood at 28% (FY20: 29%) and 27% (FY20: 31%), respectively. Meanwhile, proportion of micro-enterprise loans comprising trading, services, and manufacturing categories, increased to 44% (FY20: 39%) while proportion of housing loans have remained minimal in FY21.

During FY21, the bank managed to grow its gold-backed portfolio to Rs. 4.1b (FY20: Rs. 2.5b) with a higher contribution of 21.1% (FY20: 11.8%) in GLP. There was an improvement in client retention rate to 41% from 20% in the preceding year. The number of active loans decreased to 202,094 (FY20: 225,288) while average loan size increased to Rs. 97,458 (FY20: Rs. 95,658). The bank has an equal proportion of EMI and bullet loans. Given the bank has been making efforts to dilute its agri loans exposure, no new disbursement has been made under group lending over the last two years. In addition, the bank plans to enhance collateralized or secured agri lending through structured finance products.

Considerable deterioration in asset quality indicators during FY21: Asset quality indicators have deteriorated given aftermaths of the relief provided by SBP pertaining to deferment and rescheduling. The bank initially rescheduled/deferred 133,964 loans amounting Rs. 12.5b under SBP relief to dampen the impact of pandemic during FY20. Out of this rescheduled/deferred portfolio, loans amounting Rs. 4.8b were rescheduled/deferred for the second time. At end-March'22, the aggregate deferred/rescheduled portfolio decreased to Rs. 4.1b. The non-performing loans (NPLs) soared to Rs. 2.9b (FY20: Rs. 739.2m) by end-FY21. Resultantly, gross infection and net infection increased to 14.8% and 11.6% (FY20: 3.4% and 2.9%), respectively. Incremental infection also increased to 17.6% (FY20: 4.6%). The bank recorded Rs. 720.2m (FY20: Rs. 115.5m) in specific provisions and Rs. 148.4m (FY20: Rs. 188.9m) as mandatory general provisioning of 1% of the outstanding advances net of specific provisions and those against which gold collaterals are taken. Provisioning coverage increased to 24.6% (FY20: 15.6%). A snapshot of asset quality indicators is presented below:

Program for Working Professionals at Wharton Business School, followed by Executive leadership programs at Wharton and Harvard Business School, USA.

Financial Snapshot

Core Equity: 1QFY22: Rs. 4.0b; FY21: Rs. 3.7b; FY20: Rs. 5.2b

Profit (Loss) After Tax:

1QFY22: Rs. 261m; FY21: Rs. (1,523)m; FY20: Rs. 905m

Portfolio quality Indicators	FY20	FY21
NPLs % Total Advances (gross):	3.4%	14.8%
Net NPLs % of Net Advances: Net Infection	2.9%	11.6%
Incremental Infection	4.6%	17.6%
Provisioning Coverage	15.6%	24.6%

Around half of the deferred/rescheduled portfolio pertained to EMI loans while the rest constituted bullet loans. As per management, recovery rate from the deferred/rescheduled EMI portfolio was around 95% with around Rs. 300m outstanding under this portfolio as of now. Meanwhile, recovery against bullet loans was lower at around 70%; major proportion of these bullet loans falls due in CY23 and CY24.

The latest revision in prudential regulations pertaining to provisioning coverage and write-offs have provided a breather for the sector. By end-1QFY22 the specific provisions held by the bank decreased to Rs. 209.2m. NPLs stood lower at Rs. 1.46b (FY21: Rs. 2.9b) while loans amounting Rs. 190.8m were written off during the same period. Resultantly, gross and net infection ratios have decreased notably to 7.4% and 6.4% while provisioning coverage stood higher at 34.6%.

Recently, the bank has taken various initiatives to expedite recovery of loans while facilitating its client base. FINCA is offering markup waiver ranging from 75-90% for its rescheduled/deferred portfolio, including the loans falling due in FY23 and FY24. The bank is also offering repeat loans to those clients who fall under a certain acceptance and risk criteria. Moreover, country-wide engagement of senior management, including CEO and all heads of departments, along with field staff, by means of in person meetings, is also expected to bode well in terms of recovery prospects. At the same time, cash recoveries around harvesting time are being actively pursued.

Adequate liquidity profile largely underpinned by sizeable investments in Government securities: Net investments portfolio augmented to Rs. 10.2b (FY20: Rs. 6.4b). As funds were parked in market T-bills, credit risk is considered minimal. Overall liquidity position of the bank is considered adequate with liquid assets to total deposits & borrowing ratio at 40.1% (FY20: 34.4%) at end-FY21. Deposits continue to be the bank's primary source of funding. Deposit base decreased to Rs. 25.4b (FY20: Rs. 26.1b) while active saver/depositors base increased to 1,708,490 (FY20: 1,527,000). The composition of deposit mix is tabulated below:

Rs. Millions	FY20	%	FY21	%
Term Deposits	14,894	57	13,707	54
PLS Deposits	8,427	32	9,025	36
Current Deposits	2,762	10	2,687	11
Total	26,082	100	25,419	100

Concentration risk emanating from deposits portfolio is considered manageable given proportion of top-50 depositors remained largely stable at 32% (FY20: 31%) at end-FY21. Top five depositors accounted for 11% (FY20: 11%) of the total deposit mix. The deposit base of FINCA remained largely tilted towards individual depositors at 80% (FY20: 78%). By end-FY21, average deposit size decreased to Rs. 14,878 (FY20: Rs. 21,300) as the proportion of deposits above Rs. 10m decreased to 43.1% as compared to 60.9% in the preceding year. Total borrowings of the bank, including subordinated loan decreased to Rs. 5.2b (FY20: Rs. 5.5b) by the end-FY21. In the backdrop of stressed CAR, the management intends to largely maintain liquidity in the ongoing year as well.

Dismal performance on account of considerable deterioration in the health of microcredit portfolio: The bank posted lower markup of Rs. 5.2b (FY20: Rs. 8.6b) given markup income on advances portfolio declined to Rs. 4.5b (FY20: Rs. 8.0b) mainly on account of contraction in net advances portfolio and decrease in yield. In FY21, markup amounting Rs. 2.35b (FY20: Rs. 244.6m) was placed in suspension account due to surge in NPLs. Markup earned on investment in government securities increased to Rs. 606.5m (FY20: Rs. 526.8m) in line with growth in investment portfolio while interest on bank accounts was recorded lower at Rs. 60.5m (FY20: Rs. 131.4m). Overall yield on markup bearing assets decreased to 25.2% (FY20: 29.4%) while cost of funds decreased to 8.0% (FY20: Rs. 9.8%). Accordingly, the bank posted lower markup spread of 17.2% (FY20: 19.7%) during FY21. Provisioning charge against NPLs was recorded higher at Rs. 2.2b (FY20: 1.2b) in the outgoing year. Bad debts written off directly amounted to Rs. 22.5m (FY20: Rs. 2.2m). Total non-markup income including fee commission and brokerage income and other income increased to Rs. 924.1m (FY20: Rs. 845.5m). The operational self-sufficiency (OSS) ratio declined to 72.2% (FY20: 117.6%) reflecting the bank's inability to adequately meet its operational expenses through core earnings. Resultantly, the bank recognized a loss before tax of Rs. 2.3b (FY20: Profit of Rs. 1.4b). After accounting for the benefit of deferred tax asset, the bank booked net loss of Rs. 1.5b (FY20: Profit of Rs. 904.6m) in FY21.

With recent changes in prudential regulations, profitability profile of the bank is expected to improve in the short to medium term. Accordingly, the bank has booked net profit of Rs. 261.1m (1QFY21: loss of Rs. 5.2m) during 1QFY22 while booking provision reversal of Rs. 173.5m vis-à-vis provisioning charge of Rs. 501.1m in the same period last year. The management is quite confident of sizeable recoveries during the wheat harvesting season which, if attained, would support the bottom-line. In view of subdued growth expected in advances portfolio for the ongoing year, the net markup income may remain largely muted.

Equity erosion owing to sizeable losses while CAR declined close to the regulatory threshold by end-FY21; timely equity injection remains essential: Equity base of the bank has depleted to Rs. 3.7b (FY20: Rs. 5.2b) owing to sizeable losses posted during the outgoing year. Net NPLs in relation to tier-1 capital increased notably to 56.5% (FY20: 11.5%) in line with higher net NPLs and depleted equity base. By end-FY21, capital Adequacy Ratio (CAR) declined to 15.19% (FY20: 20.93%), just above the minimum regulatory requirement of 15%. However, CAR has increased to 17.55% as on Mar 31, 2022 on the back on changes in provisioning charge and write-offs under revised prudential regulations. Meanwhile, the bank is actively pursuing to raise capital to support CAR while pursuing growth in microcredit portfolio.

Board composition and senior management: The Board appointed Mr. Florin Lila as Chairman in March 2021. Ms. Tazeen Adnan also joined the board as an independent director in place of Ms. Fatma Safiye Ozuygun Sahin. Brief Profiles of chairman and incoming director is attached with Appendix-I to the report. Presently, Board of Director (BoD) at FINCA comprises nine members, including three independent directors. Composition of the BoD is tabulated below:

Directors	Status
Mr. Florin Lila	Chairman/Non-Executive Director
Ms. Zarlasht Wardak	Non-Executive Director
Mr. Volker Renner	Non-Executive Director
Mr. Jeffrey Peter Smith	Non-Executive Director
Ms. Roshneh Zafar	Non-Executive Director
Mr. Makhmud Saidakhmatov	Non-Executive Director
Dr. Arif Ahmed	Independent Director
Mr. Shabbir Hussain Hashmi	Independent Director
Ms. Tazeen Adnan	Independent Director

The bank has experienced turnover at the senior management level. There was a change at the helm of affairs as Mr. Jahanzeb Khan joined the bank as CEO in June 2021. Mr. Muhammad Zahoor Khan took charge as head compliance and internal control in May 2021. Mr. Yasir Ahmad Hashmi was appointed as Head of Internal audit in September 2021. The position of Chief Operating Officer (COO) and Head Human Resource, Training and OD have been vacant for some time. The position of Chief Commercial Officer (CCO) was introduced to oversee a dedicated division for recoveries and collection, asset side, liability side, digital financial services and branch operations. Mr. Muhammad Ahmad assumed the charge of CCO in January, 2022. CCO reports directly to the CEO while Head of Business reports to him. Brief profiles of new senior management appointments have been presented in Annexure II to the report.

FINCA Microfinance Bank Limited (FINCA MFB Annexure I

FINANCIAL SUMMARY	(amounts in PKR millions)			
BALANCE SHEET	**31-Dec-19**	**31-Dec-20**	**31-Dec-21**	**31-Mar-22**
Cash and Bank Balances with SBP and NBP	1,596	1,572	1,703	1,724
Balances with other Banks and/NBFIs/MFBs	1,643	2,849	279	154
Lending to Financial Institutions	-	-	-	-
Total Investments	6,244	6,449	10,300	10,894
Net Advances	22,039	21,246	18,827	19,225
Operating Fixed Assets	3,131	2,445	1,966	1,858
Other Assets	2,613	5,171	3,033	3,323
Deferred Tax Assets	46	118	1,015	942
Total Assets	**37,312**	**39,851**	**37,122**	**38,121**
Total Deposits	23,911	26,083	25,419	26,399
Borrowings	5,553	5,511	5,181	4,997
Other Liabilities	3,129	3,014	2,714	2,714
Tier-1 Equity	4,715	5,243	3,738	4,011
Net Worth	4,715	5,243	3,738	4,011
Paid-Up Capital	6,349	6,349	6,349	6,349
INCOME STATEMENT	**31-Dec-19**	**31-Dec-20**	**31-Dec-21**	**31-Mar-22**
Net Mark-up Income	5,314	5,590	2,533	898
Net Provisioning / (Reversal)	1,087	1,226	2,170	(173)
Non-Markup Income	954	845	924	225
Operating Expenses	4,102	3,761	3,555	914
Profit/(Loss) Before Tax	1,012	1,416	(2,342)	361
Profit/(Loss)after tax	653	905	(1,523)	261
RATIO ANALYSIS	**31-Dec-19**	**31-Dec-20**	**31-Dec-21**	**31-Mar-22**
Gross Infection (%)	4.7	3.4	14.8	7.4
Incremental Infection (%)	3.7	2.9	11.6	-6.6
Provisioning Coverage (%)	41.8	41.2	29.7	34.6
Net Infection (%)	3.7	2.9	11.6	6.4
Net NPLs to Tier-1 Capital (%)	16.7	11.5	56.5	31.1
Capital Adequacy Ratio (%)	19.8	20.9	15.2	17.6
Markup on earning assets (%)	30.3	29.4	25.2	26.8
Cost of Funds (%)	10.3	9.8	8.0	9.2
Spreads (%)	20.0	19.6	17.2	17.5
OSS (%)	149.0	162.8	87.4	124.7
ROAA (%)	1.9	2.3	n.m.	2.8*
ROAE (%)	14.9	18.2	n.m.	26.9*
Liquid Assets to deposits & borrowings (%)	32.2	34.4	40.1	40.7

**Annualized*

ISSUE/ISSUER RATING SCALE & DEFINITIONS Annexure II

VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES	Annexure III
Name of Rated Entity	FINCA Microfinance Bank Limited (FINCA MFB)
Sector	Microfinance Bank (MFB)
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings
Rating History	

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
30-Apr-22	A	A-1	Negative	Maintained
30-Apr-21	A	A-1	Rating Watch Developing	Reaffirmed
30-Apr-20	A	A-1	Rating Watch Developing	Maintained
30-Apr-19	A	A-1	Stable	Reaffirmed
23-Apr-18	A	A-1	Stable	Reaffirmed
31-Oct-17	A	A-1	Stable	Reaffirmed
27-Apr-17	A	A-1	Stable	Reaffirmed
09-Jan-17	A	A-1	Stable	Upgrade
26-Apr-16	A-	A-2	Positive	Reaffirmed

Instrument Structure	N/A
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.
Probability of Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.
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Due Diligence Meeting/s Conducted

	Name	Designation	Date
1.	**Mr. Ghulam Qadir**	Chief Financial Officer	29th March, 2022
2.	**Mr. Muhammad Qaisar**	Head of Business Development	29th March, 2022
3.	**Syeda Noshina Bukhari**	Head of Operations & Digital Transformation	29th March, 2022
4.	**Mr. Aleem Masood**	Acting Head IT	29th March, 2022
5.	**Mr. Muhammad Shahzad Sadiq**	Group Head Risk Management	29th March, 2022
6.	**Mr. Yasir Ahmad Hashmi**	Head Internal Audit	29th March, 2022
7.	**Mr. Muhammad Ahmad**	Chief Commercial Officer	31st March, 2022