VIS

Credit Rating Company Limited

MICROFINANCE BANKS

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INTRODUCTION

Microfinance Banks (MFBs) in Pakistan operate under a distinct legal framework and are licensed and regulated by the State Bank of Pakistan (SBP). To address the unique needs and dynamics of microfinance, the SBP has established a specialized regulatory and supervisory framework for these institutions.

MFBs in Pakistan play a crucial role in promoting financial inclusion by offering essential banking services to the unbanked and underbanked segments of the population. These banks provide small loans, savings accounts, and other financial products tailored to the needs of low-income individuals and small businesses. By doing so, they help overcome financial barriers and improve livelihoods.

Through access to credit and financial education, microfinance banks make significant contributions to poverty alleviation, women's empowerment, and overall economic development in Pakistan. The Islamic microfinance sector has also gained prominence, with initiatives such as National Rural Support Programme (NRSP) Bank’s microfinance services and the State Bank’s pilot project for Islamic microfinance.

ECONOMIC OVERVIEW

GLOBAL

The global economy in July 2024 presents a picture of sluggish recovery with underlying vulnerabilities. Growth projections hover around 3.2% for 2024 and 2025, marking a continuation of subdued trends compared to historical averages. This slow progress is further complicated by uneven performance across regions, with developed economies expected to experience a slight uptick while emerging markets face a potential moderation in growth. Inflation remains a pressing concern, though forecasts anticipate a gradual decline throughout the remaining year and into 2025[1]. However, the threat of rising food and energy prices due to geopolitical tensions continues to cast a shadow. The ongoing impact of climate change further adds to the complexity of the situation. Despite these challenges, the global economy has demonstrated surprising resilience. The possibility of a "soft landing" that avoids a recession remains on the table, although continued vigilance and international cooperation on issues like trade, climate change, and debt management will be essential for navigating these headwinds and achieving sustainable growth in the long-term[2].

PAKISTAN

Pakistan's economy exhibits a mix of recent growth and persistent obstacles at the start of FY’24. Despite a 5.97% GDP expansion in FY’22, fueled by strong agricultural, industrial, and service sectors, growth contracted sharply to 0.2% in FY’23. This volatility underscores underlying vulnerabilities, particularly high fiscal deficits, rising debt, and dwindling foreign exchange reserves, which heighten the economy's sensitivity to external pressures like fluctuating global commodity prices. Inflation remains a concern, squeezing household budgets with rising food and energy costs. However, the International Monetary Fund (IMF) approved the Stand-By Arrangement (SBA) program in Jul’23 and reached a staff-level agreement (SLA) on a new 37-month $7 billion extended fund facility (EFF) on July 12, 2024. Steadfast implementation of the program—including through continued fiscal restraint, energy tariff adjustments, and the continued high policy rate at 19.5% following a recent 100bps rate cut on July 30, 2024 —enabled new official external

[1] *https://www.imf.org/en/Publications/WEO/Issues/2024/04/16/world-economic-outlook-april-2024*
[2] *https://www.worldbank.org/en/publication/global-economic-prospects*

inflows, allowing a loosening of import management measures, and some recovery in confidence. Looking ahead, the World Bank anticipates subdued economic activity in the near term, with growth projections of 1.8% for FY'24. Long-term success hinges on tackling external imbalances, controlling inflation, and fostering investment in key sectors to achieve sustainable economic expansion.[3]

MICROFINANCE BANKING SECTOR

GLOBAL

The global microfinance market is poised for substantial growth, with projections indicating an expansion of USD 166.95 billion from 2023 to 2028, to achieve a compound annual growth rate (CAGR) of 12.86%[4]. This growth will be driven by a combination of technological advancements, financial inclusion initiatives, and the increasing demand for accessible credit, particularly in developing regions where traditional banking services are limited. With around 1.4 billion adults globally lacking access to traditional banking services, according to the World Bank, microfinance institutions (MFIs) have a vast market opportunity to tap into[5].

Microfinance institutions (MFIs) are playing a critical role in fostering economic development by offering financial services to underserved populations. The market is characterized by an increasing emphasis on digital connectivity, product diversification, and a client-centric approach. The rise of social impact investing is further amplifying the market's growth, as investors are increasingly drawn to the sector's potential for both financial returns and positive social outcomes.

Key Market Drivers

A) **Financial Inclusion Initiatives:** The push for financial inclusion is a primary driver of the microfinance market. Access to financial products like savings accounts, loans, and insurance enables low-income individuals to invest in education, healthcare, and small businesses, which contributes to poverty alleviation and economic growth. Governments are actively partnering with MFIs to reduce lending risks, establish credit bureaus, and create favorable regulatory environments that support the expansion of microfinance services.

B) **Quick and Easy Access to Credit:** MFIs provide quick and accessible credit solutions, bypassing the lengthy approval processes typical of traditional banks. This accessibility is crucial for small and medium-sized enterprises (SMEs) and other businesses often overlooked by conventional financial institutions. The proliferation of digital platforms has further streamlined the loan application process, making microfinance services increasingly popular and driving market expansion.

Significant Market Trends

A) **Technological Advancements:** The integration of mobile banking and financial technology (fintech) is transforming the microfinance sector. Mobile technology allows MFIs to extend their reach to remote and underserved areas,

[3] *https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/original/Pakistan-Development-Update-April-2024.pdf*
[4] *https://www.technavio.com/report/microfinance-market-industry-analysis*
[5] *https://www.maximizemarketresearch.com/market-report/microfinance-market/230628/*

reducing the need for physical branches and lowering operational costs. This shift enhances the efficiency of loan processing, repayments, and transactions, while also enabling better risk management through mobile data analytics.

B) **Growth in the Asia-Pacific (APAC) Region:** The APAC region is projected to contribute 45% of the global microfinance market growth during the forecast period. The APAC region is witnessing rapid growth in alternative financial services such as peer-to-peer (P2P) lending, crowdfunding, and invoice trading. This growth is fueled by the region's substantial SME presence and increasing internet and smartphone penetration. As of 2020, India reported 63.3 million SMEs, while China had approximately 18.07 million SMEs by the end of 2018. The rising number of SMEs in APAC is driving demand for microfinance services that support business growth.[6]

Major Market Challenges

A) **Lack of Awareness:** A significant challenge in the microfinance market is the lack of awareness about financial services among potential clients, particularly in low-income and developing regions. This knowledge gap extends to MFI field representatives, who may not be fully versed in the rules and regulations governing their operations. This lack of awareness hampers the effectiveness of microfinance initiatives and poses a barrier to market growth.

B) **Risk Management:** MFIs face various risks, including credit, operational, liquidity, and external risks. Serving clients with limited credit histories increases credit risk, while operational challenges in remote areas, such as infrastructure limitations and fraud threats, add to operational risks. Effective risk management is crucial for MFIs to attract necessary funding, maintain operational efficiency, and ensure long-term sustainability.

Competitive Landscape

The microfinance industry is becoming increasingly competitive, with a surge in innovative approaches, particularly in mobile-based financial services. In 2023, several new apps and digital platforms were launched specifically for microfinance clients, reflecting the industry's ongoing efforts to be more adaptable and client-focused. Collaborations between MFIs and tech companies in fintech projects are on the rise, aiming to enhance operational efficiency and reach unbanked customers.

Additionally, the introduction of customized microloan products tailored to specific needs, such as education financing or climate-resilient agriculture, underscores the sector's commitment to innovation. However, increased competition among MFIs also brings the risk of unsustainable practices and riskier lending. Regulatory oversight will be essential to mitigate these risks and ensure the integrity and sustainability of microfinance operations.

PAKISTAN

Despite challenging macroeconomic conditions, MFBs have continued to expand their outreach to the low-income population. Although MFBs account for only 1.3% of total financial sector assets, they have a broad customer base. Over the past five years, MFBs' total assets grew by an average of 19.1% annually. However, in 2023, the sector saw a modest growth of only 2.4%. This growth was primarily reflected in 11.0% increase in advances, while investments declined by 28.4%, mainly due to reduced investments in mutual funds. The slowdown was driven also by equity erosion in the sector, which on the one hand created a resource shortfall, and on the other restricted banks' ability to leverage the balance sheet.

[6] *https://www.technavio.com/report/microfinance-market-industry-analysis*

a) Asset Mix

In 2023, Microfinance Banks (MFBs) shifted their asset mix towards advances, which rose to 49.3% of total assets from 45.5% in 2022. This strategy aimed to enhance net interest income and reduce overall losses. Deposits increased by 15.8%, supporting asset growth, while borrowings fell by 57.3% due to lower investment activity. A detailed analysis of growth in advances by segments reveals that most of the segments recorded an increase in advances during CY'23. 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.

PKR million	2021	2022	2023
Total Assets	582,104	752,982	771,336
Investments (net)	133,419	228,199	163,477
Advances (net)	278,318	342,358	379,946
Borrowings	59,022	137,025	58,461
Deposits	422,998	515,760	597,023

Table 1: Financial Soundness Indicators and Quarterly Compendium of the Banking System

b) Credit Risk

MFBs' credit risk is heightened due to factors like the lack of data-driven credit models, borrowers' susceptibility to economic shocks, and the agriculture sector's vulnerability to climate risk. The sector's credit risk is significant because around 58% of their total loan portfolio is unsecured, relying on personal guarantees and expected net disposable income. The industry as a whole is gradually shifting towards individual lending, as the share of group lending has decreased from 5.0% in CY'22 to 3.3% in CY'23 due to adverse experiences over the years.

MFBs have faced prolonged challenges since the COVID-19 pandemic, compounded by the 2022 floods and ongoing macroeconomic stress. The infection ratio, which had been increasing, reached 7.8% by Jun'23, - a new high for the domestic microfinance banking sector in recent years. However, in the latter half of 2023, total non-performing loans (NPLs) began to decrease, improving asset quality. By the YE'23, total NPLs reached Rs 27.2 billion, and the infection ratio moderated to 6.7%. Provisioning standards remained higher during CY'23, as the MFBs raised their provisioning. The improvement in provisioning coverage also reflects the implementation of IFRS-9 which was to be implemented starting January 01, 2024 but has now been extended to December 31 2024.

PKR million	2021	2022	2023
Advances	290,017	361,457	407,790
NPLs	14,979	24,237	27,229
Infection Ratio	5.2%|	6.7%	6.7%
Provisioning Coverage	78.1%	78.8%	102.3%

Table 2: Financial Soundness Indicators and Quarterly Compendium of the Banking System

c) Investment Mix and Liquidity

Investments by MFBs declined in 2023, primarily due to reduced investments in mutual funds, although investment in government securities slightly grew by 3.8%, reaching Rs 152 billion. 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% (CY'22: 9.2%) when compared with the growth of 2.4% in asset base. Despite the overall decline in investments, the increased liquidity provided a cushion for the sector.

d) Profitability

The aggregate profitability of MFBs remained negative for the fifth consecutive year, with pre-tax losses in 2023. The Return on Assets (ROA) before tax improved to -1.5% from -3.4%, and the Return on Equity (ROE) before tax improved to -26.4% from -42.9%. Operational self-sufficiency rose to 78.8% from 69.8%. Notably, net interest income (NII) almost doubled to Rs 54.8 billion, driven by rising interest rates, while non-interest income grew by 39.7% to Rs 33.6 billion.

PKR million	2021	2022	2023
Profit Before Tax	(6,845)	(21,558)	(10,835)
Profit After Tax	(8,080)	(17,155)	(8,118)
Equity	56,703	43,721	37,399
ROA	-1.3	-3.4%	-1.5%
ROE	-12.7	-42.9	-26.4%

Table 3: Financial Soundness Indicators and Quarterly Compendium of the Banking System

e) Capitalization

The sector's solvency indicators remained under pressure in 2023, with the aggregate capital adequacy ratio (CAR) falling to 7.6% from 10.9%, against the minimum regulatory requirement of 15%. Within the sector there is significant variation in capital adequacy indicators with 04 out of 11 players having negative capital adequacy, a further 04 with capital adequacy hovering around minimum capital adequacy requirement of 15% by YE'23. 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 there has been a significant equity injection by several institutions amounting 15.8 billion between two-year period (2022-2023), the capital base remained low relative to the asset base due to severe exogenous shocks and actually falling over 2 years from Rs. 56.7bn at YE'21 to Rs. 37.4bn at YE'23.

RECENT DEVELOPMENTS

The Pakistani MFB sector is undergoing a significant transformation to meet international standards and promote sustainable practices. Regarding financial reporting, the implementation of International Financial Reporting Standard 9 (IFRS-9) has seen recent adjustments. While initially planned for all companies by 2019, mandatory application for banks was deferred to January 2022. Recognizing the complexity, the SBP has granted further extension for Financial Institutions (FIs) to 31 December 2024.

In a separate but equally crucial development, the MFI sector is embracing Environmental, Social, and Governance (ESG) initiatives. The SBP's Green Banking Guidelines issued in 2017 provide a framework for banks to assess environmental risks in lending.

SECTOR OUTLOOK

OVERALL ASSESSMENT/OUTLOOK: NEGATIVE

Continued stress in CY'24 might further pressure the sector's credit risk and funding costs. Climate risks, like flooding, pose additional threats to solvency. MFBs need to strengthen their risk management capacities, enhance capital buffers, and revisit their business models to reduce operating costs and improve profitability. By focusing on stable funding sources, MFBs can support sustainable financial inclusion and withstand future disruptions.

MICROFINANCE RATING UNIVERSE

Entity	MCR Compliant*	CAR Compliant*	Profitable*	Government Support	VIS	PACRA
Advans Pakistan Microfinance Bank Ltd	No	No	No	No	BBB/A-3 (Positive)	-
Apna Microfinance Bank	No	No	No	No	-	BBB-/A-4 (Rating Watch - Negative)
ASA Microfinance Bank (Pakistan) Limited	Yes	Yes	Yes	No	-	BBB+/A-2 (Positive)
FINCA Microfinance Bank Limited	No	No	No	No	A-/A-2 (Rating Watch - Developing)	BBB+/A-3 (Rating Watch - Negative)
HBL Microfinance Bank Limited	Yes	Yes	No	No	A+/A-1 (Stable)	A+/A-1 (Stable)
Khushhali Microfinance Bank Limited	No	No	No	No	A-/A-2 (Rating Watch - Negative)	-
LOLC Microfinance Bank Limited	Yes	Yes	No	No	A-/A-2 (Stable)	-
Mobilink Microfinance Bank Limited	Yes	Yes	Yes	No	A/A-1 (Stable)	A/A-1 (Stable)
NRSP Micro Finance Bank Ltd	No	No	Yes	Yes	A-/A-2 (Stable)	A-/A-2 (Rating Watch - Stable)
Sindh Microfinance Bank	Yes	Yes	Yes	Yes (Sub-Sovereign)	-	A-/A-2 (Stable)
Telenor Microfinance Bank	Yes	Yes	Yes	No	-	A/A-1 (Rating Watch - Stable)
U Microfinance Bank Limited	Yes	No	No	Yes (Indirect Support)	A+/A-1 (Stable)	A+/A-1 (Stable)

*As Per latest available financials (March 31, 2024)

RESEARCH & PUBLICATIONS

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