MICROFINANCE SERVICE IN PAKISTAN OVER THE DECADE

AN OVERVIEW

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Introduction

The term Microfinance, also called microcredit, is a category of banking service. Which is provided to low-income or unemployed individuals or groups, who have no or limited access to mainstream/conventional financial services. In the term microfinance, ‘micro’ stems from the fact that relatively small money quantities are borrowed or saved in the financial transaction. Oxford Dictionary defines microfinance as “a system of providing services such as lending money and saving for people who are too poor to use banks”.

Micro-finance has existed in various forms for centuries in several areas of the world, and even longer in Asia. The microfinancing history traces back to middle 19th century as evident from the script of Theorist Lysander Spooner, who wrote “the benefits from small credits to entrepreneurs and farmers as a way of getting people out of poverty”. The phenomenon started with microlending and now offers almost all sorts of banking services. “Irish Loan Fund system”, introduced by Jonathan Swift in Ireland was first occurrence of microlending. However, the concept did not elicit a big impact until end of World War II through “Marshall Plan (European Recovery Program, ERP)”. The advent of microfinance as a global industry started in 1970’s.

In Asia informal lending and borrowing dates back to thousands of years. The first organization to receive attention for modern system of microfinancing was the Grameen Bank, founded by Muhammad Yunus in 1976 in Bangladesh.

Pakistan has made considerable developments in Microfinance though a late starter in this industry. The sector formally started to develop from 1999 although; semiformal sectors since the 1980s are providing micro-credit in Pakistan. Including Non-Government Organizations (NGOs) and Rural Support Programs (RSPs). Subsidies have played an important role in the growth and promotion of the microfinance sector’s growth phase. Now the sector is in its maturity phase. MFBs funding structure suggests lack of own-resource base through deposits mobilization. For long-term sustainability, Financial Self Sufficiency is vitally important for microfinance institutions.

Pakistan, unlike other countries, has separate regulatory framework and laws for microfinance banks (MFBs). The Ministry of Finance, State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP) regulate Financial Institutions in Pakistan. Primarily SBP is responsible for regulation and supervision of Exchange Companies, Commercial/Scheduled and Microfinance Banks (both conventional and Islamic), and Development Finance Institutions (DFIs). The rest of the financial institutions SECP regulate and supervise them, including Asset management companies, Discount Houses, Housing finance companies, Insurance companies, Investment banks, Leasing Companies, Modarabas, Mutual funds, and Venture capital companies. The Central Directorate of National Savings (CDNS), a department of Ministry of Finance, manages the National Savings Schemes (NSS).

Since 1999 Pakistan has been a leader and trendsetter in comprehensively, accurately, and transparently measuring the performance of a large majority of the microfinance market in Pakistan. Islamic Financial Institutions function in parallel with conventional institutions.
Microfinancing has received international attention in 2000s after the success of Grameen Bank. Majority of the institutions focus on underdeveloped and developing economies. As majority of the masses in these economies live at less than $2 a day hence are unattractive markets for traditional banks. These poor people operate mainly in informal economy their businesses are often unregistered, untaxed and sometime illegitimate. Hence, prove to be risky and expensive for banks to deal with. “Some see microfinance as the long-sought-after tool for eliminating poverty around the world. After all, microfinance has the appeal of bringing financial power to the people who need it most and whose resourcefulness and ingenuity it will fuel”. (Khavul, 2010)

**Background and Context**

The microfinance sector started with inclusive reliance on subsidized debt and grants to meet funding requirements. Numerous multilateral and bilateral donors support microfinancing in Pakistan along with the government. Examples of such donors include the “Kashf Foundation (local donor)”, “World Bank”, and “Department for International Development (DFID) (UK-based donor) and International Fund for Agricultural Development (IFAD)”.

The microfinance in Pakistan evolved in three distinct phases. These are known as; Phase-1: 1970s – Government directed credit, Phase- 2: early 1980s to mid-1990s – philanthropy of finance, and Phase-3: late 1990s to present – entry of the specialist MFI both local and foreign.

Microfinance is the fastest acting tool in poverty elevation. Hence is vital to boost the current scenario of Pakistani economy. “The results of the first microfinance impact evaluations were controversial because the world was eager to find that one magic bullet that will finally ‘solve’ poverty,” said Esther Duflo, economics professor at Massachusetts Institute of Technology (MIT) and co-author of “The miracle of microfinance”.

“The country’s GDP witnessed an 8-year high of 4.7 percent during 2016 as compared to 4.0 percent in 2015” (Annual Report 2015-16 (State of the Economy), 2016).The Pakistan Microfinance Sector’s Growth rate is not as high as expected. After entering the growth stage, the government predicted growth rate to rise. The paper aims to look at the reasons because of which the sector has failed to grow at a higher rate. Gradually, microfinance is expanding its penetration across Pakistan, due to collaboration of government with international organizations in promoting microfinancing in Pakistan.

**Need for microfinance**

Microfinance provides funds to the Poor and vulnerable households economically at the Bottom of the Socioeconomic Classification Pyramid. Worldwide considered one of the most effective poverty alleviation tool that not just mobilizes money to the bottom SEC group but also enables them to create a

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**Figure 1: Number and Major Financial Soundness Indicators of MFBs**

<table>
<thead>
<tr>
<th></th>
<th>CY12</th>
<th>CY13</th>
<th>CY14</th>
<th>CY15</th>
<th>CY16</th>
</tr>
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<tbody>
<tr>
<td><strong>Number of MFBs</strong></td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td><strong>Percentages</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAR</td>
<td>47.48</td>
<td>43.11</td>
<td>37.57</td>
<td>28.95</td>
<td>23.38</td>
</tr>
<tr>
<td>NPLs to Advances</td>
<td>1.04</td>
<td>1.02</td>
<td>1.16</td>
<td>1.32</td>
<td>1.57</td>
</tr>
<tr>
<td>Net NPLs to Net Advances</td>
<td>(0.68)</td>
<td>0.11</td>
<td>0.13</td>
<td>0.16</td>
<td>(0.56)</td>
</tr>
<tr>
<td>ROA (After Tax)</td>
<td>(0.03)</td>
<td>1.20</td>
<td>2.12</td>
<td>4.75</td>
<td>4.72</td>
</tr>
<tr>
<td>ROE (After Tax)</td>
<td>(0.14)</td>
<td>5.28</td>
<td>9.76</td>
<td>23.41</td>
<td>27.77</td>
</tr>
<tr>
<td>Cost / Income Ratio</td>
<td>86.95</td>
<td>83.68</td>
<td>81.20</td>
<td>77.32</td>
<td>73.28</td>
</tr>
<tr>
<td>Liquid Assets to Short term Liabilities</td>
<td>87.98</td>
<td>70.93</td>
<td>70.58</td>
<td>59.37</td>
<td>66.45</td>
</tr>
<tr>
<td>Advances to Deposits</td>
<td>85.00</td>
<td>83.60</td>
<td>85.43</td>
<td>86.73</td>
<td>73.04</td>
</tr>
</tbody>
</table>

Source: (Annual Report 2015-16 (State of the Economy), 2016)
Continuous source of income generating for them. Given the potential of Pakistani economy to grow, there is a lot of room for entrepreneurship at all economic scales especially for niche markets. It helps in empowerment of women specially in enabling them to earn for themselves in the absence of male members support in the family.

This financing tool has a better ability to function in times of economic recessions when the borrowers become more risky or seek for lower amounts of credit/loans. The growth of microfinance sector is crucial for the development of small-scale entrepreneurship in Pakistan and today’s global era is of entrepreneurship.

Current Scenario

For its latest MicroWatch issue, the Pakistan Microfinance Network’s (PMN) aggregated data was created from 39 microfinance providers (MFPs), including 11 microfinance banks, 12 microfinance institutions, 4 rural support programmes, and 12 social sector organisations that provide microfinance as part of a multi-dimensional service offering. The report calculated the following results for the sector. The microfinance penetration rate is roughly 25%, based on an estimated potential market size of 20.5 million.

Gradually, microfinance is expanding its penetration across Pakistan. With sector’s growth, funding sources have diversified. Currently the sector is raises funds by a combination of debt securities, mainly, Plain Vanilla Bonds (by National Apex Committee), Debt from Commercial Banks (by utilizing guarantee funds), and deposits (in case of MFBs).

Introductory stage of Pakistan’s microfinance sector is coming to the end. While the sector faces numerous challenges like improper regulation, fierce competition, and product differentiation (Mohammad, 2010). He further stated, “The rapid increase in poverty along with other opportunities is paving way for the sector’s growth and indicates a huge market potential for microfinance beyond the capacity of current MFIs’ management.” Badly designed microfinance programs of the government has limited the sector’s impact on poverty. The industry has witnessed rapid growth since 2000 after the entrance of international players and of local mega banks. There are enormous opportunities that can be availed if the government provides a levelled playing field to the private sector market players in the arena. Pakistan Microfinance industry is still in Early-Development-Phase. Pakistan has very few interested commercial banks who supply micro-funds. Pakistan microfinance industry relies significantly on international donor funds (Bugvi, Sahibzada Ahmad Muneeb, 2014). In Pakistan Microfinance is a social service and banks lack a Socio-Commercial approach. Pakistan Microfinance Industry has not achieved sustainability (Bugvi, Sahibzada Ahmad Muneeb, 2014). Commercial Banks deliver less than 6 % of their funds to SME sector. The solution lies with the commercial banks, who have the economies of scale to withstand the higher operation costs associated with microfinancing, due to primitive development in the microfinance sector as compared to other finance sectors in Pakistan.

Microfinance banks are regulated by state bank of Pakistan while nonbank microfinance providers are regulated by SECP hence enjoy a relaxer term and conditions for the same operations. The guarantee funds available to MFP’s are Institutional Strengthening Fund (ISF) and Microfinance Credit Guarantee Facility (MCGF) by SBP. National Debt Fund by KfW Development Bank. To raise funds some MFPs are utilizing money market and capital market instruments. In 2016 the first successful debt placement was by an International Lender, despite continued investor interest in the sector.

“Pakistan has been endeavouring to increase financial inclusion in the country and the National Financial Inclusion Strategy has been a milestone in this context. Over the past decade and a half, Microfinance Banks (MFBs) have been playing their part towards enhancing financial inclusion. The
sector has flourished well in recent times; though asset quality has somewhat worsened.” (Annual

As per PMN annual report for 2016 on the borrowing side, Number of active borrowers reached
5.2 million by June 2017-a growth of 14 percent since December 2016. Gross loan portfolio increased to
PKR171 billion, up by 25% from PKR137 billion reported six months ago. Average loan size is
PKR44863, up from 41663 in December last year. On the savings side, number of savers has increased to
25.2 million as of June 2017, up by 9% from December 2016 figure. There is higher growth in saving
deposits, which have grown by 22% from December to June reaching a figure of PKR148 billion in June
end.

“Profitability has been high and deposit base has been growing at a significant pace. Most of
the credit is extended to enterprises, agriculture and livestock with majority of the customers belonging to the
under-served rural areas. The penetration has been limited though, as the client base stands at 1.9 million
in a country of around 126 million adults; pointing to huge potential ahead. Encouragingly, women
comprise around one-fourth of the clientele. Future of MFBs seems bright though careful supervision is
required especially in the area of branchless banking.” (Annual Assessment of the Industry, 2017)

Institutions having strong ownership profile, sound asset quality, increasing geographical presence
and improving profitability indicators, characterize the industry.

“The industry is poised to play a pivotal role in meeting the targets of the National Financial
Inclusion Policy that aims to increase the number of adults having access to transaction or formal
accounts from 10% at present to 50% by 2020” (Microfinance Sector Update, 2017).

Under the present development of Microfinance sector in Pakistan, trade-off between
sustainability and outreach exist, due to higher operational costs associated with MFBs as compared to
commercial banks while NGOs providing Micro-Finance Services lack the expertise and network to
provide services at par with MFBs. Hence a combination of subsidies and support should be used to make
MFBs an attractive investment as it beneficial for both the poor and FIs. “The critics of microfinance
doubt whether access to finance may contribute to a substantial reduction in poverty. They claim that
microfinance does not reach the poorest of the poor, or that the poorest are deliberately excluded from
microfinance programs.” (Niels Hermes, Robert Lensink, 2011)

Considering the efforts done by various national and international organizations in feeding microfinance
sector in Pakistan and comparing, the results with other countries Pakistan needs to improve a lot.
Types of Micro Credit Providers in Pakistan

There are three types of microfinance institutions in Pakistan as follows:

1. **Commercial Financial Institution (CFI)**: provide services to small and medium sized entities as part of their core operations.
2. **Non-Government Organizations (NGOs)**: provide funds as part of their aid programme
3. **Rural Support Programs (RSP)**: provide finance services as part of multi-dimensional rural development program.

The foremost constraint to microfinance sector in Pakistan is natural disasters. Since they lead to large amounts of write-offs

Exhibit 5

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Affected Areas</th>
<th>Financial Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>Earthquake</td>
<td>AJK and KPK</td>
<td>Microfinance portfolio worth PKR 265 billion (US$ 5.3 billion)</td>
</tr>
<tr>
<td>2009</td>
<td>IDP Crisis</td>
<td>5 districts &amp; 2 agencies</td>
<td>Microfinance portfolio worth PKR 280 million affected</td>
</tr>
<tr>
<td>2010</td>
<td>Floods</td>
<td>60 districts</td>
<td>Microfinance portfolio worth PKR 2.6 billion affected</td>
</tr>
<tr>
<td>2011</td>
<td>Floods</td>
<td>9 districts</td>
<td>Microfinance portfolio worth PKR 34 million worth of Microfinance infrastructure damaged</td>
</tr>
</tbody>
</table>
2009’s recession of the industry slowed the growth rate due to economic downturn of the customers. Resulting in increased default rate. Secondly, cost of doing business and managing smaller loans is generally high but MFI’s have to charge a rate, which is slightly higher than commercial banks. Thus, many customers try to obtain loan from commercial banks

Customer Base consists of mainly illiterate population, majority has not used a formal banking service in past and most of them view MFI to be unislamic. State Bank report, potential microfinance borrowers in Pakistan are around 28 million whereas the existing, actual borrowers are a mere 2.8 million.

A completely well knitted network with almost doorstep reach is required, which is only possible when the commercial banks will be involved in microfinance.

**Critical Skills for the Managers in Microfinance Institutions:**

1. Business Planning for Microfinance Institutions
2. Delinquency Management in Group Lending
3. Execution Capabilities
4. Financial Analysis and Accounting for Microfinance Institutions
5. Financing Portfolio Management
6. Information Systems & Technology for a vibrant MF sector
7. Micro Enterprise Development and Rural Marketing
8. Operational Risk Management for Microfinance Institutions
9. Product Development to meet the diverse needs of clientele in Microfinance
10. Social Appraisal Techniques

**New frontiers in Microfinance:**

1. Innovation, Adaptability and Agility
2. Need for Commercialization
3. The Enabling Digital Finance

The microfinance industry face three main financial risk, which have a significant on them. The default rates of the clients are too high. Greater transparency for loan performance and credit risk appraisal is crucial for long-term survival (Rai Intiaz Hussain, Zeeshan Fareed, Iffat Saleem, Shahbaz Hussain, Sohail Adnan, 2012). They recommend application of Basel II for significant and prominent improvement in management culture and risk based supervision in microfinance sector. However implementing the accord will translate into higher cost as regulatory minimum capital requirement will shoot up. Similarly, administrative cost will rise in engaging advanced supervisory review process and control. The rise of Microfinance Investment Vehicles (“MIVs”) in early 2000s gained attention from many Development Finance Institutions (DFIs) however, soon a prolonged steady decline in the fund creation through the source countered by the rise. As the microfinance sector continues to grow, the systemic risk of these maturing MFIs has indisputably increased. This holds especially true for MFIs that expand within the same geographic and operational areas. The paper proposes implementation of Basel to counter weaknesses in risk management and integrate the increasing number of MFB’s into mainstream financial system

**Conclusion**

The foremost constraint to microfinance sector in Pakistan is natural disasters. Since they lead to large amounts of write-offs as microfinancing is mainly concentrated in villages which are prone to earthquakes in the north and floods in the plain area. Barriers to entry exist for conventional banks
because of rules and regulations like Basel accords make the sector unprofitable for large commercial banks. Secondly, this sector is riskier to mainstream banking sector hence make it unprofitable for commercial bank, considering the strict regulations imposed on them especially regarding risky activities/operations. Competition in the sector is increasing with entrance of international players like FINCA who are apt with the rules of the game and have the necessary tools/leverages to sustain the hardships of the sector. Islamic Microfinance Institutions heavily rely on subsidies and grants because their foremost objective is providing ribbah free microfinance services without considering profitability and sustainability of the institution. Based on operating expenses to assets (OEA) and cost per borrower (CPB) IMFIs are more cost effective than conventional MFIs.

Credit worthiness for customers with no collateral nor a salary cannot be based on automated scoring used by traditional banks and credit providers in the urban areas. Credit decisions for borrowers without collateral or salary cannot be based on automated scoring cards used by commonly commercial banks thus is more complex for microfinance institutes to measure credit worthiness of its clients. Few MFIs are able to meet the needs for remittances, deposits/savings or insurance of its clients. High interest rate & high transaction cost in provision of microfinance services. Customers avoid the sector as high interest rate & high transaction costs are involved in formal microfinancing along with compulsory referral of peer group. Making the customer turn towards gathering portions of loan amount from peers informally. Inadequate investment in Agricultural and Rural development by government negatively impacts the sector indirectly. Inappropriate donor subsidies since majority of donations come from local NGO’s like Kashf foundation that don’t have personnel with microfinance specialization. Low level of technical understanding of banking and finance by the customers shy them away from formal microfinancing. There are no innovative Mix of products by microfinance institutions in Pakistan. There is a need for more dissemination and adoption of rural, agricultural microfinance methodology rather than just importing the foreign microfinance model which is developed primarily for African region. Institutional inefficiencies are present as majority of MFI are still naïve and need time to build solid grounding in the sector to give services at par with conventional financial institutes. 13. Poor supervision and regulation of MFIs as the government/ regulatory body don’t fully understand the dynamics of the sector. The institutions fail to raise adequate funds because of:

1. Few numbers of MFIs that meet the needs for savings, remittances or insurance
2. Inappropriate donor subsidies.
3. Institutional inefficiencies
4. Limited management capacity in MFIs
5. Poor regulation and supervision of deposit-taking MFIs
6. Need for more dissemination and adoption of rural, agricultural microfinance methodology.

Since Customer Base consists of mainly Illiterate population, majority has not used a formal banking service in past and most of them view MFI to be unislamic. State Bank reports, actual borrowers are 2.8 million whereas potential microfinance borrowers are around 28 million in Pakistan.

A completely well knitted network with doorstep service is required, which is only possible when the commercial banks involve in microfinance services. And educating the customer base regarding the service is required especially regarding the belief among people that it is unislamic and will eat away barkat from our business.
Works Cited


