# BUDDING ISSUES IN MICROFINANCE SECTOR OF PAKISTAN

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***ABSTRACT****: This paper looks at emerging issues on microfinance in Pakistan and strategies towards building up a sustainable microfinance sector on developing Pakistani microfinance sector through a review of the state of the art. The paper has concluded that Pakistan witness microfinance as an anti-poverty grooming plant started in 1980's and still has a number of areas to pay full attention and pull this industry out of problems. In order that it will ensue the paper has classified emerging issues such as policy on macro economy and stability of financial system, regulation and supervision of microfinance institutions, institutional capacity building, enlarging the border of microfinance services in remote areas, and financial practicability and exposed the clear need to deal with these issues properly and in time.*

***Key words:*** *Governance Rising Issues, Microfinance Sector, Pakistan.*

## 1. INTRODUCTION

Pakistan has developed substantial history in providing microfinance services to the poor clients; the evidence of which is the emergence and growth of a great number of microfinance institutions (MFIs) and microfinance programmes in due course. In Pakistan it has come a long way ever since 2000 and is steadily mainstreaming into the formal banking structure. Eight Microfinance Banks (MFBs) have been set up, together with the transformation of three foremost Microfinance Institutions (MFIs) and two of the world's biggest MFIs have started operating its functions in Pakistan, indicating institutional diversity and private sector participation. The policy and regulatory environment keeps on improving and is recognized as well developed. In addition, the industry infrastructure is getting bigger which requires improving risk management practices. Mainly, the sector's visibility has grown up globally owing to the launch of initiatives of transformational branchless banking which leverage postal networks and mobile phone technology for expanding cost-efficient financial services to the unbanked people.

Even so, the industry so far has to make major breakthroughs for becoming a dynamic member within the overall financial sector and still has to reach millions of underserved populace. The existing outreach of 2 million borrowers is merely 7 percent of the potential market. The sector achieved a remarkable growth rate of 43 percent per annum in 2007 and 2008, though, the microcredit growth slowed down in 2009 and 2010. Although credit growth stayed below, the micro-banking industry showed progress in micro-insurance and deposit mobilization.

As a development tool, microfinance is believed as one of the significant financial resources for poor people to demeanor income generating activities and household economic, which can decrease their vulnerability and permit them to mount up capital and hold valuable assets. In another standpoint, microfinance is also a means of helping micro entrepreneurs to spread out their businesses to the summit of becoming viable business and suitable for credit from commercial banks. Still, it is satire that microfinance services are locked up to a greater extent among relatively less poor rural population segment that are living in accessible districts and those large number of vulnerable poor living in remote mountain districts are yet to be serviced in the course of microfinance services.

This paper looks at emerging issues on microfinance in Pakistan and strategies for developing a sustainable microfinance sector. The study is organized into five sections as: introduction, growth and sustainability of microfinance in Pakistan, microfinance as a part of financial mainstream; emerging issues and conclusions.

## 2. GROWTH AND SUSTAINABILITY IN MICROFINANCE SECTOR OF PAKISTAN

During the five years from 2004 to 2008, there was 67 percent Compounded Annual Growth Rate (CAGR) in microfinance sector. After that growth slowed down and in 2009, in microfinance industry there was just an increase of 5 percent in active borrowers and 16 percent increase in Gross Loan Portfolio (GLP). However, insurance policy holders and active savers have constantly shown remarkable growth. During 2008-09, savers grew by 35 percent and saving grew by 59 percent, while sum-insured and insurance policy holders increased 27 percent and 48 percent respectively. For 2010, the substantial growth in the insurance policy holders and number of active savers is observed.

On sustainability grounds, Pakistan microfinance industry is struggling very hard. During 2009, with an increasing trend the ratio for industry average financial revenue to assets was just above 80 percent. For the entire sector, the average operating expense/asset ratio was found stable at almost 20 percent, but there was an increase in average operating expense/loan portfolio from 33 percent to 44 percent for the year of 2009.

The figure 1 shows the sustainability of Microfinance Sector in Pakistan over six years in weighted average percentage. It depicts the rising and decreasing trend of operational self sufficiency of microfinance institutions.

Microfinance institutions in Pakistan still have to make inroads in the market in-terms of depth and breadth of outreach among credit borrowers and deposits. Furthermore, operational self-sufficiency needs to be noticeably increased. On the other hand, portfolio at risk (30 days) in Pakistan remains quite low. The table 1 depicts this.

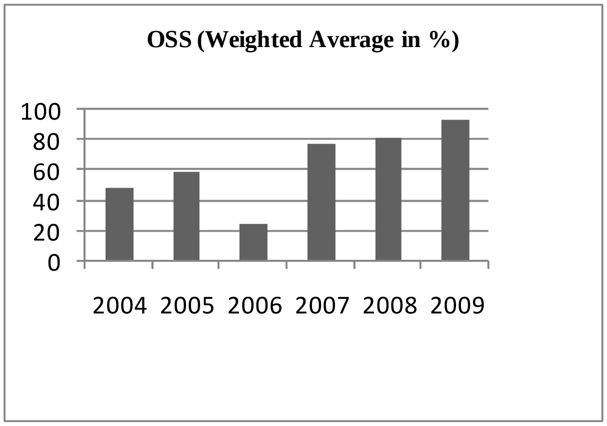



Figure 1: Operational Self Sufficiency (OSS, weighted average in %)
Source: Pakistan Microfinance Network

Table 1: Key indicators (in % for 2009)

| | Gross Loan Portfolio/ Total Assets | Deposits to Total Assets | Operational Self-Sufficiency | Average Loan Balance per borrower/ GNI per capita | Portfolio at Risk >30 days |
|---|---|---|---|---|---|
| MFIs in Pakistan | 57 | 21 | 94 | 14 | 1.9 |

Source: PMR 2009 by PMN

## 3. EMERGING ISSUES

Microfinance has been considered among the key vehicles in attaining the "The Millennium Development Goals" by 2015. All head stakeholders of the microfinance movement each nationally and internationally have targeted to strengthen microfinance industry and provide sustainable and attainable access of poor populace and micro-entrepreneurs to financial services. So as to support the achievement of this worldwide movement, future Pakistani microfinance ought to concentrate on establishing a policy environment favorable to microfinance institutions, developing regulatory and framework for supervision, institutional capacity and capability building, increasing services to remote areas, and also attaining financial viability.

### 3.1 POLICY ON MACRO ECONOMY AND FINANCIAL SYSTEM STABILITY

Stable and unwavering macro economy and financial sector are the nuts and bolts for developing sustainable microfinance industry. In view of that, success of microfinance relies on the condition of development of other sectors; the government policy should focus, on provision of infrastructures, education, skill development and job creation. The government should put some effort in controlling the rising inflation rate of the country. It should formulate appropriate regulations whose focal point is on interest rate reforms predominantly on credit and savings. Additionally, it is important to educate the public about microfinance and its significance for the economy development.

### 3.2 REGULATION AND SUPERVISION

Governance for microfinance entities differs with institutional structures. The non-governmental organizations (NGOs) are registered in one of the three forms: most of them are incorporated as company and they are regulated by the Securities and Exchange Commission (SECP), some are registered as 'societies' under the Societies Act and the remaining are 'trust' which are registered with Ministry of Industries. As being grant-based welfare organizations, many of them do not stick on formal and transparent governance structure and processes. Per se, most of them have weak management structures having little board oversight. It is creating different risks (specifically credit and reputational risks), which have sector wide implications. Formulating and improving the governance structure of MFIs will develop private investors' confidence in the sector.

Good governance is the last backstop for crisis prevention and management. One report by which focused on Latin America by [1] emphasized that an institution's governance structure is the primary differentiating factor among those entities that overcome a crisis and those that does not. Amongst the weaknesses, it identified; excessive concentration of power and authority in the hands of a dominant individual; inexperienced, ill-informed and un-skilled board members; and also poor internal controls. An additional reason for having strong and good governance is that regulators increasingly require it. Current initiatives like the international Basel accord on liquidity and capital adequacy, and the raft of new steps and measures following on from the crisis, stresses the importance of strong boards, effective and good controls and independent audit. Though these are aimed at banks, but they are increasingly placing influence on the regulation of non-bank MFIs. This is also shaping the approach in use by investors when they evaluate MFIs for funding: the strength of governance is now an item on checklist.

The regulation and supervision should be focused to maximize the functions of industry in providing the financial services for economically active poor clients. It requires regulatory and supervisory framework to be flexible enough and it should provide incentives, both for clients and service providers. Firstly, the regulation and supervision system in Pakistan should balance a number of objectives and concerns of different parties. It should also protect the financial system from unstable practices which can pose a domino effect on overall financial system particularly MFIs which heavily depend upon donor funds. Secondly, it should provide legal support to small depositors that save their money at MFI and it should protect them. Thirdly, it should promote the industry in which regulation may attract more deposits from public and may become able to obtain financing at the lower costs. Finally, it should protect public funds in case that liability of MFI is covered with the blanket guarantee from government or by some public deposit insurance.

### 3.3 INSTITUTIONAL CAPACITY BUILDING

As the microfinance sector in Pakistan is moving towards maturity it requires to be strengthened. Internal controls have yet to keep up with growth. Management Information System, human resource and marketing have to be made stronger to become comparable with the controls/systems of mature and well established institutions. The FIP Institutional Strengthening Fund[1] aspires to deal with institutional and human resource capacity constraints being faced by individual microfinance organizations. The GBP (Banking Grant Projects) 10 million funds, launched in December 2008, have provided grants of up to one million USD to several microfinance banks and institutions. All these grants support MIS development, trainings, branchless banking, deposit mobilization, transformations, and product development.

Strengthening the institutional capacity is one of main issues for sustainability of microfinance sector in Pakistan. Strong institutions jointly with good governance will be able to offer quality financial services to poor populace which will increase their outreach appreciably and achieve financial self-sufficiency. A few of the issues to speak up on institutional capacity building includes: improving on management capacity with autonomous body and adapting good governance practices, operations and procedures that focus on ever-increasing efficiency, improving client satisfaction, lowering transaction cost, and ensuring that generated income covers operating and financial expenses; augment management information systems and accounting policy; make stronger the internal supervisory system and audit capacity which is integrated with daily operations and routines; widen risk management framework with a wide-ranging strategy for arrears and fraud prevention; build up human resources through career development, training and corporate culture included with promotion/incentive system for motivating the employees; provide ample physical infrastructure, convenient offices that are accessible for customers so that they can avail the services relatively easily; and product development should be suitable to the customers.

### 3.4 EXPANDING THE FRONTIER OF MICROFINANCE SERVICES TO REMOTE AREAS

The following graph shows the outreach by microfinance service providers in terms of the credit clients. Year of 2008 depicts a declining trend and it was the start of the crisis period. The deceleration in growth may be attributed to funding problems and portfolio at risk (Micro Note No. 10). But in 2010 the number of started to increase. Historically

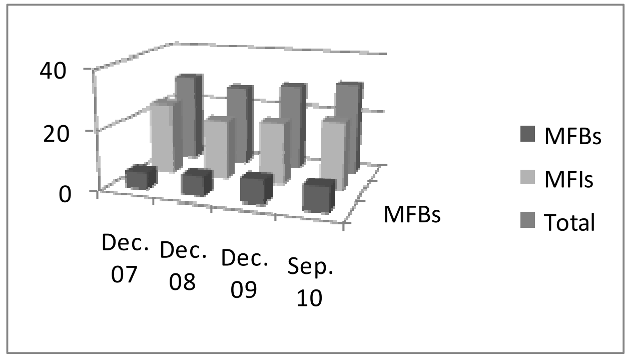
[redacted]

microfinance has been striving hard in Pakistan to reach a maximum number of borrowers to alleviate poverty in such an unstable economy. The figure 2 is as follows:

Figure 2: Microfinance Outreach (in ‘000’)

Source: Pakistan Microfinance Network

Figure 3 shows number of microfinance providers from




December 2007 to September 2010. Again during 2008 and 2009, the number of microfinance institutions declined and the microfinance operations ceased.

Figure 3: Number of MFPs

Source: Pakistan Microfinance Network

Pakistani microfinance sector is reaching its potential target market with access concentrated in the accessible areas and virtually no or very limited access in inaccessible hilly areas. So the expansion and extension of microfinance services to a large number of under-served and un-served micro-entrepreneurs and poor households living in such remote districts is yet a big challenge. Whereas commercial MFIs are quite successful to break in their services in urban and densely populated peri-urban areas, but community based MFIs have made comparatively better penetration in relatively inaccessible areas.

Current existing service delivery cost structure is a blockade to commercial microfinance providers to expand their services in remote areas; whereas such barrier is at minimum among community based microfinance providers. Innovation to reduce the operating cost is one of the basics to expand microfinance services of existing microfinance services providers in inaccessible hills and mountains. Furthermore, products and service delivery methodologies daunt commercial microfinance service providers to expand their services in inaccessible hilly areas, while capacity constraints weaken potential of community based service providers to intensify their services in their working areas and extend their services in more remote areas. Partnership of apex institutions with community based microfinance service providers on capacity enhancement and access to

[1] Launched under the Financial Inclusion Program that is sponsored by the United Kingdom’s Department for International Development and managed by the State Bank of Pakistan.

loanable fund is the most effective and efficient alternatives for expanding microfinance services in such areas.

### 3.5 FINANCIAL VIABILTY

Financial viability refers to the capacity of MFIs for providing continued access to financial services in the long run. For doing this they must make sure that the provided savings and credit services should meet the needs of their credit clients and it should be done in a financially sustainable manner. For reaching financial viability, effective financial management is required which includes: making sure that there are enough capital funds for meeting credit demands; generating sufficient revenues to cover operating costs (financial self-sufficiency); and also maintaining accurate financial reports (financial reporting). Continued reliance on subsidies obstructs ability of a MFI to attain financial viability. For the most part, MFIs in Pakistan have access to adequate capital funds. Main exceptions are indigenous NGOs and those organizations which are providing financial services in the more remote areas.

For becoming fully financially self-sufficient, a MFI must earn enough revenue for covering all of its costs and should have enough excess revenue to increase the capital base (retained earnings) for providing services to a growing client base. Expenses of the MFIs include: operating costs, financial costs, loan losses and cost of capital. The primary source of funds for covering these expenses is interest revenue earned by loan portfolio. The following table gives an insight towards the real average loan size of MFIs in recent years in Pakistan.

Table 2: Real Average Loan Size in Rs

| Year | MFBs | MFIs | Industry |
|---|---|---|---|
| 2005 | 8,525 | 7,981 | 8,163 |
| 2006 | 9,946 | 9,117 | 9,312 |
| 2007 | 9,404 | 9,035 | 9,302 |
| 2008 | 10,824 | 9,152 | 9,976 |
| 2009 | 13,576 | 11,326 | 12,131 |

Source: Pakistan Microfinance Network

The table clearly shows that in recent years average loan size has remained relatively stagnant. An analysis of average loan size distribution also reflects that almost 82 percent portfolio of Microfinance Banks (MFBs) is concentrated in loan size below Rs. 20,000. Whereas on the positive side, there is a number of evidence of MFBs' emerging and increasing interest in the upper loan sizes. The current prevailing high concentration of small loan sizes is expected to encourage poor households to smooth consumption, but it may not add value directly to the development of micro-businesses and to bring improvements in the economic prospects of households. It is concluded that in fact microfinance may be supporting consumption rather than providing the business capital. It is also highlighted by findings of the Pakistan Microfinance Network (PMN) in 2008, when it studied Microfinance competition in Lahore [2].

At present, most Pakistani MFIs are not financially self-sufficient. The inability of Pakistani MFIs to reach financial viability is chiefly attributable to high loan losses, small client base, and lack of well-trained staff. To achieve financial self-sufficiency, MFIs must have to reduce their loan losses and develop more efficient operating procedures to increase their outreach. In addition, interest rates should be taken up to that level where it covers all of costs based on the most efficient delivery of services.

The incapability of many MFIs to lessen their loan losses is partially attributable to a lack of credit discipline and lack of ownership felt by clients. Clients that do not look forward to continued access to financial services, often fail to pay back their loans. For MFIs this not only results in high loan losses, but it also reduces interest revenues. Loan losses should be kept to its minimum in order to reach financial self-sufficiency. Qualified and dedicated staff is also an important factor in achieving self-sufficiency. Suitable training, compensation and accountability are vital to the success of MFIs.

As the client base of MFIs increase, financial self-sufficiency (FSS) becomes easier to achieve as economies of scale are reached. Though, the growth of a MFI should be slow and gradual, as the organization builds up its products with delivery mechanisms to suit its clients. Sustained growth will only be attained if MFI accurately assess the needs of the market and manage its activities accordingly. When MFIs grow, they require increase access to capital funding and with financial self-sufficiency there comes increase access to capital sources in the course of commercial banks, allowing them for continued expansion of services.

## 4. KEY INSTRUMENTS FOR SUSTAINABLE ENVIRONMENT

About 90 percent of populace living in developing countries still lacks access of having financial services from institutions, that fuels the "vicious cycle of poverty", as per a report on Sustainable Micro-entrepreneurship by Guy Vincent. The poor have restricted or no skills and education and for them micro-enterprises are a means of economic opportunity as business owners and employees. Microfinance promotes entrepreneurship and income generation and it also serves as a mean to empower the poor in becoming economically self-sufficient. It provides sustainable and long-term benefits to low income populace in Pakistani community, enabling them to earn sufficient to escape poverty over the long run.

## 5. CONCLUSIONS

Historically microfinance has been witnessed as an effective poverty alleviation and development tool. There is a noteworthy paradigm shift on microfinance sector starting in the late 1990's and it observed the movement forward as an industry, which benefitted thousands of poor populace, poor women, peasant farmers and micro-entrepreneurs. In the future, microfinance industry will further transform as a lucrative and profitable business providing financial services for the poor. This realization requires that emerging issues such as policy on macro-economy and financial system stability, good governance with regulation and supervision of microfinance sector, institutional capacity building, expanding and extending the frontier of microfinance services in remote areas, and financial viability identified in this paper is properly and timely addressed.

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