

JCR-VIS SECTOR UPDATE

Microfinance Sector

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JCR-VIS initiated Micro-finance Ratings in Pakistan and announced rating of Kashf Foundation in October 2005;

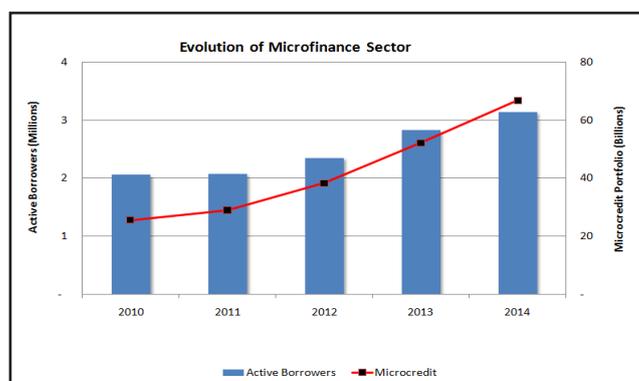
JCR-VIS also rated the first TFC in the sector issued by Kashf Foundation in April 2007;

JCR-VIS rates 8 out of 10 Microfinance Banks operating in Pakistan

Pakistan's microfinance sector has evolved over the years. The industry has witnessed emergence of new players, both local and international, along with innovation in products and technology. While the sector's overall objective remains poverty alleviation, providing sustainable and market based microfinance services has also gained importance.

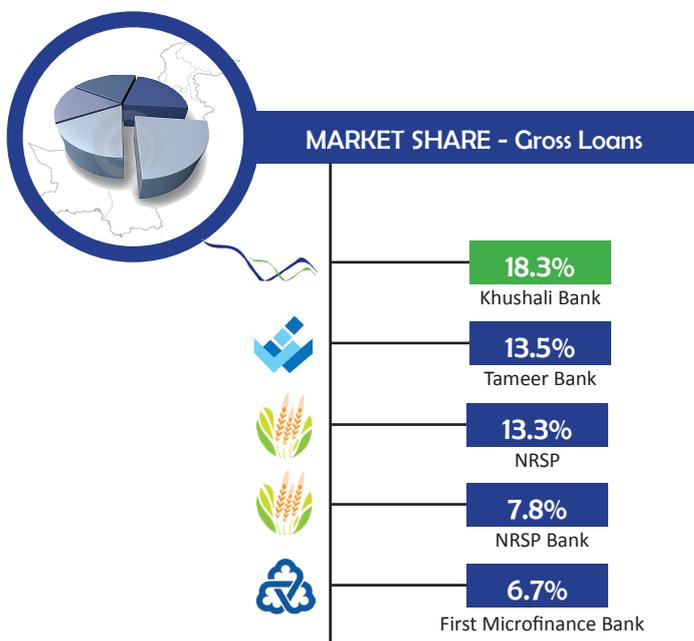
The sector offers significant potential for growth, with market penetration estimated at 11.6% by the Pakistan Microfinance Network. Microfinance sector is expected to play an increasingly important role in improving the level of financial inclusion in Pakistan which has remained

low. Only about 10% of the population (age 15+) has a bank account; this is well below the South Asian average of 33% for developing economies. Over the span of last five years, Cumulative Average Growth Rate (CAGR) of the Gross Loan Portfolio (GLP) was above 20% while the sector added more than 1 million borrowers. Microfinance Banks (MFBs) have led the growth with their share increasing to 55% in GLP and 38% in active borrowers by end-FY14. Khushhali Bank Limited maintains its position as the largest provider of microcredit in terms of GLP with a



market share of 18.3% followed by Tameer Microfinance Bank Limited (13.5%) and National Rural Support Programme (13.3%). The sector is currently dominated by a few players, with top 5 MFPs collectively accounting for 60% of the GLP and 57% of active borrowers.

Growth in microfinance sector is supported by an enabling regulatory framework which was first formulated in 2001; Pakistan is one of the few countries with a separate legal and regulatory framework for MFBs. This has propelled interest of both domestic and international investors in the microfinance segment in Pakistan; shareholding of MFBs comprises various mobile network operators (MNOs), commercial banks and international microfinance institutions. Moreover, international lenders have extended debt financing to MFPs. State Bank of Pakistan



(SBP) revised the Prudential Regulations (PRs) for MFBs in June, 2014 which further strengthens regulations in the areas of governance, AML/CFT and consumer protection with the overall objective of managing risk of the sector. The annual income ceiling for an eligible borrower has been revised to Rs. 500,000 from Rs. 300,000 to incorporate the impact of inflation and expanding market space. Efforts are also underway to bring all MFIs under the regulatory ambit of the Securities & Exchange Commission of Pakistan (SECP).

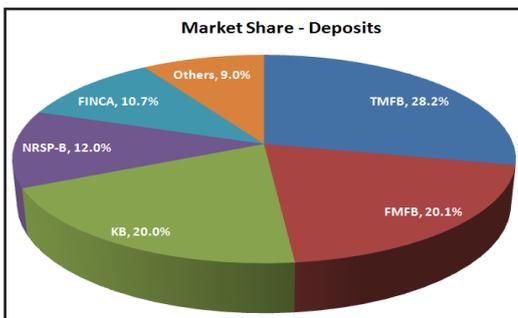
Asset composition in the microfinance sector varies across the peer group with advances representing around 50% of asset base for MFBs while among MFIs and RSPs, share of advances is higher. MFBs have sizeable portion of asset base deployed in investments, mainly government securities and fixed income mutual funds.

In terms of borrowers' mix, trade and agriculture sector borrowers account for more than 50% of the active borrowers followed by livestock and manufacturing sector borrowers. MFBs are tapping the microenterprise market with larger loan size; underwriting guidelines for such lending may however be distinct from the existing lending and would require considerable investment in capacity building of the field staff. While group lending continues to dominate, share of individual lending in terms of active borrowers has increased from 10% to around 32% in the last five years in line with increasing share of MFBs in the sector's GLP, which are mostly undertaking individual lending.

Barring one institution, share of secured lending in the GLP remains low. Moreover, asset quality indicators of the sector have remained strong reflected by manageable incremental infection rates. While being diversified on a per counterparty basis, the sector remains prone to natural calamities and other economic conditions which may adversely impact borrowers across the board in large clusters.

Over indebtedness is perceived to be one of the largest risks facing the microfinance sector triggered by increasing competition among the MFPs. Most players have been slow in entering new geographical areas owing to high operational cost and security concerns in some areas. Resultantly, most of the growth has been triggered from within existing markets with three-fourth of the gross loan portfolio currently in Punjab. This has led to heightened competition in the province.

In view of this, role of Microfinance Credit Information Bureau (MF-CIB) has gained an increasingly important role. Some of the MFPs have completely operationalized MF-CIB enquiries as also evident from the consistent increase in number of enquiries made per month. This is expected to improve quality of credit decisions made by MFPs.



Over the years, the funding structure of the sector has tilted towards deposits, whereas, the share of debt financing has declined. This is attributable to the successful mobilization of deposits by some MFBs. While microfinance borrowers comprise unbanked population, MFBs have been targeting commercial bank clients to raise deposits. Value of savings has increased manifold in the last five years and amounted to Rs. 43.5b at end-FY14. On aggregate basis, deposits held by MFBs are greater than the loans outstanding, though large deposit base is concentrated with a few. Meanwhile, MFIs remain primarily dependent on Pakistan Poverty Alleviation Fund (PPAF) for their funding needs implying that future growth of

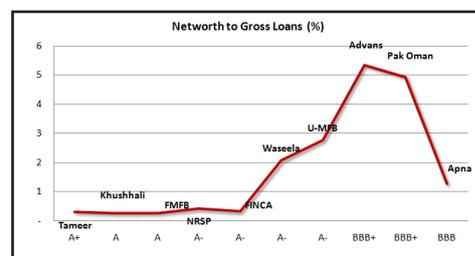
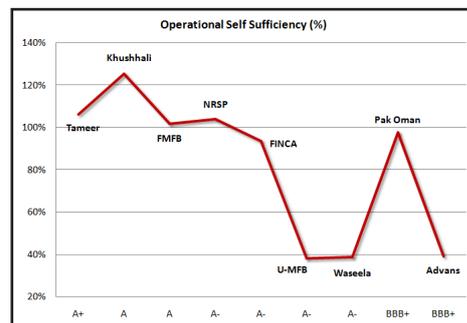
this segment is contingent upon availability of funding from the apex organization.

With increasing GLP, total revenues of the MFPs have increased on a timeline basis. While income from loans represents the largest share in overall revenues, revenues from financial services have also increased with the scale of branchless banking services in case of MFBs. Spreads

have largely remained range bound in recent years; declining interest rate scenario bodes well for the profitability of the sector as funding cost is largely linked to market benchmark rates while loans are priced at fixed rate. Given the nature of operational activities, overheads remain high at above 12%; these are also higher in comparison to global benchmarks. This is attributable to smaller loan size offered by the industry as compared to regional peers in addition to which deployment of assets in loans in case of MFBs is also on the lower side.

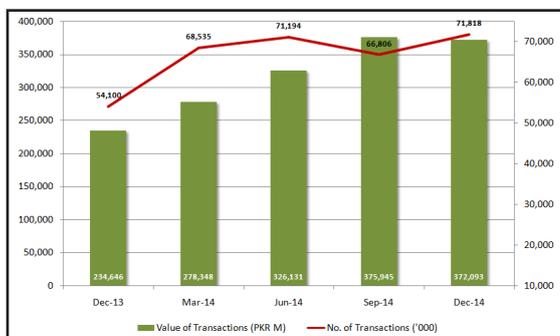
While there is variation among sub-peer groups, Operational Self Sufficiency (OSS) continues to remain above 100%. Going forward, profitability of the sector is expected to remain a function of increasing lending activity as the MFPs endeavor to expand outreach and enhance loan sizes, while maintaining asset quality.

Capitalization levels vary among peer groups with MFBs adequately capitalized due to the Minimum Capital Requirements (MCR) set by the SBP. Capital structure of MFIs remains weak impairing their ability to access commercial financing. With a net worth of above Rs. 17b, portfolio at risk in relation to equity is negligible on a sector wide basis.



Branchless Banking

Branchless banking has posted tremendous growth in recent years. A two player market for mobile financial services has expanded to eight with representation from entire telecom sector and leading commercial banks. Growth is supported by an established regulatory environment; branchless banking regulations were first introduced in 2008 and later revised in 2011.



With a nationwide network of almost 160,000 active branchless banking agents, volume of transactions undertaken over this medium continues to grow. The delivery channel is mainly used to perform over the counter (OTC) transactions which represent around 80% of the overall volume of transactions. Mobile money penetration remains low in Pakistan; about 5% of households use mobile money while less

than 1% have a registered mobile money account. Number of mobile banking accounts were reported at 5.4m at end Dec. 2014, with a deposit balance of Rs. 6.7b only.

While there is significant room for growth, an outcome of increasing number of participants in the sector has been the upward pressure on commission rates, which has squeezed the returns from branchless banking operations. In this backdrop, achieving higher volume of transactions and innovation in product offering would be the key drivers of profitability in this segment, going forward.

ANNEXURE I**Peer Groups in Microfinance Sector**

Microfinance Institution: A non-bank non-government organization (NGO) providing microfinance services. Organizations in this group are registered under a variety of regulations, including the Societies Act, Trust Act and the Companies Ordinance. The MFI peer group includes local as well as multinational NGOs.

Microfinance Bank: A commercial bank licensed and prudentially regulated by the State Bank of Pakistan to exclusively service the microfinance market. MFBs are legally empowered to accept and intermediate deposits from the public. Currently there are 10 MFBs operating in the country.

Rural Support Programme: An NGO registered as a non-profit company under the Companies Ordinance. An RSP is differentiated from the MFI peer group based on the purely rural focus of its operations.

ANNEXURE II

Microfinance Sector Over The Years	2014	2013	2012	2011
Number of Branches/Units	2,538	2,157	1,918	1,739
Number of Districts Covered	94	94	92	89
Penetration Rate (%)	11.47	10.34	8.60	7.56
Number of Active Borrowers	3,142,589	2,832,715	2,355,943	2,073,071
Gross Loan Portfolio (PKR Millions)	66,761	52,092	38,238	28,845
Average Loan Size (PKR)	30,604	26,838	24,131	21,126
Number of Savers	8,520,718	5,977,426	4,682,422	3,933,496
Value of Savings (PKR Millions)	43,497	34,784	24,974	15,508
Average Saving Balance (PKR)	5,105	5,819	5,334	3,942

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