PMIC Insight - IV

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Impact of Macro-economic Factors on the Microfinance Sector

As we continue to highlight in our section of The Economy, Pakistan's economy is under-going a tough time on both the domestic and external fronts. As per the recent announcement, it now appears likely that we will be entering into an IMF program and there are a lot of speculations regarding the terms that this would entail.

What does the current macro-economic situation mean for the microfinance sector?

The microfinance sector has been growing very rapidly in the last few years. While the sector has been around in previous troughs in the market, the pace of growth had not been significant back then. In the current environment, PMIC believes that there would be certain trends that will be common to NBMFIs and MFBs while as secondary market borrowers, NBMFIs may be further constrained on some accounts.

MFBs have been funding their growth through deposits; in a rising interest rate scenario, competition from commercial banks, and more pertinently, from national saving schemes is likely to intensify, placing upward pressure on the cost of funds for MFBs. In case of NBMFIs, the pressure may be felt both in terms of cost of funds which is linked to market benchmark rates and ability to raise funding from the market, particularly commercial banks. In previous high interest rate scenario, we have observed tendency of commercial banks to deploy a large part of their balance sheets into risk-free and high yielding government paper. A segment of the sector that has already been marginalized in recent years, the NBMFI segment faces the risk of further shrinkage in market share in this environment.

The rise in cost of funds would place pressure on the margins of MFPs; further efficiencies in economies of scale and use of technology could potentially help off-set this pressure. While there is option of passing on the higher cost of funds to the end clients, MFPs may be better positioned to absorb this cost internally to manage the pressures on the end clients.

In terms of repayment capacity of end clients, inflationary trends could potentially have an adverse effect. While in the past, negative trends in portfolio quality have largely been isolated from interest rate movements, counterparty assessment is nevertheless an area where microfinance practitioners may have to exercise greater caution. Institutions which invest in building the capacities of end clients, may be better positioned to manage this risk. PMIC will continue to work with the sector participants to build institutional capacities while also investing in the end clients to enhance their capacity to generate higher income levels, through skills based trainings, and other interventions.

Focusing Outward

Global Financial Inclusion – 2017

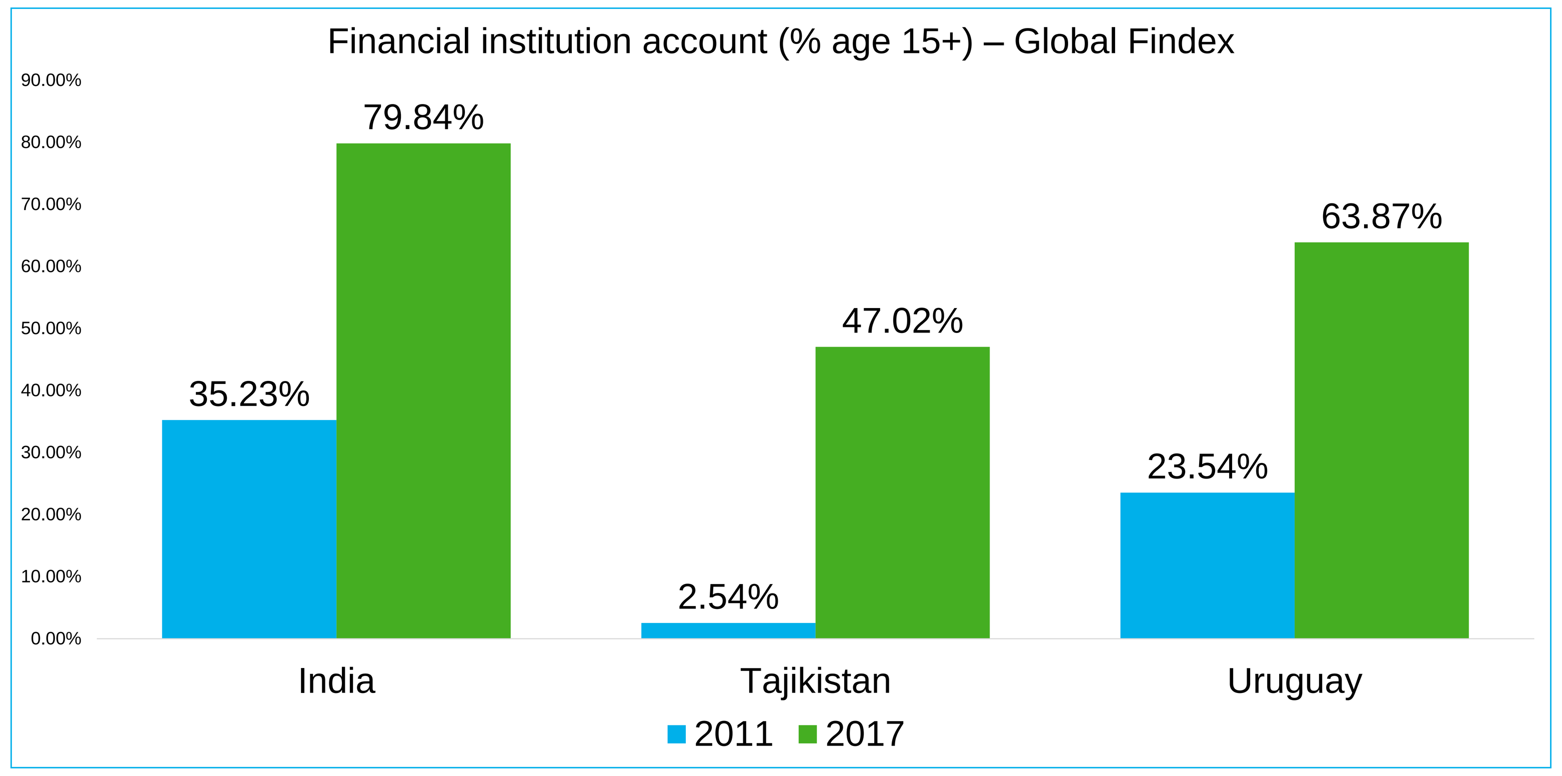
- 69% of adults had an account in 2017, up from 62% in 2014 and 51% in 2011, globally.
- About 1.7 billion adults remain unbanked i.e. without an account at a financial institution or via a mobile money provider; in 2014 this number was 2 billion.

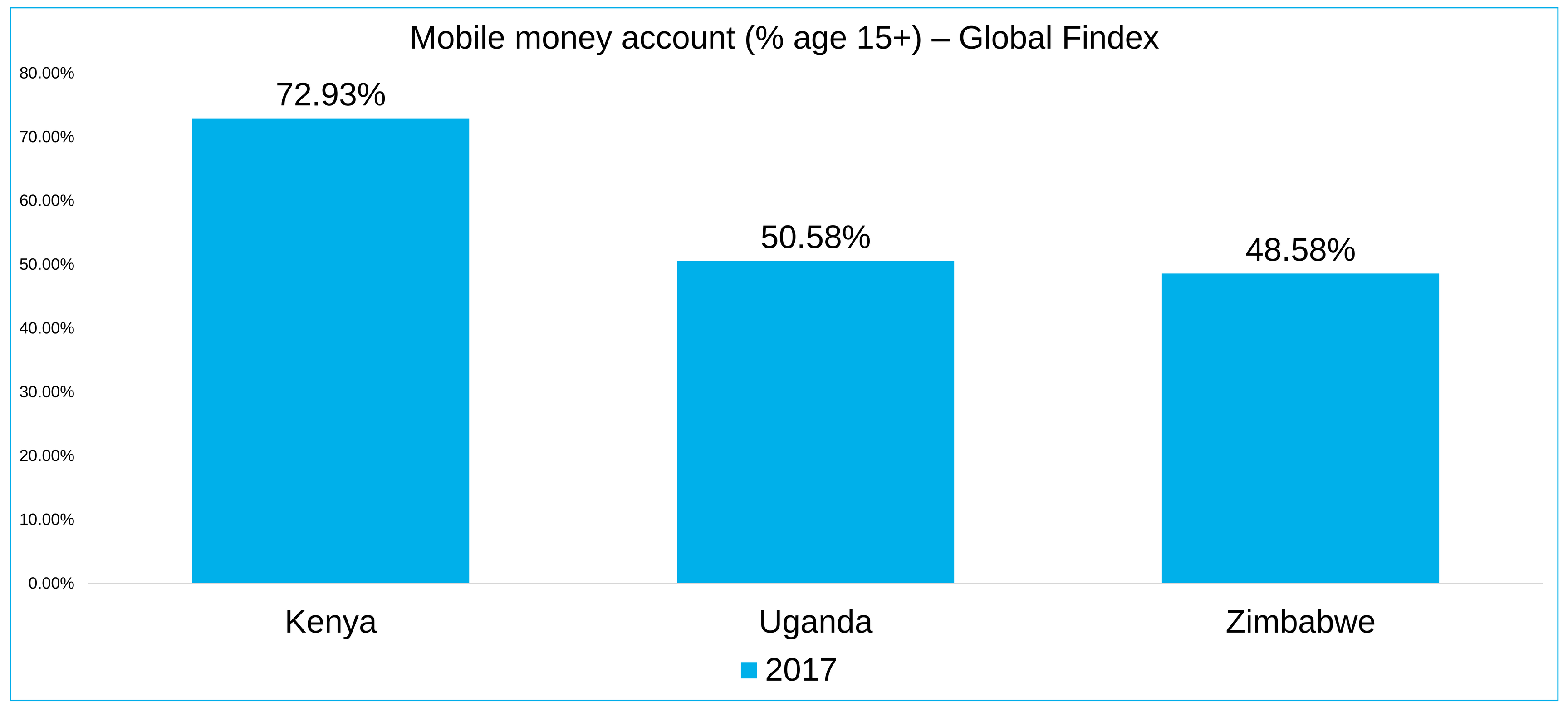
Addressing Barriers to Inclusion - Policies

An Asian Development Bank paper, evaluating factors affecting the ability of the underserved to access financial services and financial literacy, and of financial regulatory frameworks that improve financial access based on experiences of advanced and emerging economies highlights the following policies:

i. establishment of inclusive financial institutions, such as microfinance institutions, credit cooperatives, special purpose state banks, post offices, and agents;
ii. subsidies for borrowing for specific segments;
iii. low-cost and innovative financial products and services, such as no-frills accounts and microinsurance;
iv. innovative technologies, such as mobile phone banking and e-money;
v. innovative ways to increase credit access, such as credit databases, broader ranges of collateral, credit guarantee programs, and innovative financing vehicles; and
vi. innovative regulations, including proportionate regulation and national identification schemes.[1]

Increasingly Inclusive Economies and Policy Initiatives





India

i. Pradhan Mantry Jan-Dhan Yojana: Launched in 2013 with a new approach of focusing on households, account integration with credit, insurance and pension, inter-operability, simplified KYC and e-KYC rules, and financial literacy.
ii. Aadhaar Unique Identification Authority: The institution provides biometric-based unique ID numbers to every citizen which affords them access to banking, mobile phone connection and other government or non-government schemes.
iii. Credit Guarantee Trust Fund for MSEs: Created in 2000, the trust covers the loss incurred by the lender up to 85% of the credit facility
iv. Jan-Suraksha Scheme: Launched in 2015, this scheme involves the creation of a universal social security system for all Indians through three key instruments: accident insurance, life insurance and pension scheme.

Tajikistan

i. Low-Cost Financing: ADB, EBRD, UNDP, and World Bank provide Tajik commercial banks and NBMFIs with low-cost financing which is channeled to borrowers at relatively low interest rates.
ii. Credit Databases: Credit Information Bureau of Tajikistan (CIBT) and Bureau of Credit History Somonion (BCHS) were holding credit information via 22 banks and 136 NBMFIs collectively in 2015.[2]
iii. Credit Guarantee: Designed to absorb 60% of credit losses in the SME segment.

Uruguay

i. Reduction of value added tax for purchases via debit cards and e-money instruments
ii. Tax incentives to expand the country's network of point of sales
iii. Free access to an account at a financial intermediary
iv. Small companies can hold Simplified Accounts i.e. accounts with limits on balances and transactions, and streamlined KYC rules.

[3]	Kenya	Uganda	Zimbabwe
Allows Non-Banks to issue mobile money	✓	✓	✓
Has specific regulation regarding mobile money	✓	✓	✗
Has tiered KYC rules	✗	✗	No basis
Requires full KYC Registration	✓	✓	No basis
Ease of registration to get a mobile money account	Customers can register at agent's stores	Customers can register using any ID with a photograph	No basis
Restriction to entry for mobile money operators and other non-bank FSPs	Minimal	Minimal	Minimal

[1] Yoshino, Naoyuki, and Peter J. Morgan. "Assessing Policies to Promote Financial Inclusion, Regulation, and Education in Emerging Asia." Asia Pathways. October 19, 2016. https://www.asiapathways-adbi.org/2016/10/assessing-policies-to-promote-financial-inclusion-regulation-and-education-in-emerging-asia/.
[2] World Bank Finance sector assessment report 2015.
[3] Evans, David S., and Alexis Pirchio. "An Empirical Examination of Why Mobile Money Schemes Ignite in Some Developing Countries but Flounder in Most." March 18, 2015. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2578312.

Learning Hub

Topic of the Quarter

Subsidies in Agriculture Finance

A World Bank report that explores “Subsidies as an Instrument in Agriculture Finance” identifies important learnings that must be considered prior to design of any subsidized agriculture credit program:

- subsidize the institution but not the borrowers to reduce distortions – when borrowers are subsidized, the credit culture gets distorted. *In case of Pakistan, microfinance institutions have become sustainable so there is limited case for subsidizing them either.*
- avoid subsidies to institutions that undermine competition, *particularly in situations where client segments cannot be easily segregated as there are potential downside risks emanating from such institutions tapping into clients that have the ability to pay*
- subsidize the creation of public goods that benefit the entire financial sector
- subsidize individual financial institutions where there is natural spillover to non-subsidized institutions
- identify quantitative performance measures so subsidies to financial institutions do not dull incentives for high performance
- conduct comparative cost-benefit studies to identify subsidies that generate the greatest payoff
- require grant recipients to demonstrate commitment through matching contributions
- design grants to financial institutions so recipients clearly understand the difference between grants and loans.

Subsidized Agricultural Credit in Brazil – 1970s

Policy Objectives

- Agricultural modernization
- Increasing output
- Redistribution of income to the rural poor.

Context

- Commercial banks, by law, were required to allocate at least 15% of their demand deposits to farmers.
- Rural credit interest rate was fixed at 17% initially. It was revised to 15% in 1971.
- The inflation rate ranged from 20% to 40% during the 1970s with average rate hovering around 40% a year after 1973. The credit interest rate averaged out at 15% during the time.
- The subsidies were supported by large income tax deductions.

Impacts – Literature Review

- **Concentration of Credit across States and Farm sizes:** One-third of farm holders among the upper three size strata of farms reported receiving loans in 1980 while 4% of farm owners in the smallest size strata reported receiving credit.[1] With limited available credit, large farm holders rationed out small holders and, in turn, led to the widening of income inequalities between small and large land owners.
- **Diversion of Subsidies to Sectors not Targeted:** Since the cost of capital of such loans was not the true cost of capital, there was an incentive for borrowers to divert the subsidized credit to investments outside agricultural activities which would yield higher returns.[2]
- **Contribution to the Budget Deficit and Inflation:** 24% of government expenditure was dedicated to these subsidies in 1977.[3] This was putting a drain on the government resources and contributing to inflation.[4]
- **Income Transfer via Non-Productive Use:** In a low credit rate and high inflation environment, the real interest rates can become negative. This leads to an artificial increase in demand for credit as borrowers can borrow and invest in an asset whose value appreciates in proportion to inflation and later liquidate them instead of making productive use of the loan. This de facto income transfer of around $3-4 bn took place owing to agriculture credit programs in Brazil.[5]

Link to Economic Development

- A paper by economists from Universities of Iowa, Manchester, Cambridge and the Central Bank of Portugal studies the quantitative effects of interest rate credit subsidies on output, wages, and inequality in a standard model of economic development with credit market imperfections. It holds that such subsidies have no significant quantitative impact on output per capita. The authors also remark that the provision of credit subsidies is not an effective way to reduce the underinvestment problem that can result from capital market frictions.[6]
- Willian G. Gala, a Stanford University Ph.D., writes a paper which presents a simulation model that describes the effects of credit interventions. The paper concludes that overall welfare costs can go as high as 60-90% of the net change in target group investment. The inframarginal nature of subsidies implies that the government typically incurs 50-90 cents per incremental dollar of targeted investment, the subsidy; the resources used for credit subsidies represent a high cost to the economy.[7]

Value Addition vs. Rate Subsidies

- Research has shown that value addition to the end clients can be more beneficial than credit subsidies.
- Training and technical assistance components of microfinance lending can be more important components of agriculture lending than interest rate subsidies, particularly for small scale farmers as they can help them improve their productivity and income levels
- The role of governments and donors should be on long term investments in public goods needed to remove the bottlenecks for thriving markets. In the case of agriculture, these may include farm-to-market roads for better connectivity.
- Studies on sensitivity of loan demand to interest rates imply that: some microenterprises earn high rates of return to capital, implying an ability to pay high NBMFI rates of interest. There is also evidence to contradict the notion that rates of return in agriculture are so low that farmers cannot pay interest rates as high as those paid by microentrepreneurs. If there is great heterogeneity in rates of return, farmers may not demand credit until they learn the correct combination of inputs to use or until enterprises and value chains are developed that generate higher returns than are possible with traditional agriculture.
- Demand for credit is driven by many factors besides interest rates. Transaction costs of borrowing, the complexity of administrative procedures, access to other financial products, loan sizes, and repayment schedules may all have an impact.

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SDG 4: Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all

Sustainable Development Goal 4

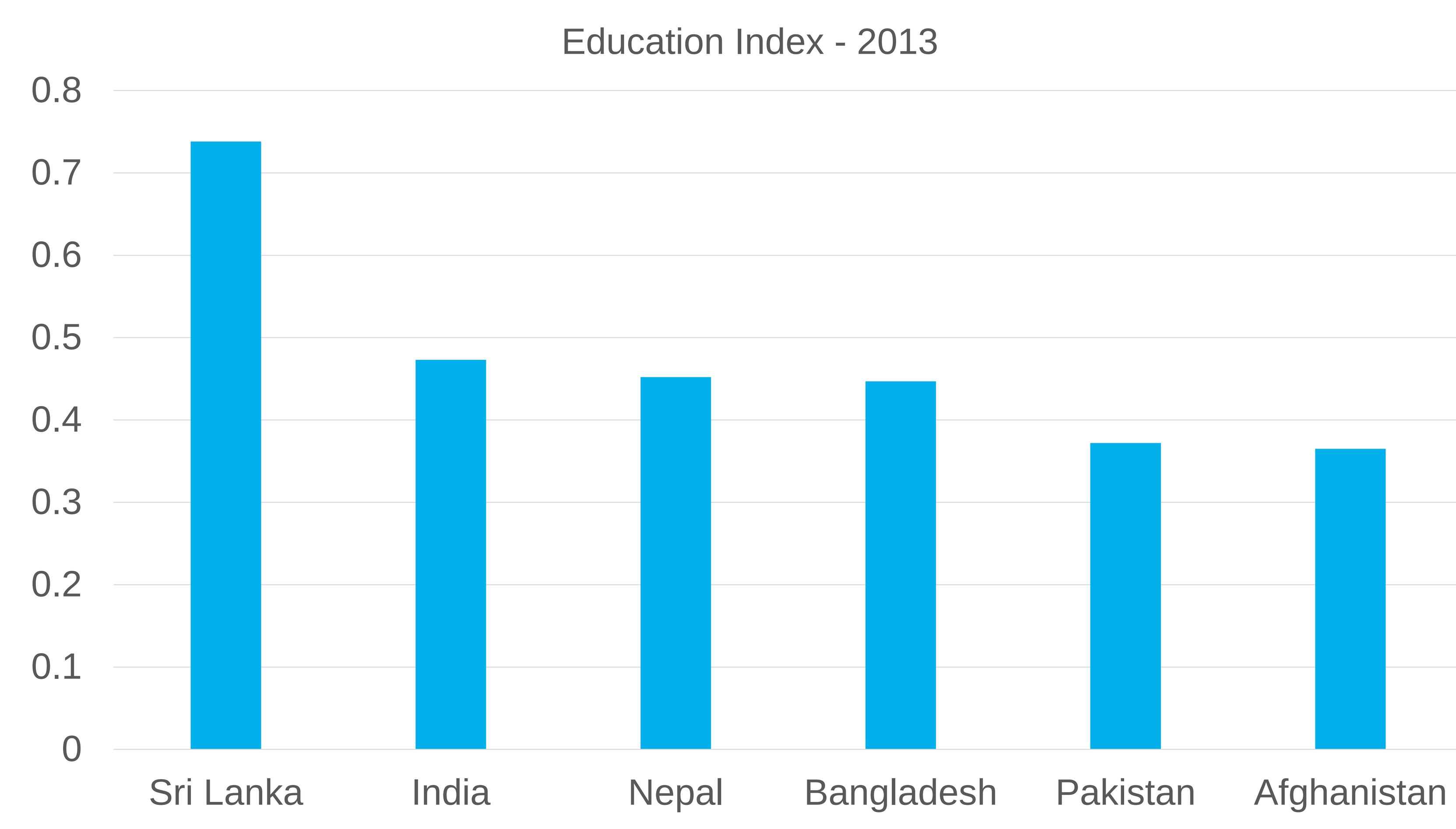
A FEW TARGETS by 2030

- Ensure that all girls and boys complete free, equitable and quality primary and secondary education leading to relevant and effective learning outcomes.
- Eliminate gender disparities in education and ensure equal access to all levels of education and vocational training for the vulnerable.
- Substantially increase the supply of qualified teachers, including through international cooperation for teacher training in developing countries, especially least developed countries.
- UNESCO reports there were still 263 million out-of-school (OOS) children and youth by the end of school year 2016.
- Pupil-Teacher ratios in Sub-Saharan Africa and South Asia were 37.5 and 35.7 respectively for primary level; these ratios are more than double than those of North America, Europe and Central Asia.

PAKISTAN

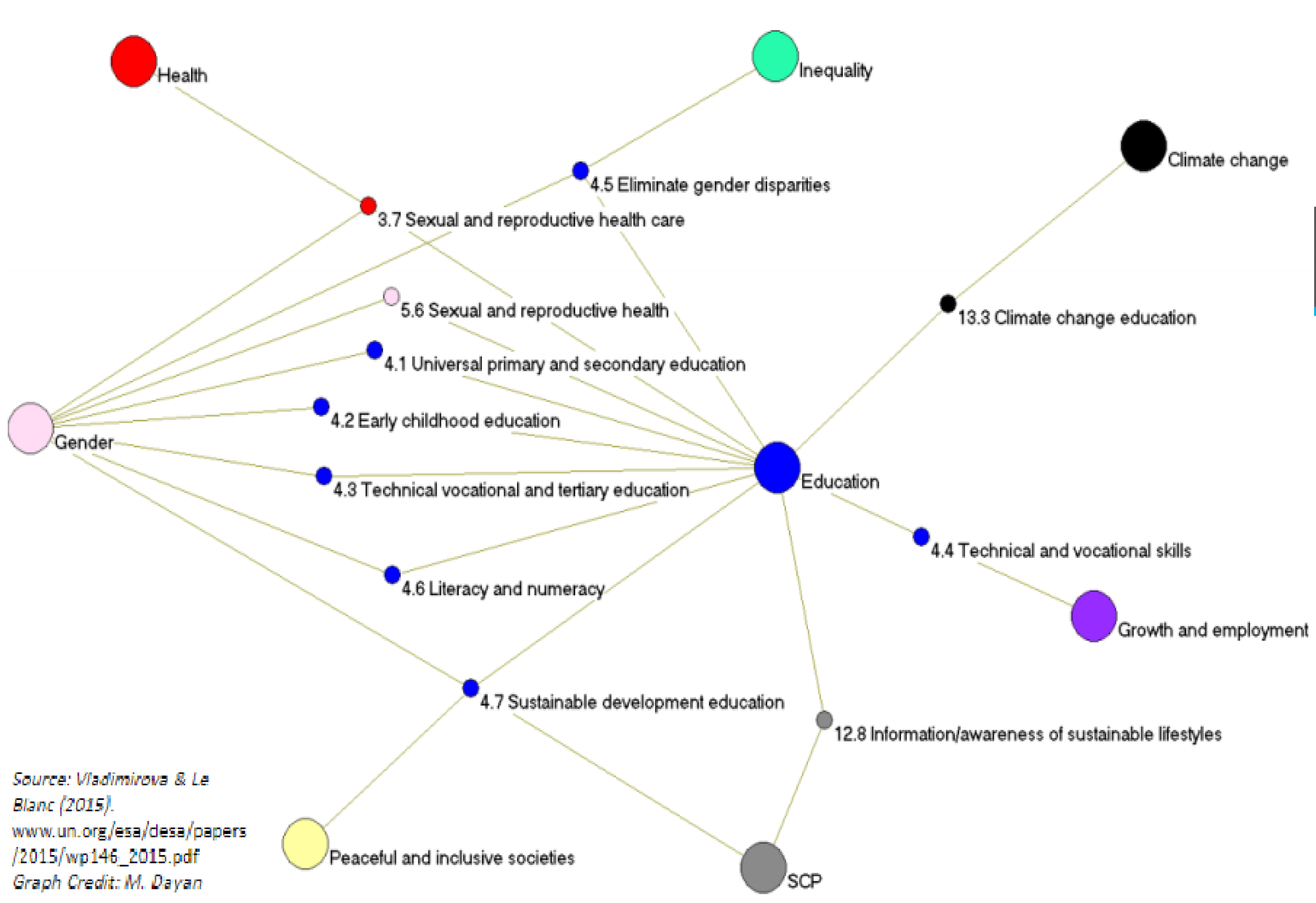
- Article 25A of the 1973 constitution makes free and compulsory education the right of every child aged 5 to 16. This article was adopted as part of the 18th Constitutional Amendment in addition to which education was devolved as a provincial mandate.
- According to the Pakistan Education Statistics 2016-17, of all the children aged between 5 and 16, nearly 44% i.e. 22.8 million were OOS. The figure had increased from 22.6 million in 2015-16.
- From primary to higher secondary level, 49% of the girl-population and 40% of boy-population were OOS.
- ASER 2016 noted that only 48% of 5th graders could do a two-digit division in Pakistan indicating an abysmal level of quality of early education.
- Physical infrastructure also requires significant improvement; 7% of all primary schools in Pakistan are operating without a building; 18% have a single classroom, 32% lack access to electricity & 22% do not have toilets.

Regional Comparison (Education Index, 2013)



Education Index – Pakistan and Regional countries

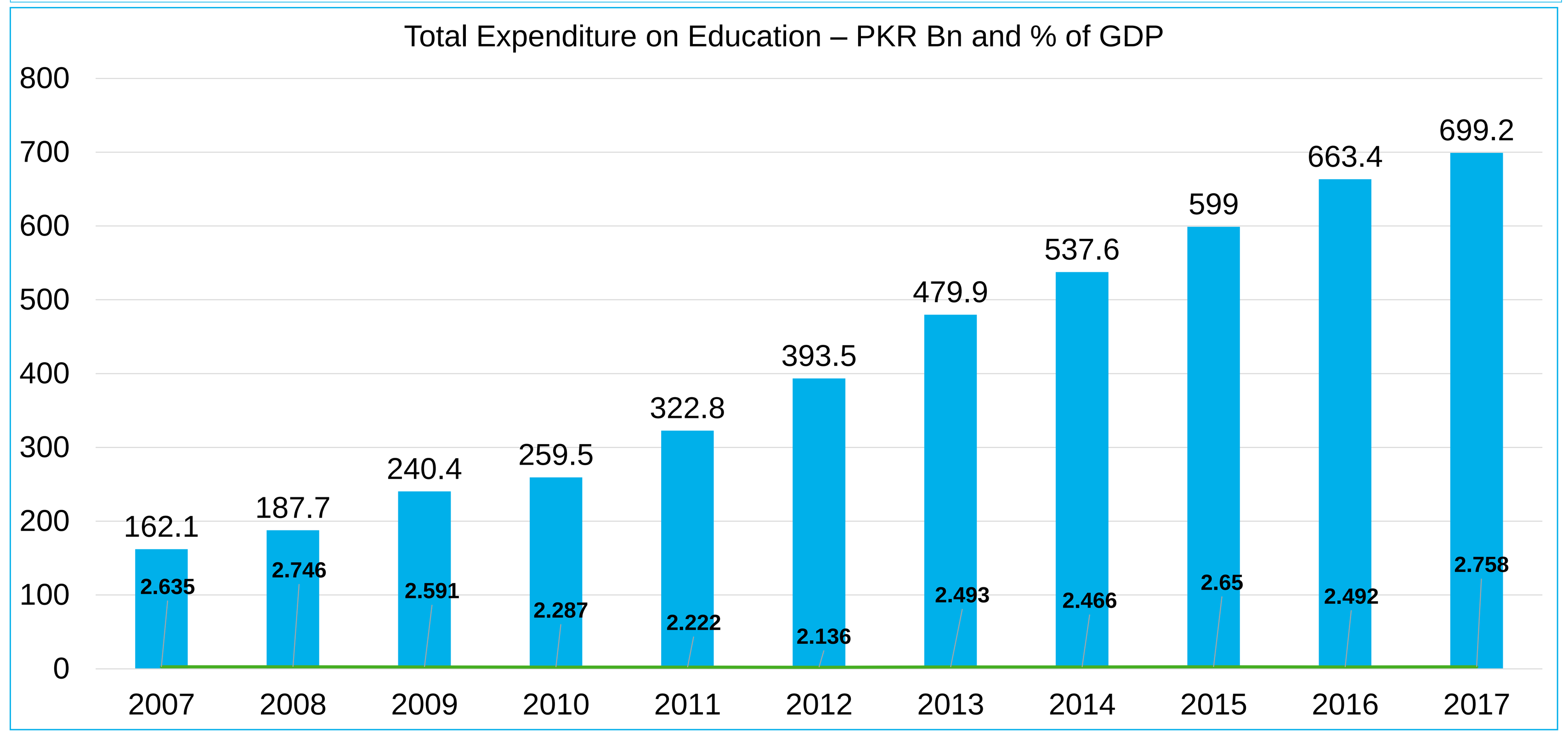
Quality Education – Achieving SDGs



Source: Vladimirova & Le Blanc (2015). www.un.org/esa/desa/papers/2015/wp146_2015.pdf Graph Credit: M. Dayan

Education Budget Allocation – Pakistan

	FY17 Budget Allocation (PKR bn)	FY18 Budget Allocation (PKR bn)	% Δ
Punjab	67.82	▲ 74.1	9.26
KPK	17.3	▲ 20.3	17.34
Sindh	20.07	▲24.03	19.73
Baluchistan	6.65	▲ 9.16	37.7



- Rough estimates indicate that achieving the net primary enrolment rate of 100% by 2015/16 would have required, besides massive improvements in governance and implementation, a fund of PKR 1, 300 billion according to a UNESCO situation analysis.[1] Taking into account the needed progress for higher levels of education, Pakistan would need much more resources.

Microfinance and Education

- A longitudinal study in Bangladesh reports that basic competency in reading, writing, and arithmetic among children 11-14 years old in microfinance client-households increased from 12% of children at the start of the program in 1992 to 24% in 1995. In non-member households, only 14% of children passed the tests.[2]
- Client households were found to be investing more in education than non-client households as a result of a microfinance program in Uganda. The clients were also significantly more likely than non-clients to pay school charges.[3]
- Adjei et al., and Lacalle Calderon et al., demonstrate that participation in microcredit programs increases a household's expenditure on children's education in Guyana and Rwanda.[4]

[1] Fancy, Haider, and Jamila Razzaq. *Accountability in Education in Pakistan*. UNESCO. http://unesdoc.unesco.org/images/0025/002595/259549e.pdf.
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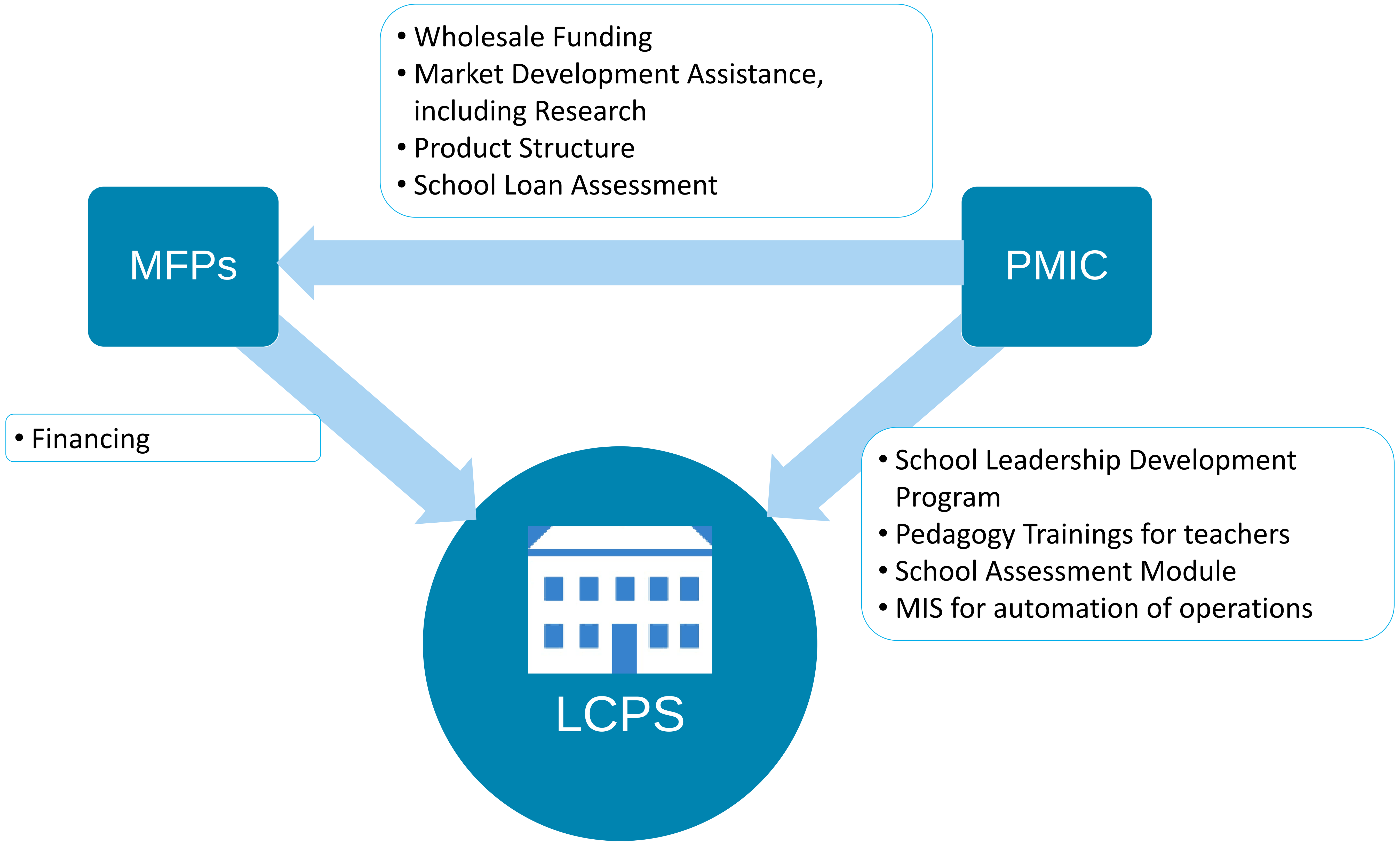
Education Financing Project - PMIC

Private Schools in Pakistan

Due to the lack of provision of education by the state, the private sector has been catering to the market demand for education. About 38% of private educational institutions out of the total education system of Pakistan comprising 317,323 institutions, are serving or facilitating 43% of students.

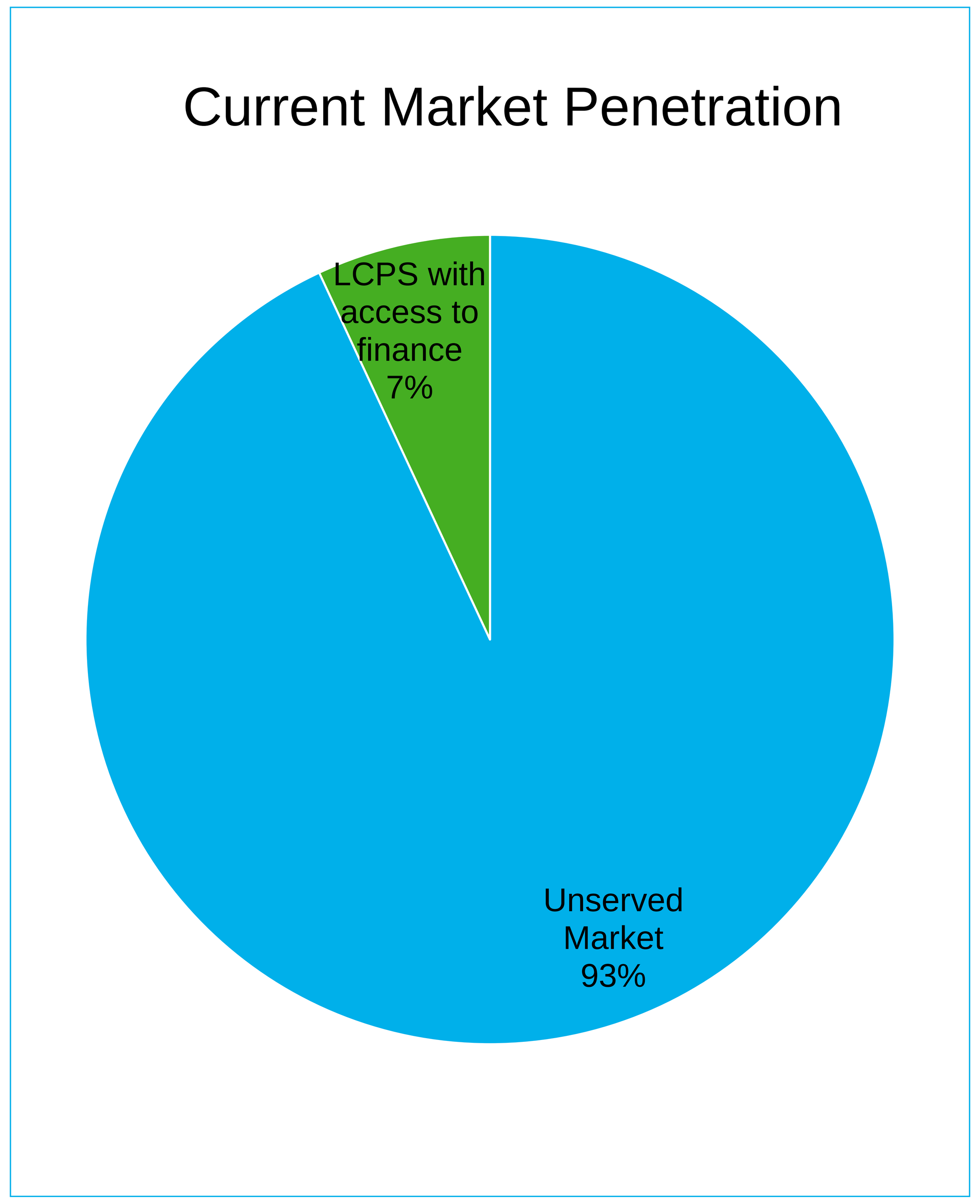
Theory of Change

The education financing initiative of PMIC entails a two-pronged approach. In addition to PMIC's traditional role of wholesale lender and creating access to funds for low-cost private schools (LCPS) via its partner FSPs; PMIC will also assist client LCPS in improving the school learning environment via technical partners.



Market Potential

- DFID estimates that around 70,000 LCPS need education financing in Pakistan.
- PMIC in collaboration with CERP organized a roundtable on August 2, 2018 titled "Scaling Education Financing" with the aim to bring together key stakeholders to jointly explore the way forward for scaling up education financing for LCPS in Pakistan. Prior to the event, participating financial service providers (FSPs) were requested to share data on their education financing portfolio. The data evidenced that out of the 15 participating FSPs, 8 MFPs and 3 commercial banks were engaged in school financing. The aggregate education financing portfolio for these institutions was a meagre PKR 763m (PKR 384m excluding commercial banks) catering to just 4,856 (4,844 excluding commercial banks) schools.



- Preliminary market exploratory survey, in collaboration with Opportunity International (OI), have been initiated by PMIC in some areas of Sindh and Punjab.
- Insights from the same will help in shaping the future strategy of PMIC in this space.
- OI is a technical service provider with which PMIC has entered into an MoU for provision of technical assistance to LCPS.
- PMIC is looking to collaborate with CERP in various capacities, including analytics.

Success Indicators

Outputs:	Outcome:
▪ Financing facilitated • Number of schools financed • Volume of funds allocated	▪ Improved learning environment ▪ Improved learning outcomes ▪ Additional jobs ▪ Increased access to education • Additional enrolment

About OI

Opportunity International is working to end global poverty by creating/sustaining 20 million jobs by 2020. Opportunity International was founded in 1971 and as one of its niche areas of operations, the entity works with financial institutions in around 13 countries in the field of education. It aims to help them build and grow profitable education finance products along with technical capacity building in related areas.

About CERP

The Center for Economic Research in Pakistan (CERP) is a research center that promotes the use of quantitative research and engages with policy counterparts to answer key policy questions. CERP was founded as a non-profit organization under Section 42 of the Companies Ordnance 1984.

The Economics

The Economy

Fitch Ratings recently cut its forecast of Pakistan's real GDP growth rate to 4.7% for FY18 – an almost 1% cut. The Asian Development Bank has also revised its growth outlook for Pakistan. Pakistan has set the GDP growth target at 6.2%, which the new government has not yet revised downwards.

There are multiple factors in play that indicate a relatively modest GDP growth for the ongoing fiscal year. Widening twin deficits (fiscal and current account) pose challenges on the external front. As per latest available details, public external debt represents 26.87% of GDP; total liquid reserves had fallen to $15.52bn by September 19, 2018 representing only 2 months of import cover.

Re-entry into the IMF program is now on the cards which could potentially bring with it some harsh steps to address the macro-economic challenges, including higher interest rates, expansion and scaling up of tax net, rupee depreciation and limitations on imports.

As expected, the State Bank of Pakistan (SBP) raised the policy rate by 100 basis points to 8.5% effective, October 1, 2018. The Finance Ministry has recently increased customs and regulatory duties on luxury consumer items including cars and cellphones. Furthermore, the tax rate in highest income tax slab has been raised from 15% to 30%. Higher inflation rate coupled with tighter monetary and fiscal policy could negatively impact the growth in manufacturing and service sector.

Item	Amount
GDP per capita (current) - FY17	$1,800
GDP (at current market prices) – Mar'18	$280.42b
Trade Balance – July'18	($33.6b)
Public External Debt % GDP – June'18	26.87%
Liquid FX Reserves – September 19, '18	$15.52b
CPI – July'18 (YoY)	5.8%
6-month KIBOR – Sept 28, '18	8.59%

Commercial Banking Sector

The overall risk profile of the banking sector has improved in the recent past. As per the periodic review by SBP, external sector pressures, fiscal sector vulnerabilities, growing domestic inflation and volatile commodity markets are the potential risks to financial stability over the coming six months. While the performance of the banking sector could be affected by these factors, it is still expected to remain sound, as per SBP. Possible regulatory action against a few institutions in the banking sector remain a source of concern for its implications on the sector at large.

Asset growth during the first half of CY2018 was recorded at 4.7%, manifested in the growth in advances. The Advances to Deposits Ratio (ADR) has inched upwards from 51.8% in August'17 to 58.5% by August'18. A 13.3% increase in advances during Jan-Aug'18 is mainly attributed to major borrowers in private sector from the cement, energy and sugar industries. Conversely, the decelerated growth of deposits is explained by reduced money supply owing to rising current account deficit, higher financial transaction taxes and scaling back of operations by a few banks in the overseas markets.

The rate of increase in demand for credit by the private sector may face a setback in the near to medium term in the light of expected slowdown in economy. The recent increase in interest rate will also contribute to that effect and it may continue if SBP keeps pushing the rates upwards – which is considered likely.

Item	Amount
Advances – August'18	Rs. 7.43tr
Deposits – August'18	Rs. 12.69tr
ADR – August'18	58.5%
Net Infection Ratio – June'18	1.1%
Risk Weighted CAR – June'18	15.9%
Credit to Private Sector % Total Scheduled Banks' Credit – Aug'18	44.5%
Credit to SMEs % Loans to Private Sector Business – Sept'18	8.0%
Agriculture Credit % Loans to Private Sector Business – Aug'18	5.91%

Microfinance Sector

The total number of savers in the sector has taken a massive dip of 16.7% since December'17. The branch-based savers have increased by 8.5% and the overall value of savings from Dec'17 to June'18 has also seen an increase of 12%. This bodes well for the sector as enhanced savings mobilization implies more available funding for on-ward lending. On the other hand, the decrease in M-Wallet savers since Dec'17 is significant – 26.7%. The is the second time the sector has witnessed a decline in M-Wallet savers; the first time involved a meager 5.6% decline in 1Q2017. This time, however, an initial dip of 8.61% in 1Q2018 was followed by another 19.83% in 2Q2018. In both these periods, the fall in M-Wallet accounts of Telenor Microfinance Bank was the most significant.

The reason for expiry of an M-Wallet account is inactivity over a considerable period of time. Under the SBP regulations, there is neither an initial deposit requirement nor a minimum balance requirement for attaining an M-Wallet account. While this may be to stimulate financial penetration, it is devoid of conditions that could actuate the users to actively engage in digital transactions and maintain their accounts once they have gotten them registered, particularly in the backdrop of an under-developed ecosystem for mobile money transactions.

This calls for innovative product development, marketing and advertisement campaigns in favor of enhanced usage of m-wallets, low transaction costs, and enhancing interoperability among and between FSPs and MNOs.

	Q2-2018	2017	2016	2015	2014
Penetration Rate (%)	31.5	28.3	22.3	13.7	11.5
Active Borrowers (In m)	6.46	5.8	4.6	3.8	3.1
Gross Loan Portfolio (Rs. in b)	239.4	202.7	136.9	93.0	66.8
PAR-30 (%)	1.4	0.1	1.4	1.4	1.1
Value of Savings (Rs. in b)	209.3	186.9	121.4	64.7	43.5
Number of Policy Holders (In m)	8.02	7.3	5.9	4.6	3.8