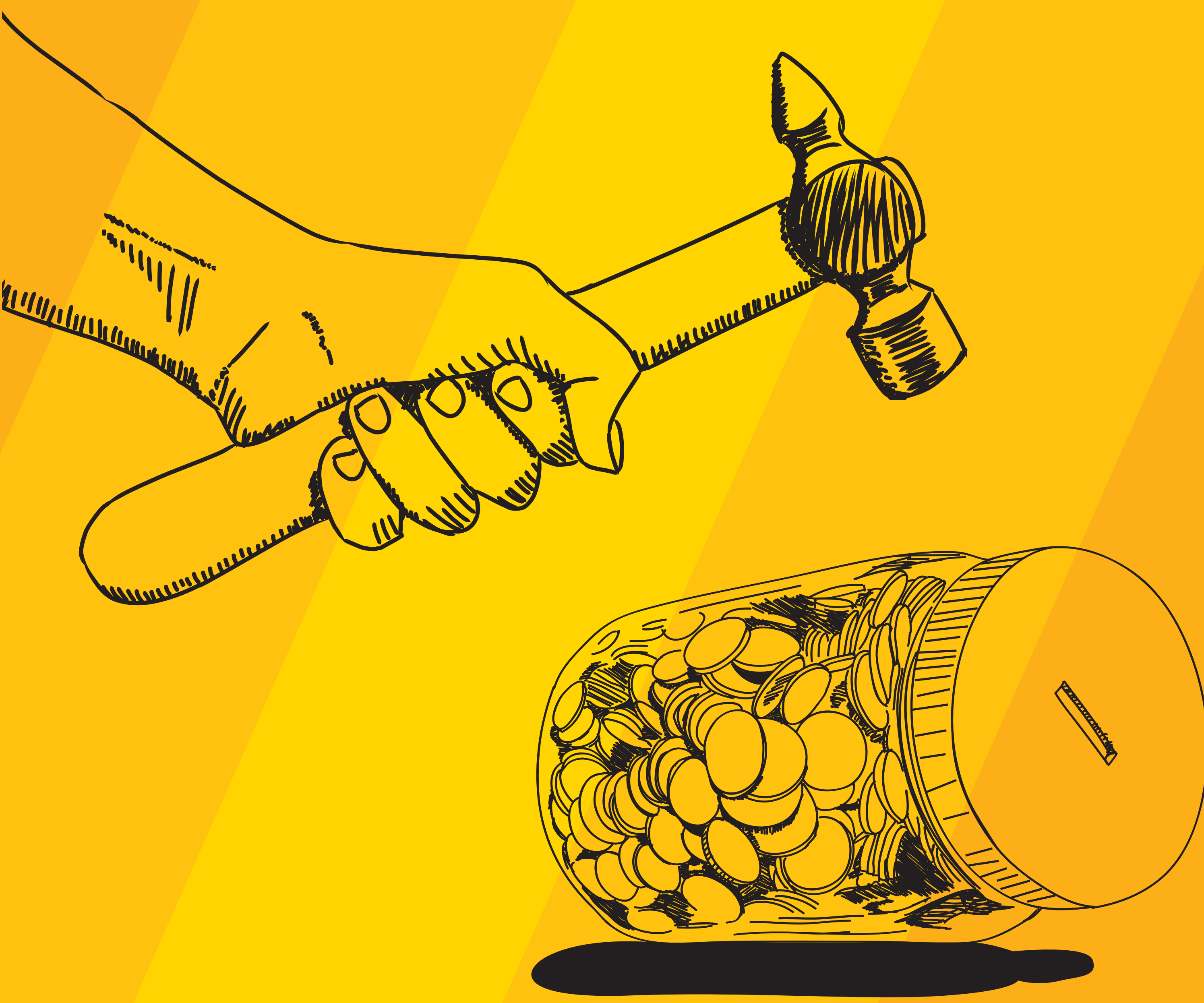
Pakistan Microfinance Network

RISKS TO MICROFINANCE IN PAKISTAN

Findings from a Risk Assessment Survey



Authored by Ammar Arshad and Ali Basharat

The Pakistan Microfinance Network is an association of retail microfinance providers. Our vision is to extend the frontiers of formal financial services to all and mission is to support the financial sector, especially retail financial service providers, to enhance their scale, quality, diversity and sustainability in order to achieve inclusive financial services.

Assessing Risks to Microfinance in Pakistan: Findings from a Risk Assessment Survey

Pakistan Microfinance Network
117, Street 66, F-11/4, Islamabad, Pakistan
Telephone: +92 51 2292231 / 2292270
Fax: +92 51 2292230
www.pmn.org.pk

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Authored by
Ammar Arshad and Ali Basharat

Advisor
Aban Haq

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Acronyms and Abbreviations

CAGR	Cumulative Average Growth Rate
CGAP	Consultative Group to Assist the Poor
CSFI	Centre for Study of Financial Innovation
DFID	Department for International Development
EIU	Economic Intelligence Unit
FATA	Federally Administered Tribal Areas
KIBOR	Karachi Interbank Offered Rate
MCGF	Microfinance Credit Guarantee Facility
MF-CIB	Microfinance Credit Information Bureau
MFB	Microfinance Bank
MFI	Microfinance Institution
MFP	Microfinance Provider
MIS	Management Information Systems
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
ROA	Return on Assets
RSP	Rural Support Programme
SBP	State Bank of Pakistan

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Contents

***Risks to Microfinance in Pakistan** is the second study of its kind, which seeks to map the risks being faced in Pakistan's microfinance sector as seen by various stakeholders. The first study, Risks to Microfinance in Pakistan: Findings from a Risk Assessment Survey, conducted in 2011 by the Pakistan Microfinance Network (PMN), served as a starting point in the discussion on risks and threats encompassing the Pakistan microfinance sector. This study aims to update the risks highlighted in the initial publication in the face of the changing business and macroeconomic environment, as well as keeping in mind the new initiatives and developments in the microfinance sector.*

*The study is categorized into three main sections: Introduction, Analysis of Data and Risk Mitigation Strategies. The first section, **Introduction**, examines why risk management is crucial for microfinance institutions and provides an overview of the methodology used for this study. The following chapter, **Analysis of Data**, showcases the responses and perceptions of the participants and provides a detailed analysis of the results. The third section briefly discusses possible **Risk Mitigation Strategies** for risks and threats highlighted in section two.*

Introduction

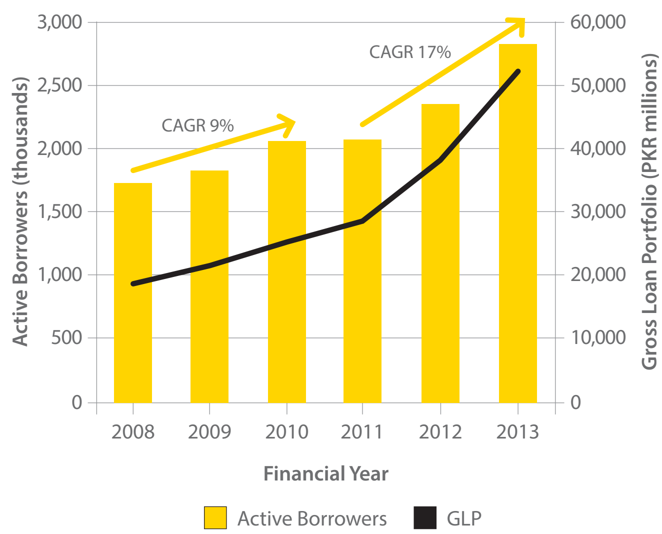
Why Risk Management is important for Microfinance

Like all financial institutions, microfinance providers (MFPs) face risks that they must manage effectively to be successful. The failure to do so can result in MFPs falling behind in terms of meeting their social and financial objectives. Unlike other for profit financial institutions, MFPs are evaluated on the basis of both social and financial performance; hence, mitigating risks can be more challenging for an MFP than for an institution solely driven by profitability.

Risk management has been an integral part of large businesses and financial institutions for decades but the concept is still fairly new for many MFPs. Most MFPs operating in Pakistan (especially non-bank MFPs) focus only on a handful of risks such natural disasters or credit risks and do not have formal risk management structures in place to counter other potential threats. Without a sound framework to assess and mitigate risks, MFPs remain vulnerable to threats like liquidity shortfall, political crises, security issues, macroeconomic slowdown and delinquency problems. Although MFPs are financial institutions (FIs), they differ significantly from conventional commercial banks. For one, they target a different client segment which faces a completely different set of risks as compared to the corporate and high net worth clients that a commercial bank serves. Secondly in Pakistan's context, a large proportion of the sector remains outside any formal regulatory framework exposing such institutions to various additional risks. Also, a large amount of public and donor funds have been channeled into the sector which creates an operating environment different from the one of conventional for-profit MFPs.

The Pakistan microfinance sector has evolved considerably in the last few years. The industry has witnessed innovation in products and technology (such as branchless banking), along with the emergence of new players (both local and international) in the sector. The growth rate of the sector has also improved significantly in recent years. The cumulative average growth rate (CAGR) of microcredit outreach was 9 percent between the period 2008 to 2010 when the sector collectively added 320,000 new borrowers, whereas from 2011 to 2013, the sector grew at a CAGR of 17 percent and added 760,000 new borrowers (**FIGURE 1**).

FIGURE 1: Trend in Microcredit Outreach



The increase in growth rate came on the back of several MFPs which are growing exponentially, expanding into larger geographic areas and offering a wider range of financial services and products. Such growing institutions are exposed to a broader spectrum of risks as they navigate forward. Similarly, the mounting competition in the Pakistan microfinance sector is encouraging MFPs to enhance their scope of operations while, at the same time, increasing their appetite for risk in order to capitalize on growth opportunities.

MFPs in Pakistan are increasingly moving towards market driven sources of funds to fuel their growth. Though reliance on donor based funds still prevails, many MFPs are now focusing on raising capital from commercial financial institutions or, in the case of MFBs, through deposits. In order to safeguard investors' money, it is imperative that MFPs have a proactive approach towards assessing and mitigating potential risks.

This report aims to provide a contextual document for developing and tracking a risk framework for the sector. It will serve as a key information source for MFP managers, policy makers and funders in identifying the threats faced by the sector, their relative severity and the ability of the service providers to deal with the risks.

Methodology

The Microfinance Banana Skins, published annually by the Centre for the Study of Financial Innovation (CSFI), is considered a flagship publication when it comes to risk assessment in microfinance. Our study uses the methodology of the Microfinance Banana Skins 2012 report. This report describes risks as viewed by a sample of stakeholders including practitioners, investors, donors, researchers and consultants. Data was collected from 55 respondents through an online survey (see Annex A). The questionnaire first asked respondents to describe, in their own words, what they thought were the top three risks faced by Pakistan's microfinance industry. The next section presented the respondents with a list of 27 risks and asked them to rate the following:

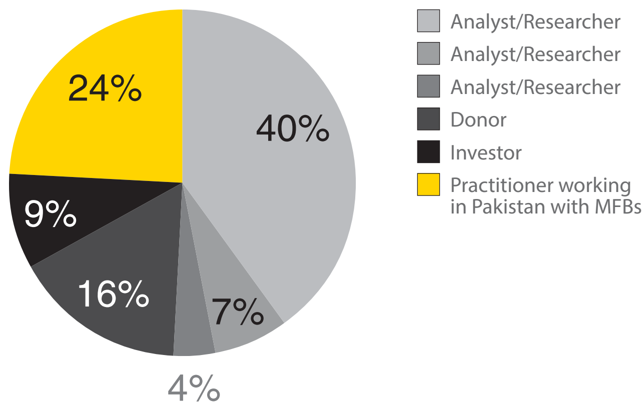
- **Risk severity:** High risk, average risk, low risk, or very low risk;
- **Risk trend:** Rising trend, steady trend, or falling trend;
- **MFPs' ability to cope with risk:** Excellent ability to cope, good ability to cope, average ability to cope, or poor ability to cope.

Respondents also had the option of providing comments on each risk, if they so chose. They were also asked to rank their level of familiarity with Pakistan's microfinance sector (very familiar, somewhat familiar, or not familiar) to enable the research team to understand the relevance of the responses. Responses were confidential, but a respondent could choose to be quoted. The views expressed in this survey are thus, those of the respondents, and do not necessarily reflect those of the Pakistan Microfinance Network (PMN).

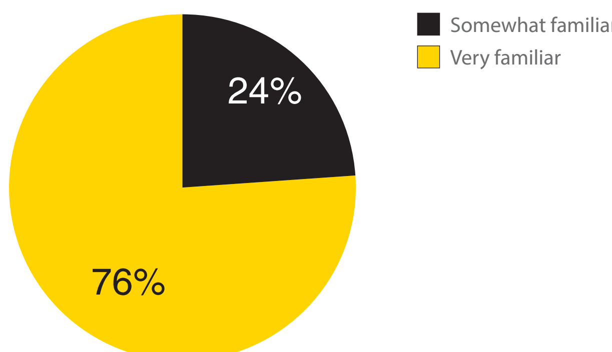
A breakdown of respondents by stakeholder group and by respondents' familiarity with the sector is shown in **FIGURE 2**. More than 60% of the respondents were practitioners working within Pakistan; this included practitioners working with MFBs (40%) and practitioners working with non-bank MFPs (23.6%). Most responses were from top and senior management tiers, with some middle managers also filling out the survey. Other than local practitioners, the survey was also completed by four practitioners working outside Pakistan (constituting 7.3% of the total respondents) – this will provide useful insight into how risks in Pakistan are perceived by the international market. Over 76% of respondents said they were very familiar with the microfinance sector, while the rest felt they had some understanding of the sector.

FIGURE 2: Respondent data

Breakdown by Respondent Type



Familiarity with Pakistan's Microfinance Sector



Headline Findings

This is the second survey focusing on identifying and ranking risks faced by the microfinance sector in Pakistan. The results are based on the perceptions of the respondents about what poses high versus low risk to the sector.

We begin by examining what emerged as the biggest risks today, what respondents perceive as key risks going forward, and what the ability of microfinance practitioners to deal with the different risks is. The rankings in **TABLE 1** are thus, based on the following:

- **Biggest Risks:** The percentage of respondents who judged a risk to be very high or high in terms of severity;
- **Fastest Risers:** The percentage of respondents who judged a risk to be rising;
- **Lowest ability to cope:** The percentage of respondents who judged MFPs' ability to cope with a risk as poor or as having no ability.

The key findings of the survey show that macro-economic trends continue to be the chief concern for stakeholders within and outside Pakistan, whereas, the increasing threat from competition has outranked macro-economic trends which was the fastest rising threat in the previous survey.

TABLE 1: Snapshot of the Sector's Risk Assessment (% of respondents)*

Biggest Risk		Fastest Rising		Lowest Ability to Cope	
Macro-Economic Trends	78% (89%)	Competition	69% (44%)	Natural Disasters	44% (45%)
Security	75% (71%)	Security	67% (73%)	Political Interference	42% (33%)
Profitability	71% (87%)	Macro-Economic Trends	65% (76%)	Religious Influence	35% (20%)
Credit Risk	69% (75%)	Managing Technology	55% (53%)	Security	31% (44%)
Inappropriate Regulation	64% (35%)	Too Little Funding	47% (36%)	Macro-Economic Trends	22% (51%)
Competition	62% (36%)	Credit Risk	45% (65%)	Foreign Exchange	20% (35%)
Political Interference	62% (62%)	Strategy	44% (29%)	Interest Rates	18% (18%)
Interest Rates	60% (67%)	Political Interference	42% (42%)	Corporate Governance	16% (35%)
Managing Technology	60% (47%)	Foreign Exchange	38% (31%)	Liquidity	15% (42%)
Natural Disasters	60% (60%)	Interest Rates	38% (53%)	Reputation	15% (31%)
Operations	56% (55%)	Staffing	38% (40%)	Inappropriate Regulation	13% (16%)
Strategy	56% (51%)	Liquidity	36% (65%)	Product Development	13% (20%)
Fraud Internal	51% (67%)	Natural Disasters	36% (35%)	Too Little Funding	13% (36%)
Liquidity	51% (69%)	Religious Influence	36% (42%)	Credit Risk	11% (24%)
Management Quality	51% (44%)	Inappropriate Regulation	35% (13%)	Staffing	11% (15%)
Reputation	49% (62%)	Profitability	35% (58%)	Unrealistic Expectations	11% (16%)
Too Little Funding	49% (64%)	Unrealistic Expectations	35% (45%)	Managing Technology	9% (22%)
Transparency	47% (44%)	Management Quality	33% (31%)	Mission Drift	9% (11%)
Product Development	45% (25%)	Reputation	33% (47%)	Ownership	9% (25%)

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Biggest Risk		Fastest Rising		Lowest Ability to Cope	
Corporate Governance	44% (64%)	Product Development	31% (35%)	Profitability	9% (35%)
Unrealistic Expectations	44% (62%)	Transparency	31% (38%)	Strategy	9% (16%)
Fraud External	42% (67%)	Mission Drift	29% (36%)	Management Quality	7% (18%)
Staffing	40% (55%)	Ownership	25% (31%)	Transparency	7% (18%)
Mission Drift	36% (47%)	Fraud External	22% (45%)	Competition	5% (18%)
Ownership	36% (47%)	Operations	22% (25%)	Fraud Internal	5% (11%)
Religious Influence	36% (42%)	Corporate Governance	15% (36%)	Fraud External	5% (11%)
Foreign Exchange	33% (33%)	Fraud Internal	11% (45%)	Operations	4% (16%)

* Figures in brackets represent the responses from the last survey in 2011

The survey shows *macroeconomic trends* and *security* as the topmost concerns for stakeholders in the microfinance industry. The ranking of *macroeconomic trends* has not budged since the first risk survey in 2011 and is still perceived as the biggest threat faced by the sector. The worsening law and order situation, dire energy crises and inflation, all have a major part in the deteriorating macroeconomic conditions, resultantly increasing the cost and risk of doing business in the country.

Top Ten Biggest Risks (2011 position in brackets)		
1	Macro-Economic Trends	(1)
2	Security	(4)
3	Profitability	(2)
4	Credit Risk	(3)
5	Inappropriate Regulation	(25)
6	Competition	(24)
7	Political Interference	(12)
8	Interest Rates	(7)
9	Managing Technology	(17)
10	Natural Disasters	(13)

It is pertinent to mention here that inappropriate regulations and competition which were ranked at 25 and 24 respectively in the previous survey are now perceived to be among the top ten most severe risks. Practitioners outside Pakistan, as well as, researchers and consultants perceive inappropriate regulations to be a major threat for the sector. On the other hand, the ranking of competition was primarily influenced by practitioners within Pakistan. Similarly, political interference, managing technology and natural disasters have climbed up the ranks to be considered among the top ten risks.

The fastest trending risk according to the survey is *competition*, which was ranked at number 11 in the risk survey of 2011. Growth in outreach in the last couple of years, particularly in urban areas, has led to an increase in competition and its perception as the fastest rising risk in the industry. It is followed by *security* which is at the same position as the previous survey. Although microfinance operations are limited in the highly volatile regions of Khyber-Pakhtunkhwa (KPK) and Balochistan, the overall threat in terms of security remains high making institutions cautious of entering even slightly risky areas.

Top Ten Fastest Rising Risks (2011 position in brackets)		
1	Competition	(11)
2	Security	(2)
3	Macro-Economic Trends	(1)
4	Managing Technology	(6)
5	Too Little Funding	(18)
6	Credit Risk	(3)
7	Strategy	(24)
8	Political Interference	(12)
9	Foreign Exchange	(23)
10	Interest Rates	(7)

The risks from strategy and foreign exchange, ranked among the least significant risks in the previous survey, are now considered to be among the top ten fastest rising threats for the Pakistan microfinance sector. Similarly, stakeholders also recognize the risk of too little funding as one of the fastest rising threats, unlike in the previous survey.

In terms of preparedness, MFPs feel least prepared to deal with risks that emerge outside their institutions. The top three risks in terms of lowest ability to cope are all external and include two risks that are rated as most severe and rising for the sector (*macroeconomic trends and security*).

A global comparison of top risks shows that stakeholders in Pakistan perceive exogenous/external risks (such as macroeconomic trends and security) to be the greatest threats for the microfinance sector, while globally, the most pressing risks facing the sector are those of the day-to-day running of the business, i.e. over indebtedness and credit risk.

For South Asia, the risk of political interference tops the ranking, followed by over indebtedness (also a global concern). According to the Microfinance Banana Skins 2014, over indebtedness remains a high ranking concern, not just in India – due to the fallout from Andhra Pradesh crises, but also in neighboring countries such as Nepal and Bangladesh.

Different Perspectives: Views of Stakeholder Groups

The survey targeted different stakeholder groups including practitioners (whose numbers far outweigh other respondents), policymakers, donors and investors (including equity investors and commercial banks), researchers and consultants working in microfinance. Practitioners have been further categorized into MFBs and non-bank MFPs in order to capture perceptions unique to each group.

Practitioners - MFBs

MFBs perceive *profitability* as the most severe risk followed by *competition* - the current growth of the sector is driving competition to a new level. Similarly, they seem comfortable with regulation as they think this is the least of their problems. Unlike some other stakeholders who ranked development and delivery of appropriate products as key risks, MFBs seem confident about their ability to do so. Risks that are perceived to be rising include the usual suspects, but also include *managing technology*. More and more MFPs have started to look at

TABLE 2: Regional and Global Comparison of Top Ten Risks

Top Ten Risks to the Microfinance Sector					
Pakistan		South Asia*		Global*	
1	Macro-Economic Trends	1	Political interference	1	Over indebtedness
2	Security	2	Over indebtedness	2	Credit Risk
3	Profitability	3	Client relationships	3	Competition
4	Credit Risk	4	Regulation	4	Risk management
5	Inappropriate Regulation	5	Risk management	5	Governance
6	Competition	6	Funding	6	Strategy
7	Political Interference	7	Competition	7	Political Interference
8	Interest Rates	8	Liquidity	8	Management
9	Managing Technology	9	Credit risk	9	Regulation
10	Natural Disasters	10	Management	10	Staffing

* Microfinance Banana Skins 2014

technological solutions to reduce operational costs through branchless banking models, contain fraud and improve credit appraisal processes through the use of credit information bureaus, and generate better management information through improvements in their management information systems (MIS). However, practitioners remain confident in their abilities to manage this change. Areas where they do not feel as confident include risks arising from *macroeconomic trends*, *security* and *competition*.

	Severity	Fastest Rising	Least Ability to Cope
1	Profitability	Macro-Economic Trends	Political Interference
2	Competition	Security	Natural Disasters
3	Credit Risk	Competition	Security
4	Macro-Economic Trends	Managing Technology	Inappropriate Regulation
5	Managing Technology	Credit Risk	Interest Rates
6	Natural Disasters	Strategy	Macroeconomic Trends
7	Operations	Product Development	Religious Influence
8	Political Interfer-ence	Too Little Funding	Managing Technology
9	Fraud Internal	Political Interference	Profitability
10	Inappropriate Regulation	Staffing	Liquidity

Practitioners - Non-Bank MFPs

Generally, macro or environmental risks seem to be worrying non-bank MFIs more than micro-risks that relate to their own institutions. As they worry about *profitability* or *credit risk*, they are equally worried about factors such as *security*, *inflation*, *interest rates* and *natural disasters*. Non-bank MFPs have ranked *macroeconomic trends* as the most severe and fastest rising threat in the sector – the persistent energy crises and inflation have severely impacted small scale MFIs which are most vulnerable to such shocks.

Sustainability also seems to be a key concern as most non-bank MFPs remain unprofitable and continue to rely heavily on funding. Issues around staffing, operations, and corporate governance continue to be considered less significant over the years.

An interesting insight from the survey results is the change in the perceptions pertaining to management quality. The risk from poor management quality, hardly considered a threat in the previous survey, is currently perceived to be the number one ranking risk which non-bank MFPs are least prepared to deal with. Most MFIs lack the resources to attract and nurture capable professionals and hence feel vulnerable to management quality risk.

	Severity	Fastest Rising	Least Ability to Cope
1	Macro-Economic Trends	Macro-Economic Trends	Management Quality
2	Security	Security	Natural Disasters
3	Profitability	Competition	Transparency
4	Natural Disasters	Managing Technology	Competition
5	Credit Risk	Credit Risk	Political Interference
6	Interest Rates	Strategy	Managing Technology
7	Competition	Too Little Funding	Operations
8	Strategy	Unrealistic Expectations	Fraud External
9	Unrealistic Expectations	Staffing	Profitability
10	Inappropriate Regulation	Interest Rates	Fraud Internal

Practitioners outside Pakistan

The survey also captures the responses of practitioners employed outside Pakistan. Though the number of respondents from this group is small, it nevertheless provides some insight into the perceptions of this group. The responses are in stark contrast with those MFPs operating in Pakistan, who do not see *corporate governance*, *inappropriate regulation* or *operations* as a major threat to the sector. Practitioners outside Pakistan consider *competition* and *foreign exchange* as the fastest rising risks.

	Severity	Fastest Rising	Least Ability to Cope
1	Corporate Governance	Competition	Competition
2	Inappropriate Regulation	Foreign Exchange	Fraud Internal
3	Operations	Macro-Economic Trends	Management Quality
4	Security	Security	Mission Drift
5	Credit Risk	Credit Risk	Ownership
6	Macro-Economic Trends	Fraud External	Product Development
7	Natural Disasters	Management Quality	Profitability
8	Competition	Managing Technology	Reputation
9	Foreign Exchange	Natural Disasters	Staffing
10	Interest Rates	Operations	Too Little Funding

Donors

All respondents in this category rated risks in areas of *credit risk*, *macroeconomic trends*, *profitability*, *security* and *managing technology* as either very high or high. Similar to other stakeholders, donors also view macroeconomic threats as a severe challenge for sector. However, it is surprising to see donors view the ability of MFPs to deal with the challenge of profitability and sustainability as weak, despite significant work on strengthening institutions and capacity building efforts by various stakeholders, including donors themselves.

	Severity	Fastest Rising	Least Ability to Cope
1	Credit risk	Competition	Credit Risk
2	Macro-Economic Trends	Fraud Internal	Competition
3	Profitability	Interest Rates	Strategy
4	Security	Liquidity	Operations
5	Managing Technology	Managing Technology	Profitability
6	Product Development	Mission Drift	Staffing
7	Competition	Security	Strategy
8	Mission Drift	Too Little Funding	Too Little Funding
9	Interest Rates	Credit Risk	Inappropriate Regulations
10	Liquidity	Foreign Exchange	Mission Drift

Similar to other stakeholders, donors seem comfortable with the regulatory framework and do not foresee any threat to the sector from this front – this is especially important as the majority of players are currently unregulated. Similarly, *foreign exchange*, *interest rates* and *funding* do not rate high in terms of risk from the donor perspective.

Investors

Risk perceptions of investors matter greatly for any institution or sector that is looking for funding, especially commercial funding. Although the sample size of investors in the study is small, it does offer some insights into what this group is thinking. Investors seem more concerned about external factors; *natural disasters*, *political interference*, *security* and *macroeconomic trends* are

	Severity	Fastest Rising	Least Ability to Cope
1	Natural Disasters	Security	Competition
2	Political Interference	Transparency	Fraud External
3	Security	Competition	Macro-Economic Trends
4	Macro-Economic Trends	Management Quality	Managing Technology
5	Credit Risk	Natural Disasters	Mission Drift
6	Profitability	Political Interference	Operations
7	Corporate Governance	Foreign Exchange	Product Development
8	Fraud Internal	Inappropriate Regulation	Profitability
9	Inappropriate Regulation	Macro-Economic Trends	Reputation
10	Interest Rates	Managing Technology	Strategy

four of the six risks that all investors rated very high or high in terms of severity.

Researchers and Consultants

Given the breadth of stakeholders this group tends to work with, their insights on risks in microfinance in Pakistan add tremendous value. Unlike practitioners, donors and investors who may view the sector through their own particular lens, researchers and consultants have a broader and more independent view of sector issues. In terms of risk profiling, this group feels that *inappropriate regulation* is a primary concern for the sector. Like all other stakeholders, researchers are also pessimistic about the *macroeconomic trends* in the country and also deem this to be one of the fastest rising threats in the country.

Researchers and consultants appear less concerned about issues of *transparency*, *corporate governance* and *managing technology*. They feel that institutions have the capacity to handle these areas.

	Severity	Fastest Rising	Least Ability to Cope
1	Inappropriate Regulation	Competition	Competition
2	Macro-Economic Trends	Macro-Economic Trends	Foreign Exchange
3	Interest Rates	Credit Risk	Credit Risk
4	Fraud Internal	Natural Disasters	Corporate Governance
5	Political Interference	Security	Fraud Internal
6	Reputation	Foreign Exchange	Fraud External
7	Security	Interest Rates	Inappropriate Regulation
8	Competition	Managing Technology	Interest Rates
9	Corporate Governance	Political Interference	Liquidity
10	Credit Risk	Product Development	Management Quality

Detailed Risk Analysis

We now examine closely the risks faced by the industry, addressing all the risks covered by the survey. Some risk mitigation strategies are also identified for the top risks.

Macroeconomic Risk

Macroeconomic risk refers to the threats microfinance providers and their clients could face due to changing trends in the wider economy. For Pakistan such trends include persistent inflation, stagnating economic growth, rising fiscal deficit, volatile commodity prices and acute energy crises.

Macroeconomic risk continues to be perceived as one of the greatest threat to the microfinance sector of Pakistan – 78 percent of the respondents rated the severity of this risk as high, 65 percent regarded the risk to be rising, and more than 80 percent of the respondents perceive that MFPs' ability to cope with the risk ranges from poor to average.

Although this risk affects microfinance providers directly through interest rates and general business conditions, it most often reaches them through clients who have been hit by economic difficulty. Such clients are either unable to fulfill their financial obligations to the microfinance providers or retreat from further buying financial services.

The economic challenges currently faced by Pakistan impact the microfinance sector in numerous ways. The dire energy crisis has significantly stalled the economic growth of the country; it has forced the closure of hundreds of factories, paralyzing production and worsening unemployment. Many microenterprises are experiencing the brunt of the crisis, especially those situated in rural areas where power outages range from 14 to 18 hours during summers.

Though the rate of inflation has declined over the past few years, it still stands high as compared to the region. A high rate of inflation hinders the capacity to save and erodes the purchasing power of consumers. This can restrict the ability of low income households to use loans for productive purposes, and instead, results in loan diversion for consumption purposes. Moreover, inflationary pressures increase interest rates, which in turn, raise the cost of funds and makes loans more expensive for the end client.

For sound economic growth, there has to be substantial inflow of investment; the present rate of investment to GDP is approximately 14 percent, which is lower than that of other developing countries and emerging economies of the world. A high investment to GDP ratio will encourage new ventures (including micro-enterprises) and stimulate employment opportunities. MFPs are growing fast, developing their portfolios in sectors like SME, housing, consumer lending, et cetera. In order to support this growth and explore new avenues, it is imperative that investments (local and international) flow into the sector.

Unfortunately, little can be done by the microfinance industry to turn the macro-economy around. However, MFPs can mitigate the impact of macroeconomic downturns on themselves through various defense mechanisms which include building up equity and setting up a risk fund to absorb shocks during economic crises. MFPs should thoroughly assess client needs and focus on building relationships with clients, and in case of an economic downturn, MFPs should actively engage with clients to reschedule or refinance loans. Diversification of client base by sector, geography and income groups will also help in mitigating the macroeconomic risk.

Security

The second most severe risk is unique to the Pakistani context. The deteriorating law and order situation in the country is a major cause of concern for the business community countrywide. Since 2007, over 51,000 civilians have lost their lives in terrorist attacks and other incidents of violence like sectarian strife, ethnically motivated target killings, the nationalist separatist insurgency in Balochistan and criminal violence.

All four provinces have come under the influence of worsening security, with Balochistan and Khyber-

Pakhunkhwa (KPK) being the worst affected. Many MFPs have ceased their operations in the more sensitive areas of Balochistan and KPK.

The current state of security in the country affects MFPs directly and indirectly – indirectly by affecting the macro-economy and directly by hindering MFP operations. According to the views of an investor, the security situation in the country is shrinking the available market for MFPs as microfinance operations are decreasing rapidly in affected areas. Most institutes prefer to operate in the safer areas of Punjab and Sindh, while the affected areas are being excluded from access to formal financial services.

In terms of risk mitigation, MFPs should possess sufficiently indepth knowledge of the local communities and maintain good relationships with local leaders. MFPs can attain a diverse geographic spread to help allay risk. A practitioner responding to our survey suggested that the use of alternate delivery channels (branchless banking) can provide a safe means of distributing financial services to far-off insecure areas. At the sector level, setting up of a risk fund, that can be drawn from in the event of security-related incidents (among other triggers for risk fund draw-down) would protect MFPs.

Profitability

The risk of profitability is perceived to be severe in Pakistan's microfinance segment – especially among practitioners – since most of the MFPs are donor driven and financially unsustainable. Though start-ups are characterized by a larger dependency on donations, the long term sustainability of MFPs is dependent on their profitability.

Moreover, profitable MFPs are vital for maintaining the stability of the overall microfinance sector; low profitability weakens the capacity of microfinance providers to absorb negative shocks, which subsequently affects solvency.

The responses depict that 71 percent of the respondents are of the view that profitability can have a severe impact on the sector. The practitioner group has ranked profitability as the most severe risk among the stakeholders. This is true for many small sized MFIs which do not generate enough profits to sustain their operations and are dependent on funding.

However, at the same time, only 35 percent regard the profitability risk to be rising, whereas, barely 9 percent of the respondents consider the MFPs ability to cope with the risk as poor. Such positive feedback is backed by the changing trends in the profitably of the sector; over the past couple of years, the profitability of the sector has improved remarkably (Table 3). This progressive change has been primarily driven by microfinance banks and large scale MFIs which have recognized the need for building viable and sustainable institutions by devoting resources to improve efficiency and profitability.

TABLE 3: Profitability of Pakistan Microfinance Sector

	2010	2011	2012	2013
Net Income (PKR '000)	(15,696)	664,589	932,602	2,536,124
ROA	-0.1%	1.5%	1.6%	3.6%

Source: Pakistan Microfinance Review

In the long run, MFPs will need to generate ample profits to cover both their operational as well as financial costs. To achieve this, MFPs – especially small scale MFIs – need to revamp their business operations keeping productivity and efficiency as core goals to mitigate this risk. They must also revisit pricing structures and loan sizes in terms of pricing. The use of technology in operations and in building partnerships will help the sector increase productivity and improve efficiency. MFPs across the world have demonstrated that financial and social goals can be, and must be, achieved simultaneously.

Credit Risk

Credit risk arises from the late payment and/or non-payment of loan obligations. This risk includes both the loss of income resulting from the MFP's inability to collect anticipated interest earnings, as well as the loss of principal resulting from loan defaults.

Factors that worsen credit risk include over-indebtedness, irresponsible lending practices and weak internal control systems. Irresponsible lending practices are mostly influenced by competition, staff incentive structures, staff quality and inadequate market information.

Although it is one of the most severe risks being faced by the Pakistan microfinance sector, the ranking of credit risk has inched down a notch from the third most severe risk in the survey conducted in 2011 to the fourth most severe risk as per the current survey. Moreover, 45 percent of the respondents consider the risk to be a rising threat, which has fallen from 65 percent in the previous risk survey.

The positive change in the perceptions of respondents can be attributed to a number of factors. Firstly, the successful implementation of the Microfinance Credit Information Bureau (MF-CIB) across the country is facilitating MFPs in tackling over-indebtedness. Secondly, large sized MFPs have started focusing on credit risk management and improvements in portfolio quality by strengthening internal controls and systems and building staff capacity. Most MFBs have separate risk management committees to counter potential risks and improve portfolio quality.

What is interesting to note is that there are divergent views on credit risk within various stakeholder groups. On the one hand, a practitioner has pointed out that credit risk is falling as MFPs are *continuously enhancing checks and internal controls using modern technology*, whereas, a sector analyst has indicated that the risk is on the rise as there is a poor understanding among the microfinance institutions about differential needs of the clients. Similarly, a representative of Acumen Fund feels that the MF-CIB will help mitigate credit risk but there is little diversification in terms of exposure.

Potential measures to mitigate credit risk could include employing quality human resources and revisiting incentive systems, adopting a comprehensive 'know-your-customer' philosophy, developing due diligence procedures with uniform application, rethinking loan sizes, systemic use of MF-CIB and focusing on building long-term relationships. MFPs should develop strong risk exposure plans within each sector they operate in (or alternatively, for each product) and limit the proportion of their portfolios subjected to risk from one sector/product, thus, keeping a healthy risk-versus-growth balance. These levels of exposure should then be tracked and monitored through a strong MIS and by carrying out financial stress testing of sector/product portfolios.

Inappropriate Regulation

The ranking of inappropriate regulations has risen drastically and it is considered the fifth most severe risk as compared to its earlier ranking of twenty-fifth in the first risk survey conducted by PMN. Though respondents are of the opinion that the threat from inappropriate regulations would have a severe impact on the sector, most stakeholders feel that the threat is not something that MFPs cannot cope with nor is it gaining significant momentum.

The primary threat of inappropriate regulations stems from the fact that non-bank MFPs currently do not fall under any regulatory requirements while the Securities and Exchange Commission of Pakistan (SECP) is in the process of exploring a possible framework for regulating non-bank MFPs. Though regulations are the need of the hour, MFIs are uncertain about the impact the regulations will have on the operations of the institutions.

A similar response was recorded by a respondent who was of the view that so far, regulators have been careful and lenient with regards to enforcement but a poorly calculated move will have an adverse impact on the MFPs. A number of respondents have praised the prudential regulations for MFBs set out by the State Bank of Pakistan, highlighting the important impact such regulations have had on the stability and success of Pakistan microfinance sector.

To minimize the impact of inappropriate regulations, MFPs should build strong relationships with regulators to remain actively engaged in the dialogue process to effectively communicate any concerns pertaining to the sector.

Competition

The risk from competition arises when growth of existing providers and the entrance of new players push microfinance service providers to compromise their business methodology, while taking greater risks in areas such as pricing, product innovation and credit quality.

According to the survey, competition is considered the fastest growing risk in the sector where 69 percent of the respondents consider competition to be a growing threat. There has been a drastic change in the perception of respondents – in the previous risk survey, competition was hardly considered a major threat. However, over the last two years, the sector has undergone considerable growth in active borrowers and gross loan portfolio (see **FIGURE 1**). The growth in the sector has come on the back of various initiatives and developments such as the entrance of new players, branchless banking initiatives, product innovation and ease in the access to funds. Many large institutions are aggressively pursuing a growth strategy to enhance their share of the pie. Furthermore, the entry of new institutions into the microfinance market, mostly telecom companies with mobile payment systems, has increased the competitive pressure.

In order to ease the risk from competition, MFPs will need to explore untapped markets and introduce innovative product offerings tailored to the needs of the low end segment. However, it is important that MFPs focus on the quality of their human resource; as put by a respondent:

> ***"If MFPs are unable to expand to other regions, competition may rise but the current HR quality does not inspire confidence in their ability to work with innovative products/ pricing."***

Political Interference

Interference by governments and politicians in the microfinance business can harm the microfinance sector and distort the market. Political interference in the Pakistan microfinance segment was not considered a material threat a few years ago, but with the change in government in 2013, respondents now consider it to be a risk with substantial negative impact.

The new government in 2013 introduced two schemes for poverty alleviation and job creation: the Prime Minister (PM) Youth Loan Scheme and the Prime Minister (PM) Interest Free Loans. In the former scheme, loans are to be provided to young entrepreneurs at a subsidized rate, whereas, in the latter, interest free loans are to be provided to people living in poverty.

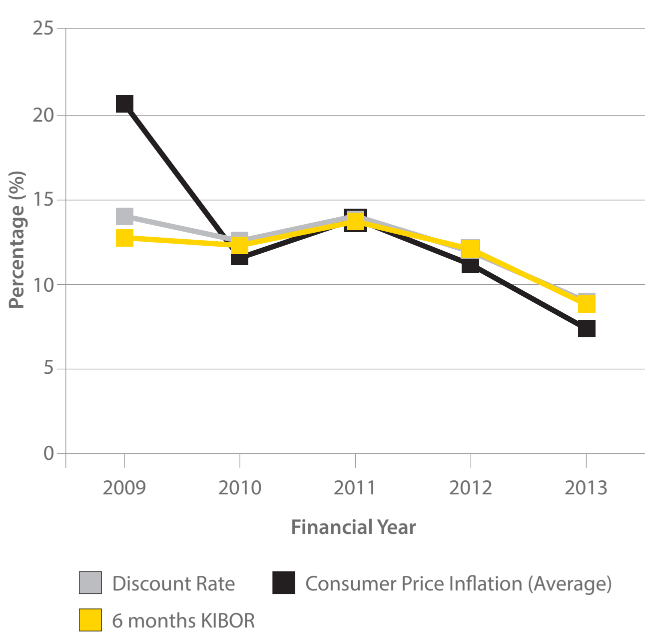
It can be argued that the target market of both these schemes does not overlap with the market of conventional MFPs but nevertheless many practitioners consider such government interventions to have negative implications for their businesses. There is little MFPs can do to counter political interference but there are steps they can take to minimize the impact of the interference; MFPs can develop strong contacts with the government to remain informed of such initiatives. MFPs can also use a collective platform (networks or associations) to raise their concerns and advise the government about the implications of interference. The sector has tried to manage the spillover effects of these schemes thus far through strong advocacy with the government and its implementing partners. In addition, creating more objective information around the profile of the poor and owning the narrative on the positive impact of microfinance is crucial to keep political interference at bay. Experience has also shown that having a strong regulator behind institutions can protect it from such risks (as with MFBs and the SBP). Thus creating regulatory cover for the non-bank MFIs could be an important tool in terms of managing such risks.

Interest Rates

Interest rate volatility can have severe implications for the microfinance industry; the balance sheets of most MFPs lack the robustness to absorb shocks from interest rate changes while the client base of MFPs is not in a position to take on higher rates, which could result in the deterioration of portfolio quality.

The transformation of MFPs in Pakistan from donor/subsidized funding to commercial sources of lending has made the sector sensitive to interest rate volatility. Even the national apex, the Pakistan Poverty Alleviation Fund (PPAF), has its lending rate tied to that of the Karachi Interbank Offered Rate (KIBOR). However, there has been an improvement in the ranking of interest rate risk and now less than 40 percent of the respondents consider it a growing threat as compared to 53 percent in the first risk survey. The improvement in the ranking can be backed by the drop in inflation to single digits in the fiscal year 2013, which eventually led to the lowering of the policy rate by the State Bank of Pakistan (**FIGURE 3**).

FIGURE 3: Discount Rate, 6-Months KIBOR and CPI



Source: State Bank of Pakistan

In terms of risk mitigation, the sector needs to improve its financial management. In the short-term, MFPs should carefully review their pricing structures and set mechanisms to ensure periodic reviews of rates. Additionally, asset and liability management in terms of duration gaps and rate sensitivity can be applied to hedge microfinance practitioner portfolios against interest rate risk.

In the long-term, the sector would do well to move to a deposit-based funding approach – in other words, take on less debt. Interest rate risk can be hedged against through dealing in financial instruments such as derivatives, and carrying out scenario analysis based on expected shifts in interest rates. This will, however, require institutions to focus on establishing strong risk management and finance functions.

Managing Technology

The mismanagement of technology can result in heavy losses for microfinance providers, as can the failure of capitalizing on new developments in IT. Many of the small and mid-sized MFPs operating in Pakistan have poor information and control systems and lack adequate skills and resources to improve their technology infrastructure.

The use of technology in microfinance has the potential for operational scalability and reduction in costs, notwithstanding its initial cost. However, this often proves prohibitive for smaller players to adopt. MFBs are more technologically advanced, especially the telco-based MFBs which are reshaping the provision of banking services to microfinance clients via mobile payments.

In terms of the responses recorded, 60 percent of the participants think that the mismanagement of technology can have severe implications for the sector, while more than 50 percent perceive it to be a rising threat. However, most of the practitioners were of the view that this risk was manageable and with the right infrastructure and resources in place, the risk can be mitigated to a great extent.

Natural Disasters

Over the past five years, the country has faced a series of floods across all provinces, severely hitting the portfolios of several microfinance providers. Unsurprisingly, the majority of respondents feel that MFPs have very little ability, if any, to cope with the risk from natural disasters.

In order to minimize the risk from natural disasters, MFPs need to spread their geographical presence and abstain from concentrating their portfolios in regions prone to natural hazards. Micro-insurance can play a vital role in this regard; MFPs should provide insurance coverage (livestock/crop) to their clients to safeguard portfolios from exogenous risks. Floods, the most commonly occurring disaster in Pakistan's context, tend to hit agriculture and livestock portfolios the hardest. Diversification into other lending sectors is important to hedge this risk. Also the government has launched a number of schemes to encourage lending to small scale agriculture and livestock by providing risk cover (to an extent). The sector should explore availing these schemes and advocate for changes in the schemes to make them a better fit for their own needs.

Operations

Risks posed from operations continue to be considered a mid-level risk, with many respondents claiming to see an improvement in an area which has traditionally been a low priority for MFPs. Only 22 percent of the respondents recognize the risk as a growing threat, whereas a mere 4 percent are of the opinion that MFPs lack the ability to cope with operational risk.

As highlighted earlier, MFPs in Pakistan have undergone significant growth in the past three years – expanding their loan books, introducing new and innovative products and adapting to new technology. However, managing operations becomes more challenging when MFPs are growing faster than their operational capacities, which leads to problems like fraud and credit risk. Moreover, many MFPs in Pakistan are small sized institutions and lack the capacity and resources to ensure an efficient back office operation. In the case of non-bank MFIs, the lack of any regulatory framework further makes them vulnerable to operational risks. Strong internal control systems and qualified back office staff can help prevent operational disasters.

Strategy

The lack of a sound strategy will leave MFPs redundant in today's competitive financial inclusion marketplace and call into question their long term sustainability. The majority of MFPs do not give much consideration to strategic risk and are more focused on the day-to-day running of the business. In the current challenging environment, it is imperative for microfinance providers to develop a holistic strategic framework to achieve their long term objectives.

According to the responses of the stakeholders, 56 percent are of the opinion that risk from strategy will have severe implications for the sector. Policymakers seem to be the most concerned and rank this as one of the top ten risks the sector faces today. Institutions do seem to realize that they must adapt to the changing environment, but there also seems to be an acceptance that some institutions will fail in this process.

Internal Fraud

Internal fraud refers to the risk posed by dishonest staff of an organization. Fraud remains a reality for MFPs, especially at the loan-staff level. Cash in the hands of corrupt staff leads to major problems in the smooth flow of disbursement and recovery, which eventually negatively impact profitability.

Though more than half of the respondents believed internal fraud to have a critical impact, only 11 percent of the respondents perceive the risk to be growing. With the sector now having several years of experience in field operations, it seems that respondents were confident that MFPs could control this risk internally, possibly using some form of disciplinary policy.

An investor has pointed out that the lack of proper governance leads to internal fraud while a practitioner mentions that fraud is mostly committed by professionals who do not focus on their career growth and often shift organizations.

A number of risk mitigation strategies are available as this particular risk is internal and hence, controllable. MFPs should review staff incentive and salary structures to pre-empt corruption in staff members that are pressed to resort to such measures due to harsh economic conditions. Making a strong example of corrupt staff when their fraud is exposed or resorting to litigation should be considered, in at least some instances, to convey a strong message of zero tolerance towards fraud. PMN also operates a staff bureau which can serve as a tool to manage information on frauds in the sector but its use to date has been limited.

Liquidity

Liquidity risk relates to the ability of MFPs to finance the short-term cash needs of their businesses. The ranking of liquidity has decreased significantly in the current risk survey where it is considered as the fourteenth most severe risk as compared to its position of fifth most severe risk in the previous survey.

The sharp decline can be attributed to a number of factors. One is tight regulations and close involvement by the State Bank of Pakistan to ensure microfinance banks remain adequately liquid. Another reason is the remarkable increase in deposits over the past few years as MFBs have adopted a strategy of deposit mobilization to fund their portfolios. Commercial financial institutions have always been reluctant to fund MFPs in Pakistan, but in the recent years, we have witnessed a change in the attitudes of commercial banks which are now more open to MFPs.

However, liquidity is still a major concern for many practitioners, especially non-bank MFIs which are legally restricted from mobilizing deposits. A respondent highlighted that MFIs focusing on agriculture markets are struggling with liquidity issues, and missing a season can severely impact their bottomline.

Management Quality

Management quality and skills are recognized as crucial elements in the success of any institution. Poor management quality in microfinance service providers can pose severe risks for the business. It is important that microfinance providers have strong and capable professionals at a time when the sector is growing in a fast changing landscape and competition is getting tougher.

The risk of management quality is higher for MFIs as compared to MFBs; the regulatory requirements ensure that microfinance banks are operated by a competent management. Moreover, MFBs have adopted a culture of hiring the best from within and outside the sector. As a sector analyst has pointed out,

> ***"MFBs are doing a good job and have good management."***

However, only a handful of large MFIs have qualified top tier management. Thus, most of the NGO-MFIs need to focus on their management quality and take solid steps to enhance their capacity in this area.

Reputation

Risk from reputation arises from negative public opinions which may affect the MFPs ability to sell product and services or impact its access to capital. Reputational risk has slipped down in ranking and currently stands as the sixteenth most severe risk as compared to the tenth most severe in the previous survey.

The change in perception of stakeholders is due to the fact that more and more MFPs are focusing on a client-centric approach and adopting client protection best practices. MFPs realize that growth at the expense of clients is not sustainable and does more harm than good.

Though the overall perception has improved, some feel that the recent steps taken by the Government of Pakistan (see Political Interference) can have harsh implications for the reputation of MFPs. A CFO of a leading MFI in Pakistan has indicated that,

> ***"The inadequate treatment of different MFPs by the government can harm the sector. Furthermore, the new schemes introduced by the government will also contribute negatively to the reputation of the sector."***

Too Little Funding

Limited access to capital has always been a key constraint for growth for MFPs in Pakistan. However, the risk from too little funding has been alleviated over the past two years as commercial financial institutions have become less stringent in their policies for lending to MFPs. Moreover, guarantee funds continue to play a vital role in facilitating MFPs to access funds from commercial banks.

Among the responses captured, 47 percent still perceive the risk to be a growing threat for the sector. Many stakeholders feel that with the current growth, the funding requirements of MFPs will further rise and hence, it will be challenging to raise sufficient funds from existing sources. Non-bank MFPs are more exposed to this risk as MFBs have been successful in meeting their funding requirements through deposit mobilization.

Transparency

The risk from transparency can cause microfinance providers to lose the confidence and trust of funders, partners and clients. Players shy away from taking steps to ensure full transparency to clients as they fear distortions in a level playing field. Consequently, backlash from political agents and the media may have to be faced. Nevertheless, many industry stakeholders felt that this was not a significant risk area.

For donors and investors, transparency is still perceived to be a prominent risk that will impact the sector. A representative of DFID (donor perspective) expressed that MFPs need to have robust reporting systems through which they can report the unique numbers of savers, borrowers and policy holders. This will help remove double counting and can improve the overall results and credibility of the sector, which in turn, will help reposition the sector on a more internationally competitive basis. An industry researcher also indicated that some institutions do not report reliable data.

Overall, the sector does not recognize transparency to be a growing threat and with the recent Transparent Pricing Initiative (a joint collaboration between PMN and MFTransparency) stakeholders are confident that the sector is moving towards transparency (see **BOX 1**).

BOX 1: Transparent pricing initiative

Under the initiative, pricing information was collected and standardized calculation methods employed to calculate Annualized Percentage Rate (APR) interest rates for all products of the participating MFPs. This was the first sector-led move towards greater transparency and standardization in pricing calculations and disclosures in the local industry.

Product Development

Product development has witnessed a substantial rise in its risk ranking as sector stakeholders have realized the importance of product development for the sector and the repercussions of not offering appropriate products tailored to client needs. The risk to microfinance service providers who offer poor or inappropriate products is that they will lose business and put their very existence at risk. Also, inappropriate products may also lead to issues of over-indebtedness at the clients' end and push them into using products that are not optimally suited to their business needs – an inefficient outcome.

Recent trends show that product development in the

Pakistan microfinance sector is gaining momentum and many MFPs are experimenting with innovative product offerings, especially in the field of branchless banking, micro-insurance and Islamic microfinance. A key criticism has been the small loan sizes which have not increased to keep pace with the eroding purchasing power due to inflation. We are now seeing a consistent increase in loan sizes as MFPs not only offer bigger loans to existing clients but also segment the market. Loans for small enterprises based on individual lending models, gold backed loans and loans for emergencies are now being offered also. Having said this, there is still a long way to go before growth in the sector is driven by innovation in products. Many MFPs still lack the resources and desire to conduct market research. A CEO of an MFI stated that,

> ***"The new wave of Islamic microfinance has prompted many MFPs to launch Islamic microfinance without having the proper knowledge or the proper mechanisms. This will not only harm the individual organization but also the Islamic Microfinance Sector."***

Corporate Governance

The lack of strong corporate governance in the microfinance sector has remained one of the primary concerns of regulators and donors. Work has been done to improve the quality of corporate governance in recent years, but the perception persists that many players in the industry have a low commitment to improving their leadership and do not, therefore, inspire confidence.

All the stakeholders had similar views on corporate governance. A CFO of a leading practitioner was of the view that small MFPs lack the ability for good corporate governance though PPAF and other stakeholders are investing in the sector to further build the capacity of all MFPs. A CEO of another MFI mentioned that there are many weaknesses at the Board level in the microfinance industry, especially across medium and small sized organizations. An industry analyst was also concerned about the gender imbalance at the Board level and suggested the need for a greater representation of women and their interests.

Risk mitigation for corporate governance rests largely with practitioners – they must first realize that all stakeholders are pointing at this risk, and then take steps to rectify it. As the sector goes into its maturity stage, both senior management of institutions and their boards will have to be of a high caliber. Donors can also ensure that funding is subject to improved governance by having independent directors on boards, setting up committees, and developing committee and Board terms of reference.

Unrealistic Expectations

The ranking of unrealistic expectations has slipped substantially in terms of severity, and the risk is not expected to rise in the future. Over the years, stakeholders have become more clear about the potential of the sector, and have aligned their expectations accordingly. The government and regulators had seen microfinance as a silver bullet for poverty and income inequality, but the expectations have been considerably rationalized after the experiences of the past decades. Institutions have also become more open and transparent about their objectives and capacity.

Though this risk does not pose any significant threat but MFPs should be careful in raising any unrealistic expectations of the general public as well as donors, which can also have significant impact on the reputational risk.

External Fraud

External fraud refers to the threat that originates from dishonest customers. With the sector now having several years of experience, it seems that respondents are confident that MFPs can control this risk due to improved customer relationship management and deeper involvement with communities. Similarly, MFBs have to fulfill the "know your customer" requirements for new customers as laid out by SBP. The risk is further mitigated with the sector-wide roll-out of the Microfinance Credit Information Bureau (MF-CIB) which is playing a vital role in determining the credibility of microfinance clients.

Staffing

Overall, the sector does not consider the risk of recruiting and retaining suitably qualified staff as a high-risk area. The optimism among stakeholders is based on the notion that MFPs are developing better human resource systems, are building the capacity of their staff and are reducing turnover.

However, on the flip side, many MFBs feel that the sector competes with commercial banks in terms of staffing and is not able to offer comparable compensation due to which human resource quality suffers. Given that nearly all stakeholders see a more or less steady trend in this risk, it seems there is acceptance that this is a challenge for the sector and will remain one that has to be dealt with constantly.

Mission Drift

The concept of mission drift in microfinance lies around the premise that the sector will "drift" away from its intended focus on social impact and towards more commercial objectives. According to the survey, many stakeholders are optimistic that the industry in Pakistan faces little mission drift – 36 percent of the respondents perceive the risk to have a severe impact while only 29 consider the risk to be a growing threat.

Some respondents have indicated that a 'double bottom line' approach has been adopted by the sector because either way, both the funders and the microfinance providers will not achieve their objectives if the financial objectives are prioritized over the social objectives or vice versa. A practitioner was, however, concerned about the sector's diminishing interest towards a double bottom line objective and stated that,

"This has over the time changed and only financial inclusion has become the key to the MFPs' work."

Ownership

The ownership structure of an institution drives its mission and practice, and any conflict or transformation at this level could pose risks to the institution. The results from the survey depict conflicting views on ownership among different stakeholders; less than 35 percent of the practitioners consider this to be a severe risk, whereas, almost 60 percent of donors and investors combined perceive ownership to have harsh implications for the sector.

There appears to be a disconnect between practitioners' views of the appropriateness and stability of MFP ownership structures and the views of other key stakeholders. It can be inferred that donors and investors are not confident about the ability of MFPs to handle risks that emanate from the structure of ownership (especially for non-bank MFIs which have a weak governance structure). Overall, this risk ranks very low and is of little concern for the sector at present.

Religious Influence

The threat from religious influence is especially relevant to the issues of interest rates. In regions considered relatively more religiously conservative, MFPs have found it extremely difficult to operate and grow through conventional MF products and services and there has been a steady decline in the provision of microfinance in such areas. Nonetheless, stakeholders do not consider this a prominent threat for the sector and its impact has reduced over time.

A reason can be the increasing popularity of Islamic microfinance in the sector; many MFPs are venturing into Islamic microfinance products, hence providing options for religiously sensitive customers. Having said this, MFPs entering the Islamic microfinance sector must be aware of the issues and the critical points of the sector in order to keep products Shariah-compliant.

Exchange Rate

Foreign exchange continues to be seen as a very low order risk, mainly because MFPs have low exposure to foreign currency – only a handful of MFPs (mostly MFBs) have foreign debt on their balance sheets. Nonetheless, a reasonable number of respondents feel that the exchange rate is a growing threat for the sector. Keeping in view the current growth of the sector, MFPs will have to explore commercial financing options from external sources. MFPs are also not allowed to deal or hedge against foreign currency directly which adds to the challenge of mitigating exchange risk.

Annexure:
Survey Questionnaire

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Survey Questionnaire

Section I: Who you are

1. Who you are:

Name ______________________________

Position ______________________________

Institution ______________________________

2. Please specify the stakeholder group you identify yourself with:

- ☐ Practitioner working in Pakistan
- ☐ Practitioner working outside Pakistan
- ☐ Donor
- ☐ Investor
- ☐ Regulator/policymaker
- ☐ Analyst/researcher
- ☐ Other (please specify) ______________

3. Please rank your familiarity with Pakistan's microfinance sector:

- ☐ Very familiar
- ☐ Somewhat familiar
- ☐ Not familiar

Section II: Your opinion in your words

Please describe in your own words the three main risks you see facing Pakistan's microfinance industry over the next 2–3 years, and your reasons.

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Section III: Matrix of Risks

In this section, there are some areas of risk for microfinance providers (MFPs) which have been attracting attention. How do you rate their severity, and what is their trend: rising, steady, or falling? How do you rate MFPs' ability to cope with these risks? Use the space provided for additional comments. You can also insert any additional risks at the end of this page if you feel that these were not included in this survey.

1. COMPETITION: Will competitive pressures push MFPs to take greater risks in areas such as pricing, product innovation, and credit quality?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

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2. CORPORATE GOVERNANCE: Are there weaknesses such as low calibre or lack of independence at board level of MFPs?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

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3. CREDIT RISK: Will MFPs be damaged by borrowers failing to repay their loans because of over-indebtedness, poor credit management, poor client understanding, or difficult economic conditions?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

4. FOREIGN EXCHANGE: Could MFPs be harmed by currency fluctuations?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

5. INTERNAL FRAUD: Will MFPs be damaged by dishonest staff?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

6. EXTERNAL FRAUD: Will MFPs be damaged by dishonest customers?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

7. INAPPROPRIATE REGULATION: Could MFP growth and profitability be constrained by bad rules?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

8. INTEREST RATES: Will MFPs be hurt by fluctuations in interest rates?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

9. LIQUIDITY: Will MFPs suffer a shortage of ready cash?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low
Trend: ☐ Rising ☐ Steady ☐ Falling
MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor
Please write additional comments in the following space:

10. MACROECONOMIC TRENDS: Are MFPs vulnerable to pressures in the wider economy such as inflation, recession, and low productivity?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low
Trend: ☐ Rising ☐ Steady ☐ Falling
MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor
Please write additional comments in the following space:

11. MANAGEMENT QUALITY: Is MFP management up to the challenge of growing business and managing risks?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low
Trend: ☐ Rising ☐ Steady ☐ Falling
MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor
Please write additional comments in the following space:

12. MANAGING TECHNOLOGY: Will MFPs be able to master this new area?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

13. MISSION DRIFT: How strong is the risk that MFPs will be deflected from their stated missions?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

14. NATURAL DISASTERS: Can the sector cope with the threat of another wide-scale natural disaster?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

15. OPERATIONS: How vulnerable are MFPs to risks in administration, accounting systems, and controls?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

16. OWNERSHIP: Are MFP ownership structures appropriate and stable?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

17. POLITICAL INTERFERENCE: Will political interference harm MFPs in areas such as interest rates, lending policy, and subsidized competition?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

18. PRODUCT DEVELOPMENT: Could MFPs fail to develop the right products and manage them successfully?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

19. PROFITABILITY: Could inadequate profitability affect MFP growth and commercial viability?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

20. RELIGIOUS INFLUENCE: Is there a risk to the sector from religious elements?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

21. REPUTATION: How severe are the threats to the industry's reputation?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low
Trend: ☐ Rising ☐ Steady ☐ Falling
MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor
Please write additional comments in the following space:

22. SECURITY: Does the currently volatile security situation of Pakistan pose a serious threat to microfinance?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low
Trend: ☐ Rising ☐ Steady ☐ Falling
MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor
Please write additional comments in the following space:

23. STAFFING: Will MFPs have difficulty recruiting and retaining good staff?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low
Trend: ☐ Rising ☐ Steady ☐ Falling
MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor
Please write additional comments in the following space:

24. STRATEGY: Will MFPs be able to map strategies to survive and grow in today's challenging environment?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

25. TOO LITTLE FUNDING: Will there be sufficient funding to sustain healthy growth in the industry?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

26. TRANSPARENCY: Do MFPs report enough good information to sustain confidence in the sector?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

27. UNREALISTIC EXPECTATIONS: Do people expect too much from MFPs? What happens if they do not deliver?

Severity: ☐ Very high ☐ High ☐ Average ☐ Low ☐ Very low

Trend: ☐ Rising ☐ Steady ☐ Falling

MFPs' ability to cope: ☐ Excellent ☐ Good ☐ Average ☐ Poor

Please write additional comments in the following space:

Pakistan Microfinance Network

ASSOCIATES

- Mehran Educational Society
- SVDP
- BAIDARIE
- Organization for Participatory Development
- SAATH

AFFILIATES

- ASASAH
- brac
- Kashf Foundation
- SRSP – Sarhad Rural Support Programme
- PRSP
- SRSO
- GBTI
- FFO – Farmers Friend Organization
- Waseela Microfinance Bank Ltd.
- Mojaz Foundation – Lets Bring Change
- U Microfinance Bank
- Micro Finance apnabank Limited
- Pak Oman Microfinance Bank Limited
- NRSP Microfinance Bank Limited
- Sungi
- JWS
- Safco Support Foundation – Bridge is the progress
- ORIX Leasing Pakistan Limited
- CSC
- WASIL – Connecting People to Opportunities

MEMBERS

- Tameer Bank
- The First MicroFinanceBank Ltd. Pakistan – Enabling Individuals
- khushhalibank limited
- FINCA Microfinance Bank, Ltd. – Formerly Kashf Microfinance Bank Ltd.
- AKHUWAT
- OPP-OCT
- DAMEN
- RCDS
- TRDP – Thardeep Rural Development Programme
- NRSP – National Rural Support Programme

ALLIANCES

- B.W.T.P. – Banking With The Poor Network – Asia's regional microfinance network
- DataCheck
- seep – Powering connections
- Social Performance Task Force
- mftransparency.org
- SAMN – South Asian Microfinance Network
- mix
- the smart campaign – Keeping clients first in microfinance
- SBI

Pakistan Microfinance Network

Pakistan Microfinance Network
117, Street 66, F-11/4, Islamabad, Pakistan
Telephone: +92 51 2292231 / 2292270
Fax: +92 51 2292230
www.pmn.org.pk