Pakistan

POLICY, REGULATORY, AND SUPERVISORY COVID-19 RESPONSES FOR MICROFINANCE

CGAP BACKGROUND DOCUMENT

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The Pakistan Microfinance Network (PMN) partnered with CGAP to write this note. The PMN is the microfinance industry association whose membership includes microfinance banks and non-bank microfinance companies. Since COVID-19 began, the PMN has been very active in working with microfinance providers and regulators to respond to the changing situation.

This note is part of a series of CGAP background documents that examine the impact of the COVID-19 crisis on microfinance at the country level and focus on policy and regulatory responses adopted by financial authorities in each country. The notes are based on interviews and review of publicly available materials, and, in some cases, with written input from key stakeholders in the microfinance sector. Coverage is from the onset of the crisis through mid-June, although the situation continues to evolve.

Country context and COVID-19 containment measures

Pakistan confirmed its first COVID-19 case in February 2020. Since then, there has been a steady increase in the number of confirmed cases throughout the country and a range of measures have been implemented to delay and contain the spread of the virus. These included quarantining travelers from Iran, closing borders with all neighboring countries, international travel restrictions, social distancing measures, and lockdowns of differing scales across the provinces of the country. A nationwide lockdown began in March. In the early weeks it was strictly enforced, but enforcement measures became gradually less strict after that. All the provincial governments implemented varying degrees of lockdown as well. Overall, the Prime Minister has been resistant to lockdowns due to the negative impact on the poor and daily wage earners.

On 9 May 2020 Pakistan began easing its month-long lockdown despite a steady rise in the number of coronavirus cases. The first phase of easing began when the Government announced it would allow more businesses to open and operate from dawn to 5 pm. Congregational prayers in mosques during the month of Ramzan were also allowed after the clerics agreed to follow Government guidelines on social distancing.

Fallout from the pandemic is pushing millions into unemployment and poverty. The International Monetary Fund estimated that Pakistan's economy would shrink by 1.5 percent this fiscal year, compared to 3.3 percent growth in 2018-19. The World Bank projected the decline would be 1.3 percent. At least three million people will likely lose their jobs – one million in the industrial sector and two million in the services sector. The poverty headcount is expected to rise from 24.3 percent to between 29 percent and 33.5 percent.

According to the Ministry of Finance, Pakistan's fiscal deficit will be significantly worse than projected for the fiscal year ending in June 2020. Government projects a budget deficit in the current fiscal year as high as 9.4 percent of GDP, up from a pre-crisis estimate of 7.4 percent. This reflects a shortfall in revenues, re-prioritizing of expenditures and an increase in public spending.

The microfinance sector

In comparison to many countries, Pakistan's level of formal financial inclusion is low. Findex 2017 found that account ownership among adults stood at only 21 percent. This is despite a well-established and diverse range of entities providing microfinance and other financial services.

The microfinance sector is generally understood to be made up of 11 microfinance banks (MFBs) and 40 nonbank microfinance companies (NBMFCs). The MFBs are licensed and regulated by the State Bank of Pakistan under the Microfinance Institutions Ordinance 2001. MFBs are deposit taking entities governed under prudential regulations that are separate from those of commercial banks. The NBMFCs are licensed and regulated by the Securities and Exchange Commission of Pakistan (SECP) under special guidelines approved in 2016

for microfinance non-bank finance companies under the Companies Ordinance. The table below shows the size of the sector at the end of 2019.

	TOTAL	MFB SHARE	NBMFC SHARE
Active Borrowers	7,249,943	49%	51%
Gross Loan Portfolio (USD millions)	16,767	70%	30%
Average Loan Size (USD)	296	-	-
Number of Savers	47,642,271	100%	-
Value of Savings (USD million)	1,677	100%	-
Number of Policy Holders	8,479,576	32%	68%
Value Insured (USD millions)	1,671	51%	49%
Number of branches/units	4,036	35%	65%

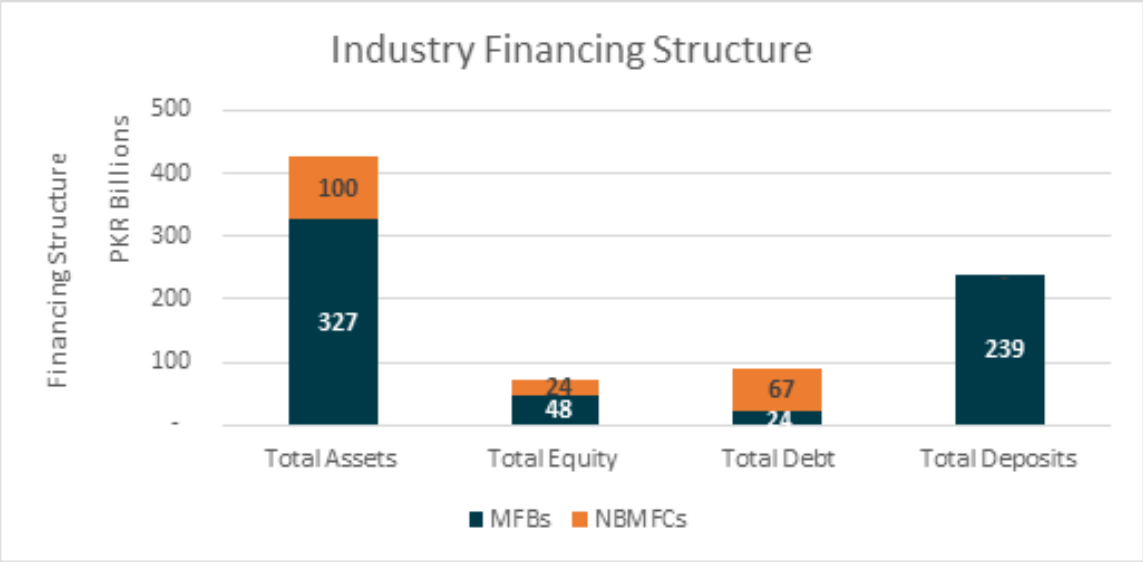
Source: Microwatch December 2019

In addition, there are eleven digital payment (branchless banking) providers, of which four (JazzCash, EasyPaisa, HBL and UBL Omni) have more than 80percent of the 46 million accounts. There are more than 400,000 agents associated with these digital payment providers. They are regulated by the SBP under the Branchless Banking Regulations approved in 2009. In 2020, the SBP also began to issue licenses under its new Electronic Money Institutions (EMI) regulations. So far six EMIs have been authorized to begin operations.

Another important player in the microfinance sector is the Pakistan Microfinance Investment Company Limited (PMIC), a national-level apex institution for MFPs. The PMIC's investors are the Pakistan Poverty Alleviation Fund, Karandaaz Pakistan (backed by DFID) and KfW Development Bank. A World Bank project also channels some on-lending funds through the PMIC.

In 2019, the growth of the microfinance sector was strong: 11 percent annual growth in gross loan portfolio, 12 percent annual growth in savings deposits, and 7 percent annual growth in the value of insurance policies held by customers. Most microcredit goes to poor people, especially women, and to micro and small entrepreneurs in the informal sector. Some 53 percent of microfinance clients live in rural areas.

The graph below shows the financing structure of MFPs at the end of 2018.



Portfolio quality was deteriorating before the COVID-19 crisis. Portfolio at risk (30-day basis) had increased from 1.6 percent in 2018 to 4.7 percent in 2019, driven mainly by MFB portfolio at risk increasing from 2 percent to just over 6 percent. A challenging macroeconomic environment characterized by double-digit inflation and a slow-down in economic activity negatively impacted borrowers' capacity to repay. For MFPs, concentration of credit in certain market segments and geographies led to over-indebtedness and an increase in default rates.

Impact of the pandemic on MFPs

According to data reported to the PMN, in February 2020, MFPs achieved a 98 percent loan repayment rate. This declined to 81 percent in March and 34percent in April[1]. This was partly due to loan moratoria and partly borrowers losing their incomes. There was wide variation in repayment rates across MFPs, but no significant difference in the average for NBMFCs and MFBs. The sectors that have been affected the most so far are service sectors and retail. The agriculture sector has been less affected.

On 27 March 2020, the central bank announced debt relief measures for individuals and businesses. Repayments on principal could be delayed by up to one year upon request from the client. MFPs initially announced a moratorium of one month on loan repayments for all their clients, though some clients still chose to pay their loan installments. The PMN has been tracking loan repayment rates of the NBMFCs and MFBs. They estimated the May 2020 repayment rate for all MFPs combined at about one third of loan amounts due, about the same as it was in April.

Many MFPs expressed a desire to use this crisis to accelerate the shift towards digital financial services and mobile banking. They worry, however, that it will be a struggle to 'go digital' within a business model that is so reliant upon close personal relationships with clients. A survey conducted by the PMN in April to gauge the impact of the crisis on MSEs

[1] COVID-19 and the Future of Microfinance: Evidence and Insights from Pakistan. LUMS, University of Oxford, New York University, Lahore School of Economics. April 2020

revealed that only 11 percent of microfinance clients were using digital channels and another 33 percent were even willing to do so.

Policy, regulatory and supervisory measures affecting regulated MFPs

Enable continued, safe operations by MFPs

NBMFCs were not designated as essential services by the federal government and it was left to provincial authorities to decide if they could operate or not. Except for the province of Punjab, branches of NBMFCs remained closed. More recently as the lockdown was eased, NBMFCs were able to open branches in other provinces as well.

MFBs, on the other hand, were declared essential services and allowed to operate, but with reduced staffing. Loan officers were given guidelines on communication with clients and social distancing. Even so, loan officers faced difficulties in moving around as public transport was not available as a result of lockdown measures.

The central bank has taken steps to promote digital transaction methods as an alternative to branch or ATM visits. These measures apply to MFBs. The central bank has waived inter-bank charges on digital funds transfers; temporarily allowed MFBs to use NADRA's online verification system in place of requiring customers to do fingerprint biometric verification for account opening and transaction verification purposes; and encouraged MFBs to introduce electronic account opening forms to acquire and record information required under AML/ CFT regulations.

Client relief[2]

At the beginning of the lock-down, the SBP announced up to a one-year deferment of principal payments announced for customers who requested it. This applied to all banks, including MFBs. At the same time some MFPs (MFBs and NBMFCs) announced a one-month moratorium on loan repayments for all customers. As the lockdown continued into April, most MFPs extended deferment of loan repayments up to six months.

The SBP took some steps aimed at helping households and businesses, including the customers of MFBs and NBMFCs. The SBP cut the policy rate by a cumulative 525 basis points to 8 percent over a span of two months with the objective of providing liquidity support to households and businesses as incomes and revenues declined during the crisis. The policy rate cuts helped maintain credit flows, bolster the cash flow of borrowers, and support asset prices. The SBP also took steps to provide relief to businesses employing large numbers of people. In March 2020 it announced some support for paying employee wages and later on increased the level of support[3] to cover employee wages for businesses with three-month wage bills up to USD 3 million. For businesses with three-month wage bills exceeding USD 3 million, the central bank will finance up to 75 percent capped at USD 6 million. This facility was also extended to non-deposit taking financial institutions.

The Ministry of Finance and the SBP introduced a risk-sharing mechanism[4] to support bank lending to SMEs. The SBP provided USD 180 million for this facility to share the burden of loan losses across the next four years. Under this arrangement, the government will bear 40percent of the first loss on the principal portion of the disbursed loan portfolio of banks. SMEs and small corporates with annual sales turnover of up to USD 12 million are eligible

[2] More details on measures for client relief can be accessed here: http://www.sbp.org.pk/corona.asp
[3] http://www.sbp.org.pk/smefd/circulars/2020/CL10.htm
[4] http://www.sbp.org.pk/smefd/circulars/2020/C9.htm

for this scheme. Discussions are underway with the Ministry of Finance, SBP and SECP to make this facility available for NBMFCs as well.

The banking sector's overall pool of loanable funds has been increased. The capital conservation buffer has been reduced from 2.50 percent to 1.50 percent to release liquidity for banks to lend to businesses and households. The regulatory limit on extension of credit to individual SMEs has been permanently increased to USD 1.1 million from its previous limit of USD 0.8 million. This measure is expected to encourage banks to provide more loans to SMEs.

The central bank also increased individuals' borrowing limits for one year by relaxing the debt burden ratio[5] for consumer loans from 50 percent to 60 percent for all banks. While payment of principal on loan obligations will be deferred by banks for up to a year upon receiving a written request from the client (by 30 June 2020), the mark-up[6] will continue to be serviced. The deferment of principal will not affect a borrower's credit history as it will be reported as a regular outstanding loan in the credit bureau's data. Borrowers can also apply for rescheduling/restructuring loans if they are not able to make mark-up payments. For borrowers whose financial condition requires relief beyond the one-year extension, SBP has relaxed the regulatory criteria for restructuring loans. Loans restructured within 180 days of the due date of repayment of installment will not be treated as defaults.

The SECP has allowed NBMFCs to defer repayment of principal loans by their borrowers for up to a maximum one year provided that the mark-up will continue to be serviced. The deferment will not be reported in the credit bureau's data and the credit history of the borrower will remain unaffected. For borrowers whose financial condition requires relief beyond one-year deferment of the principle amount, SECP may reschedule/restructure if request is received within 90 days of loan being overdue.

Liquidity to MFPs

Liquidity is one of the critical challenges faced by the microfinance industry. Several key actors are involved in mounting a response. The central bank is continuously reviewing the liquidity and risk profile of the MFBs. A similar exercise was conducted for NBMFCs and shared with SECP. The regulators are in discussions with a range of stakeholders[7] on responses to the liquidity question. The aim is to ensure access to liquidity for MFPs to cover operational costs as well as to establish refinance facilities for micro and small enterprises. The authorities are reviewing the possibility of making the SME risk participation facility available to the entire microfinance industry, including NBMFCs.

The MFBs, as deposit-taking entities, do not have severe liquidity challenges as yet. Their deposits have remained relatively stable and are diversified. However, since MFBs do not have scheduled bank status (for being a separate specialized law), they are unable to access SBP's liquidity window. Expanding access to the window would require SBP to amend the regulations. Other measures under discussion include easing prudential standards such as the cash reserve ratio, statutory liquidity requirements and the capital adequacy ratio. SBP has also "advised" banks (including MFBs) to suspend dividend payments to investors for the first two quarters of 2020.

[5] The debt burden ratio is total disposable annual income as a percentage of total outstanding debt. The change referred to here allows consumers to borrow larger amounts.
[6] This refers to amounts owing to the creditor, whether in the form of interest or *Shar'ia*-compliant earnings.
[7] The stakeholder committee includes representatives from the Pakistan Microfinance Network, the Pakistan Microfinance Investment Company, and the National Rural Support Programme.

The NBMFCs, in the absence of a lender of last resort and for not taking deposits, are generally more vulnerable to sharp declines in revenues and other risks as compared to MFBs. In addition, NBMFCs are faced with uncertainty about their own credit lines from domestic banks due to an increase in perceived risk associated with the microfinance sector. Credits from commercial banks make up an estimated 35percent of NBMFC financing.

In response, SBP has said it expects commercial banks to seriously consider rescheduling their loans to NBMFCs, and SBP intends to investigate any denials to see if they are justified. The SECP has allowed NBMFCs to raise more tier two capital and it has raised ceilings on subordinated loans that may be issued by PMIC and other investment companies.

Other stakeholders are stepping in. The PMIC, which mostly lends to NBMFCs, has rescheduled all loans to MFPs and in certain cases also deferred payment of markup. PMIC is in discussions with various donors to beef up its own liquidity offering, but it needs to underwrite the risk through a guarantee instrument. The World Bank and ADB have shown interest in providing liquidity support. SMEDA is also in discussion with the federal government and the industry to finalize a financial support package for the MSMEs. Lastly, tax refunds amounting to USD 1.5 million for MFPs are being considered.

Reduce regulatory/supervisory burden on MFPs

Both the central bank and SECP have offered regulatory relief in financial reporting. SECP has given an extension of 30 days until the end of May 2020 to hold NBMFC annual general meetings for the year 2019 and suggested they be held remotely; it has extended the filing deadline by 30 days for any statutory return required to be filled on or after 24 March 2020 without incurring any penalty. SECP deferred the deadline for implementation of International Financial Reporting Standards (IFRS) 9 (related to provisioning according to expected loan losses) to 30 June 2021. For onsite inspection of company documents and certification, SECP has issued guidelines aimed at preventing the spread of COVID 19.

MFBs are covered by the same measures announced for all banks and development finance institutions. This includes extending the deadline for starting the implementation of IFRS 9 to 31 August 2020.

Solvency

One of the challenges faced by the industry is to ensure that cash flow and balance sheet insolvency are managed. Due to stable deposits, MFBs are currently well placed to manage their cash flows. However, for NBMFCs the challenge remains since they still owe repayments to commercial banks and the apex microfinance fund, PMIC. Relief provided by the two regulators through deferment and rescheduling of their repayments to PMIC and commercial lenders was much needed during the crisis.

By the end of May, the economy was re-opening and the end of the initial deferment period for loan repayments had not arrived yet. The situation will become clearer when the time for repayment arrives. Some customers may have lost their source of income altogether and be unable to repay, while other customers might require fresh loans to help generate enough cash flow to repay. Some MFPs may become insolvent, especially given that NPLs had risen to worrying levels before the COVID 19 crisis. SBP regulations include provisions related to insolvency of MFBs whereas the SECP has no such provisions for NBMFCs, something that would need to be put in place. A more serious issue of balance-sheet insolvency can arise if there is a second wave of COVID 19 cases and the lock-down is re-imposed. Recently, a discussion began about creating a disaster risk fund to provide liquidity

to MFPs in future disasters. This discussion is supported by the federal government and includes the regulators, donors and MFPs.