MicroNOTE

No. 42 October 2019

The How & the Why of Microfinance Lending Rates

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Executive Summary

Concerns being raised about the lending rates charged by microfinance players are as old as the history of microfinance. Microfinance industry aims to provide financial services to the unbanked,comprising predominantly lower income strata of the society. Financial services are generally complemented with non-financial services provided to clients.

The paper below explains the status of the microfinance industry in the country and highlights the critical role being played by it in furthering the financial inclusion agenda in the country. Following this the paper delves into determinants of the microfinance lending rates and compares it with the region. Towards the end, the paper then sheds light on how eventually costs can be rationalized resulting in building efficiency and reducing costs.

Background

The Microfinance Industry in Pakistan is working towards achieving financial inclusion goals set out by the government as per National Financial Inclusion Strategy (NFIS)[1] , as amended in 2019[2] . At present there are more than 46 microfinance providers (MFPs) in the country including 11 Microfinance Banks and 26 Non-Bank Microfinance Companies (NBMFC). Currently, the microfinance outreach stands at 7.14 million borrowers with a Gross Loan Portfolio of over PKR 293 billion as of June 30th, 2019. In the same time period, micro-savers stand at 37.7 million with value of savings of over PKR 249 billion whereas the total number of insurance policy holders are 8.75 million and sum insured of PKR 260 billion[3] .

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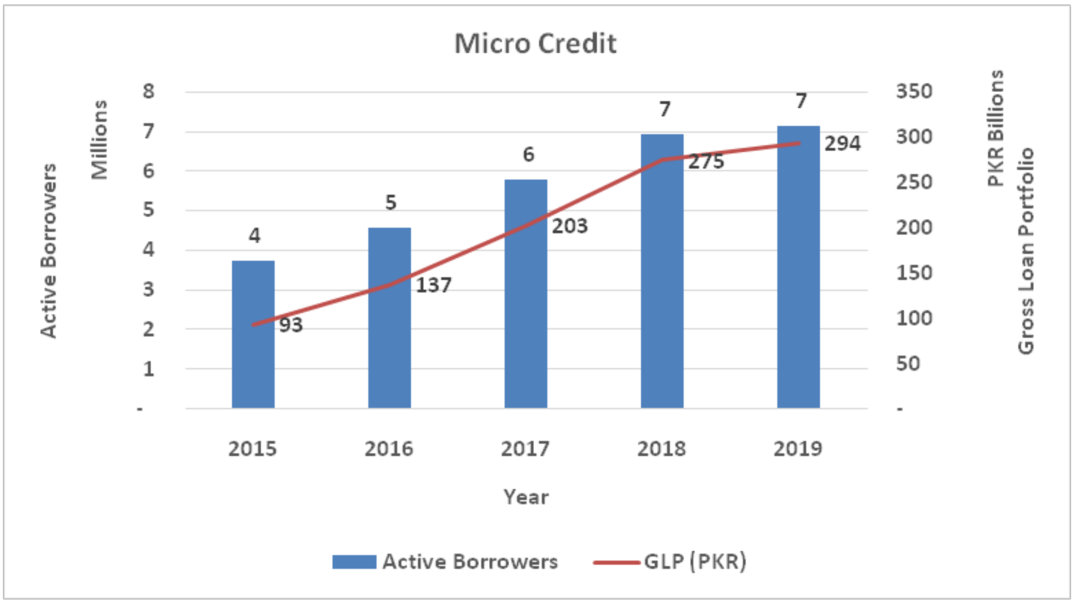
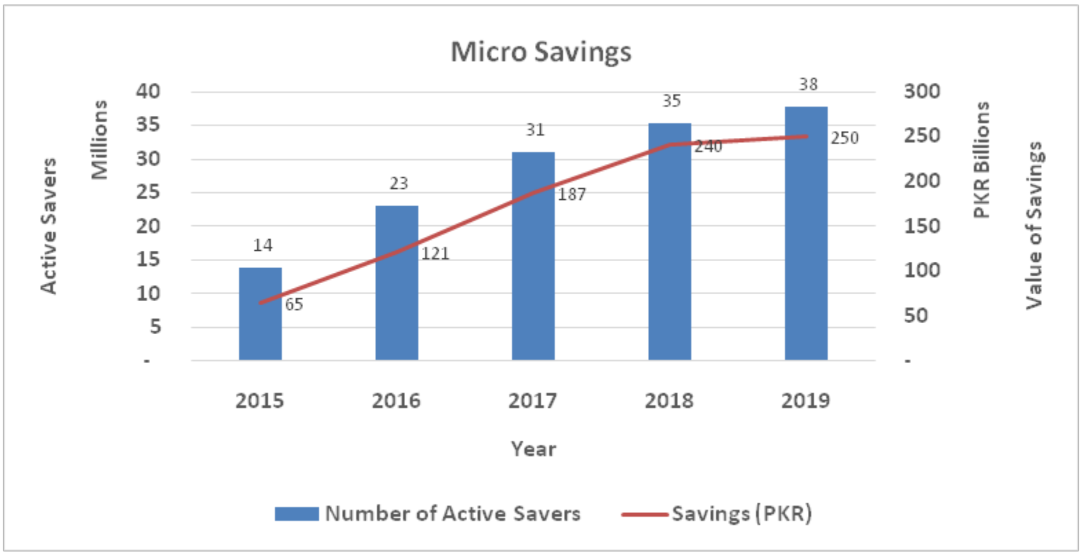
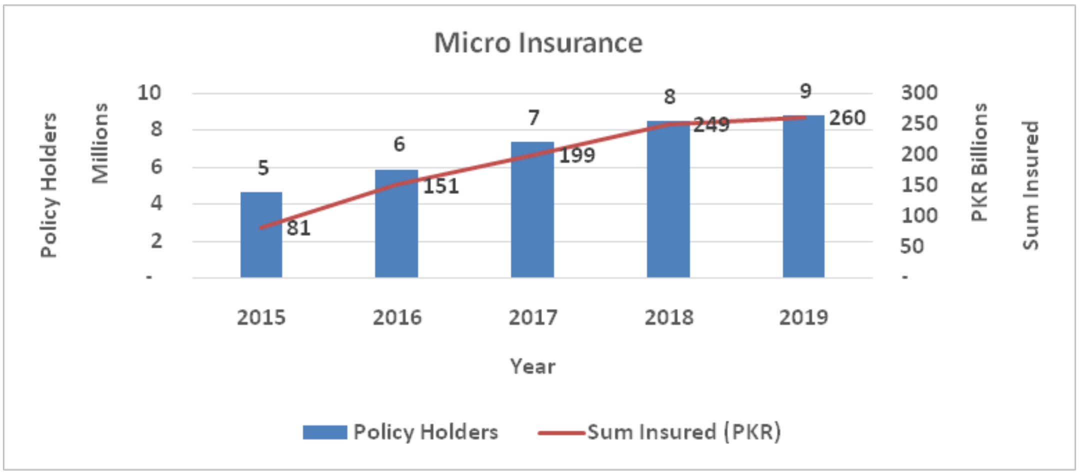
1 National Financial Inclusion Strategy, Pakistan – State Bank of Pakistan
2 National Financial Inclusion Strategy, Government's 100 – days Agenda, Ministry of Finance
3 MicroWatch: A Quarterly Update on Microfinance Outreach in Pakistan (Issue 52) – Pakistan Microfinance Network

Figure 1: Microfinance Outreach as of June 2019

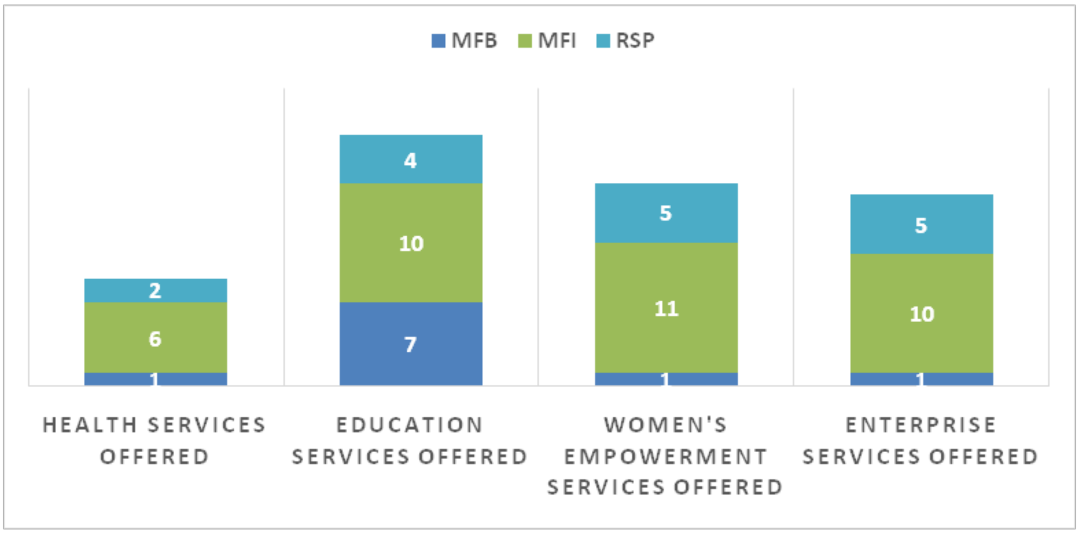






At present MFPs are not only providing credit but also savings, insurance and remittance services to its clients as depicted in figure 1. Life and Health insurance is generally extended to borrowers, though separately priced but included in the overall lending rate charged to the client. Moreover, in order to achieve the double bottom line objectives as a mission driven industry several non-financial services like enterprise development trainings, health and education service is also extended to the microfinance clientele. Figure 2 below shows the types of Non-financial services offered by these MFPs. These services add to the overall costs of the MFPs.

Figure 2: Types of Non-Financial Services offered by MFPs[4]



4 Pakistan Microfinance Review 2018: Annual Assessment of the Microfinance Industry – Pakistan Microfinance Network

The microfinance industry particularly targets marginalized segments of the society such as women and small-scalefarmers. Moreover, the industry is continuously striving to bring the informal economy into the ambit of the formal economy. Additionally, the sector also plays an important public policy role by creating and supporting jobs. It is estimated that on an average per loan disbursed, 0.11 jobs are created, while another 0.31 jobs are supported. This can be translated into the statistic that by December 2018, between 770 thousand to 2.17 million jobs have been created and supported by the microfinance industry in Pakistan[5] .

Figure 3: Proportion of Women Borrowers & Depositors[6]

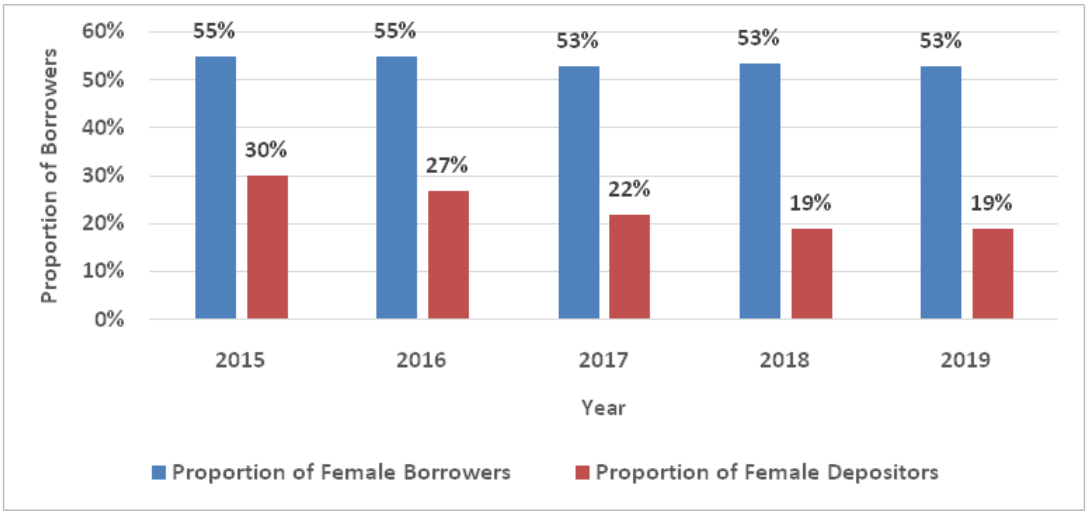
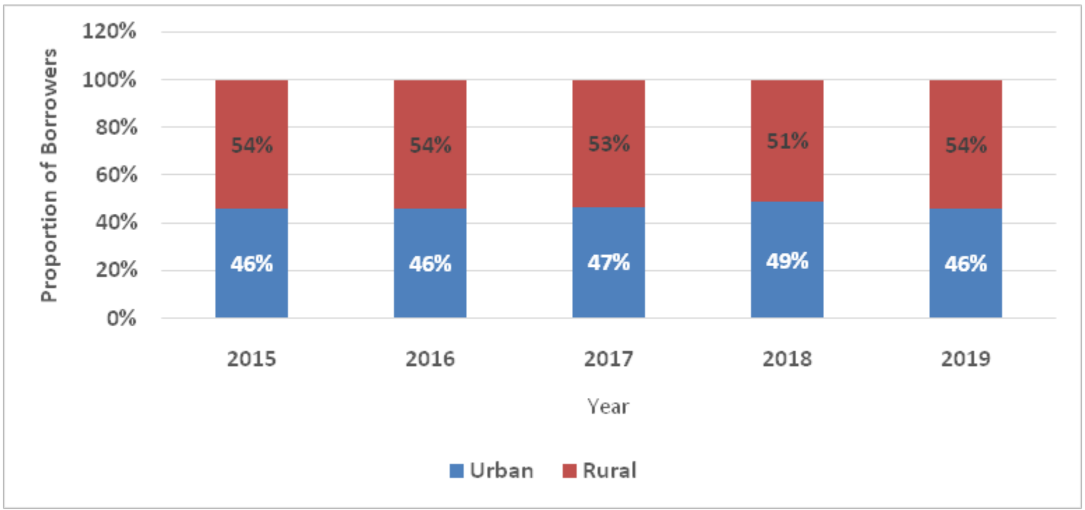


Figure 4: Proportion of Urban and Rural Outreach[7]



The financial inclusion policy in Pakistan follows a continuum that stratifies poverty into market segments and focuses on graduation. This is an excellent public policy tool which uses the poverty scorecard as a community-driven integrated development model. With the help of this model, the subsidy from the government sector is targeted for the poorest segment through the Benazir Income Support Programme or BISP for individuals that score below 16.17 on the score card. This is followed by cash transfer programs and interest free loan programs which are provided to individuals that lie between the scores of 16.17 to 40.

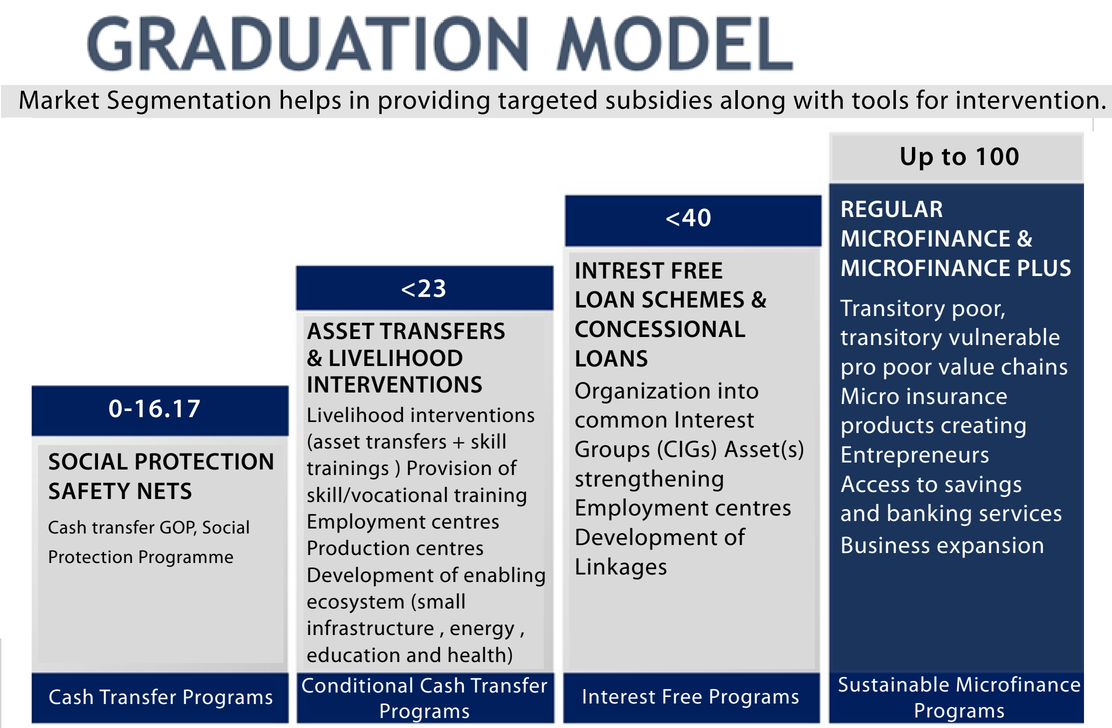
5 Microfinance & Enterprise Growth; Evidence from Pakistan 2019 – Pakistan Microfinance Network (Yet to be published)

6 MicroWatch: A Quarterly Update on Microfinance Outreach in Pakistan (Multiple Issues) – Pakistan Microfinance Network

7 Ibid

In contrast, sustainable microfinance operates in the segment of a poverty score of 35 and above, where subsidy is only for market development and removing market distortions. The focus globally and within Pakistan is now on "Graduation Models" where these clients are graduated and linked upwards. The figure below gives a brief outline of the "Graduation Model" that is in place.

Figure 5: Graduation Model by the Pakistan Poverty Alleviation Fund (PPAF)

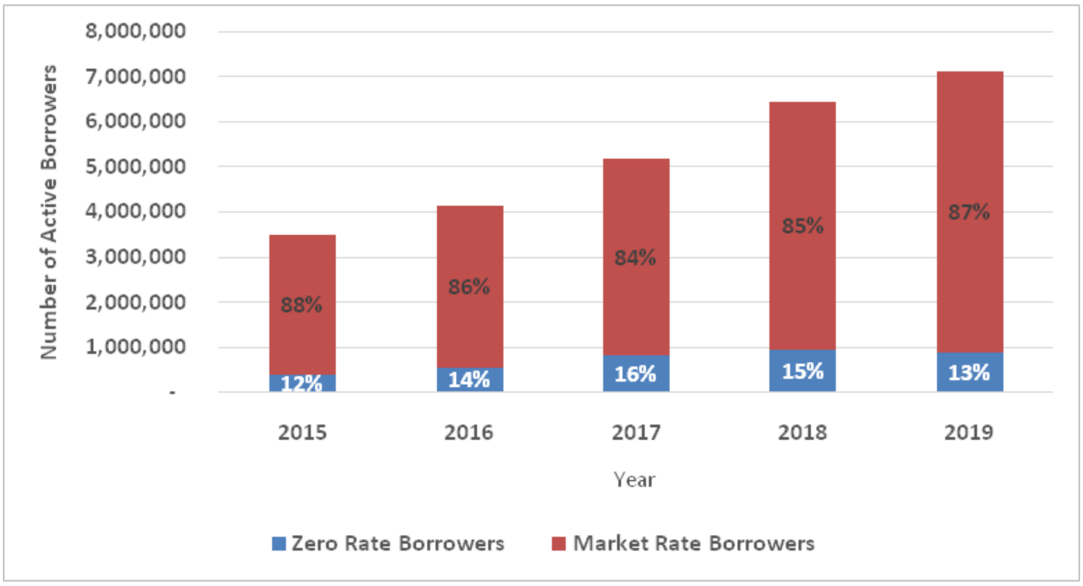


Cash Transfer Beneficiaries	Interest Free Loans	Sustainable Microfinance
6.5 Million beneficiaries	1.38 Million Active Borrowers	5.8 Million Active Borrowers

Lending Rates & Industry Yield on Portfolio

MFPs provide lending products to clients at varying rates. Certain impoverished and other marginalized segments, as indicated above, are also provided zero rate loans to facilitate them not only in the form of financing for businesses but also financial relief. Currently, the effective lending rates are broadly in the range from 0 percent to 40 percent, while, as of June 2019, approximately 13 percent of the total clientele of the sector was provided interest free loans. The following figure shows the proportion of interest free and market rate borrowers.

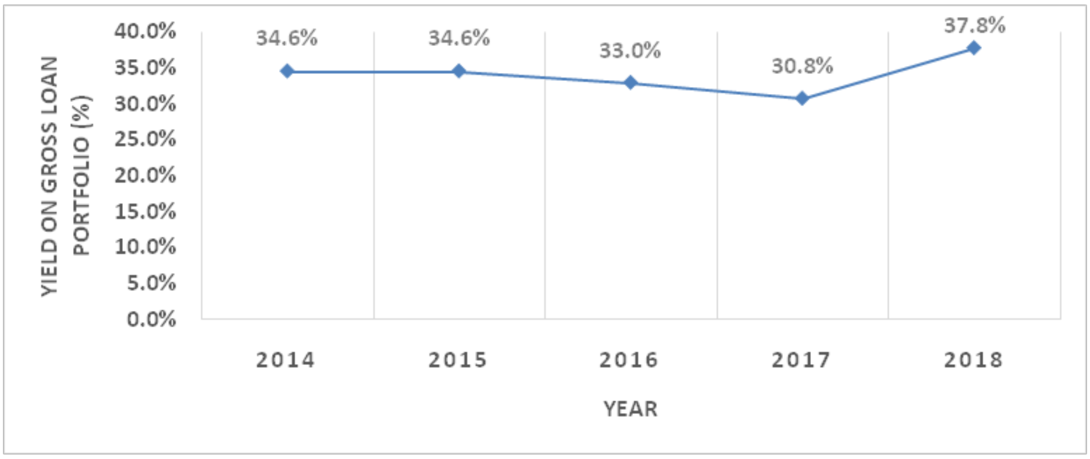
Figure 6: Market rate vs Zero rate borrowers



Both the regulators; the State Bank of Pakistan (SBP) and the Securities & Exchange Commission of Pakistan (SECP), have been pursuing a market-based regulatory approach in the post banking reforms era (1990 onwards). In accordance with this approach, regulators do not intervene in a banks' lending rates. On the contrary, lending rates are determined by market conditions, borrowers' profile and associated risks, cost of funds and the operating cost.

For the purpose of this study, the Yield on Portfolio is used as a proxy of the effective lending rate of the industry. It is defined as the total income from loans as a percentage of the average Gross Loan Portfolio of the sector. This yield was almost 38 percent for MFPs in the year 2018 after experiencing a downward trajectory in the previous years. The trend in the nominal Yield on Gross Loan Portfolio over the last few years can be observed from the figure below.

Figure 7: Trend in the Yield on Gross Loan Portfolio[8]

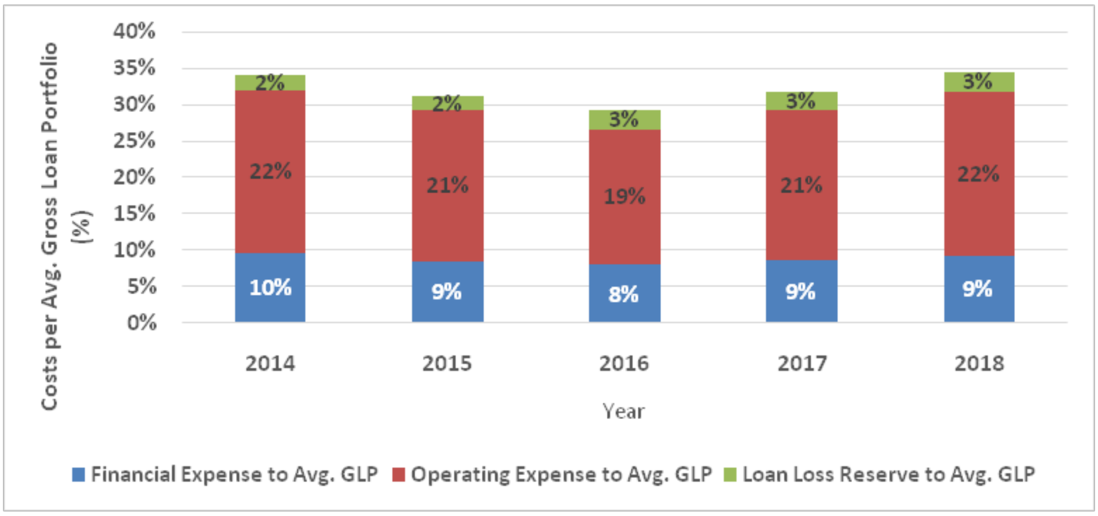


8 Pakistan Microfinance Review 2018: Annual Assessment of the Microfinance Industry – Pakistan Microfinance Network

Determining Lending Rates

While the interest rates charged by MFPs are perceived to be considerably high, what is essential to understand is that microfinance loans are priced as such due to several cost determinants and the need for profits to sustain the sector's growth. The lending rates offered by MFPs in the sector are market-driven and are dependent upon several factors; such as the **Funding Costs** associated with the MFPs, **Operational Costs** and the exposure to **Credit Risks**. The contribution to the overall costs of these components as a proportion of average gross loan portfolio can be observed in the figure below followed by an explanation of each of these components.

Figure 8: Components of Cost Structures



Funding Costs

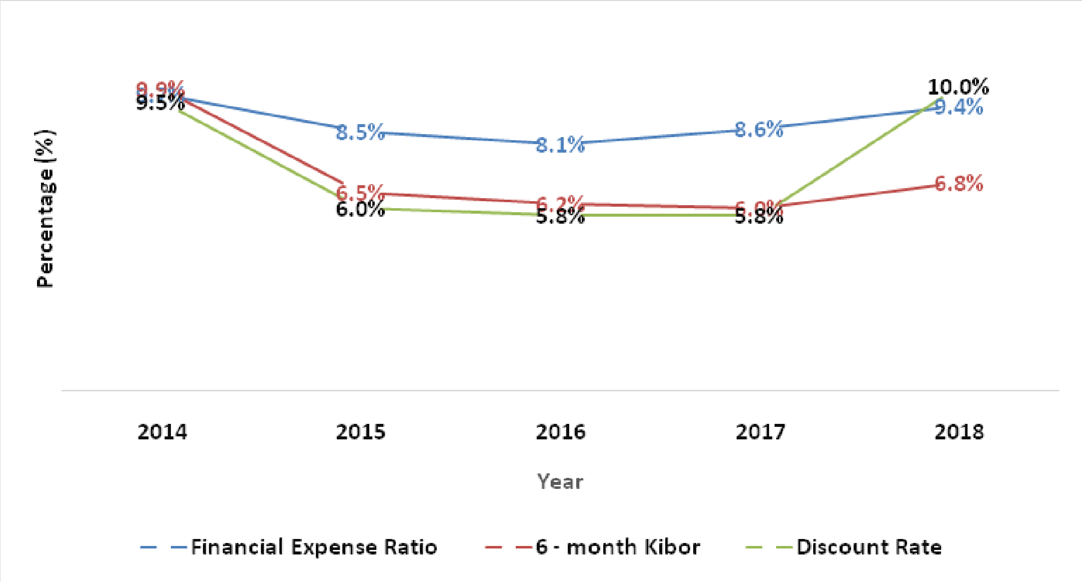
The funding requirements of the entire sector vary based on MFP peer groups. MFBs are leveraging deposits to meet their financing needs, whereas NBMFCs depend upon debt as their primary source of finance.

In the case of deposits, the rates offered by MFBs have been considerably high (up to 15 percent) given that MFBs mobilize savings from the marginalized strata such as widows, pensioners and other low-income segments. The success in leveraging deposits as a source of finance has prevailed due to the low interest rate regime over the past few years which prompted MFBs to offer returns above market rate without compromising their profitability. However, the recent tightening of the monetary policy has made raising deposits at attractive rates a considerable challenge for these entities.

For NBMFCs, the primary source of financing continues to be Debt. While larger players have found it relatively easy to tap into this source, smaller entities face a considerable challenge to borrow from commercial sources. The primary lending body for these NBMFCs is the Pakistan Microfinance Investment Company or PMIC, the national apex, and a handful of commercial banks that lend to these financial service providers as part of meeting their indicative agriculture targets provided by the SBP for on-lending to small and marginalised farmers. The average rate at which these NBMFCs receive debt financing is KIBOR + 3.5 percent.

The increase in the policy rate and discount rate over the financial year 2018 and much of 2019 has led to a subsequent increase in the financial expense ratio. This ratio is expected to escalate further given the unfavourable macroeconomic factors resulting in increased costs for the sector. A comparison of the financial expense ratio, 6-month KIBOR and the prevailing discount rates is given in the figure below.

Figure 9: Financial Expense Ratio, 6-month KIBOR & Discount Rate

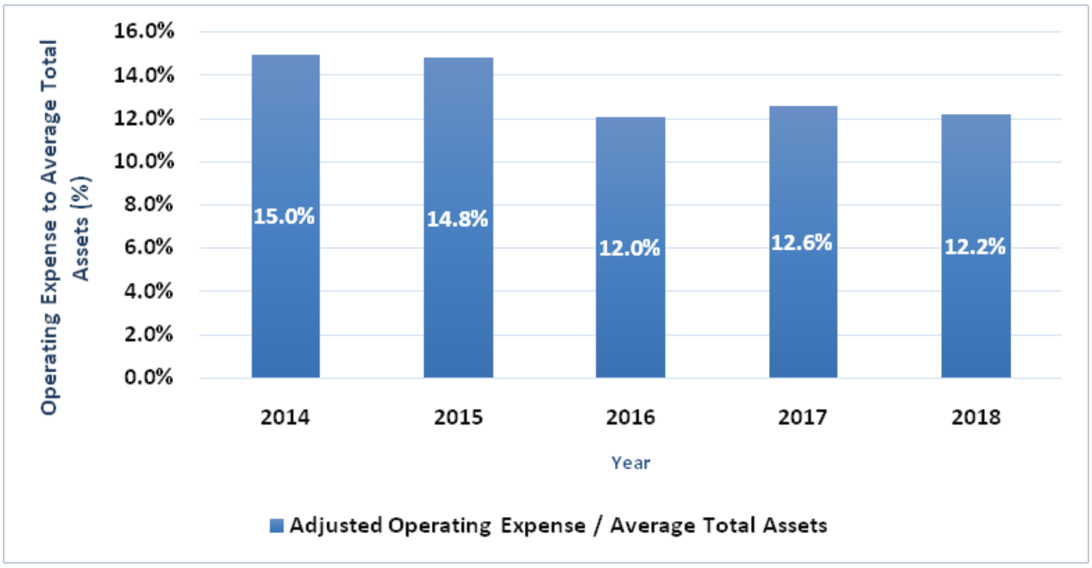


Operating Costs

The operating costs of MFPs is based on the extensive field operations in place to provide small ticket loans to poor households at their doorsteps. These small loan sizes and the labor-intensive nature of the operations of these MFPs are the primary reason for such high operational costs. The idea of economies of scale in the microfinance sector is a chimera.

Currently, the total operating costs stands at 12.2 percent when compared to the average total assets of the industry. The following figure depicts the trend in these ratios over the past few years. It can be observed that despite a decline in overall operational expenses, operating costs continue to be the most considerable determinant of pricing products of MFPs.

Figure 10: Operating Expense to Average Total Assets

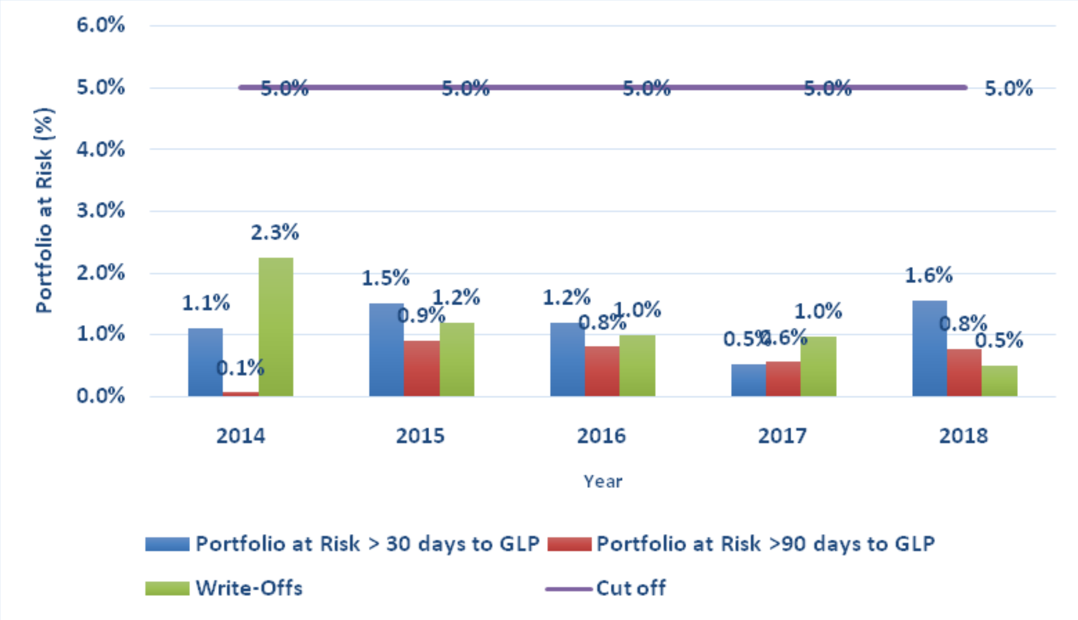


The operating costs of MFPs is significantly high when compared with its conventional banking counterparts. This is because of the higher transaction costs that are associated with providing smaller loan sizes to a clientele unserved previously. The logic behind this practice is that operating costs for loan increases as loan size decreases. Consequently, this leads to a higher interest rate being charged from the low-income segment as opposed to conventional banking services provided to higher income borrowers.

Credit Risks

The costs associated with credit risk include both, the provision for loan loss expenses and write-offs incurred throughout the year. These costs of credit risks are relatively lower compared to the other two components as MFPs invest significantly in maintaining their customers' relationship in the form periodic visits and checks at both; pre & post disbursement stages. The costs associated with credit risks are determined using the Portfolio at Risk or PAR indicator; which highlights the percentage of total loan portfolio that is at risk in a given time frame, and write-off expenses incurred. The following figure depicts the credit worthiness of the sector by highlighting trends observed in the Portfolio at Risk (PAR) and the write-offs within the sector over the years.It is also essential to note that loans offered by MFPs are generally extended to borrowers without taking any security or physical collateral. Hence, these lenders have limited or nil recourse in case of default of by clients.

Figure 11: Portfolio at Risk & Write-offs



Global & Regional Comparison of Lending Rates

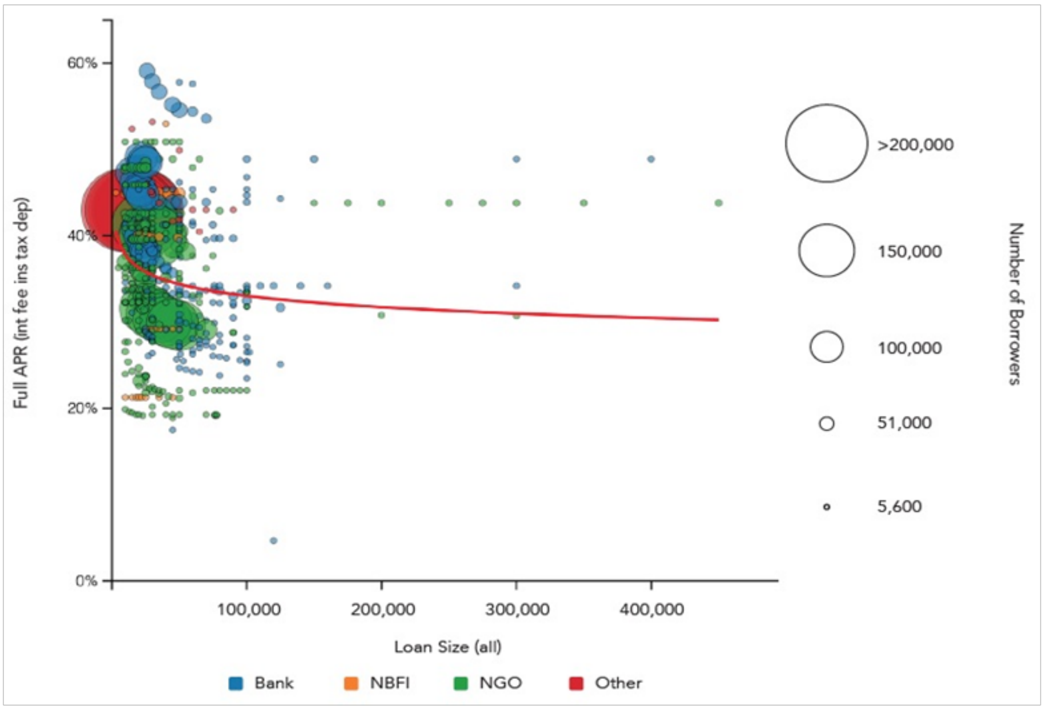
The lending rates in micro-credit are globally on the higher side. For example, the yield on micro-credit is 24 percent in Bangladesh, 21 percent in India, 40 percent in the Philippines and 66 percent in Mexico. These are countries (that have achieved economies of scale) where outreach of micro credit is between 50 million to 80 million, except Mexico where it is upwards of 15 million. It is important to note that despite high lending rates, the default rates in micro-credit in Pakistan are significantly lower, which is indicative of high demand of repeat/renewed loans by the borrowers.

Table 1 below shows that while pricing in Pakistan is low relative to loans of similar scale in other countries, the loans with lower prices are advertised with more transparency than the others. This necessitates the need to effectively monitor and advocate for responsible pricing in the sector by all major stakeholders.

Table 1: A Comparative Analysis of Loan Prices

Country (Date from 2013)	Range of full APR on Loan Sizes less than 40% Of GNI of the Country
Cambodia	35%
India (2010)	25 - 50%
India (2013, Post legislation on transparency)	30%
Kenya	25 - 125%
Pakistan	30 - 50%
Philippines	50 - 200%
Tanzania	100 - 125%
Uganda	50 - 125%

Figure 12: Comparison of Annual Percentage Rates (APRs) and Loan Sizes



The figure above indicates that Pakistan sits on a good curve, relative to its global peers in the context of loan size. The graph on the x-axis has loan size as % of per capita income whereas on y-axis shows the APR. It is evident that the APR is declining with increasing loan size, which conforms to global best practices. It is also evident that microfinance in Pakistan, despite evolution and inclusion of larger for- profit players,continues to lend to the intended clientele.

Current Developments

The microfinance industry is conscious of the implication of high costs to poor borrowers. Accordingly, the industry has been continuously striving to bring the cost of micro-credit down for the clients. To achieve this, industry has taken following measures:

Funding Costs: The MFBs are encouraged to increase their deposit base as a cheap source of funds and reduce their reliance on commercial and costly debt. In recent years, the MFBs have grown their deposits but at a relatively high cost by offering above-market rates (offering positive returns to marginalized segments). The Line of Credit Facility (LoC) by the SBP has also been made available for the all entities (MFBs and NBMFCs) to provide funds for on-lending at a discounted rate.

Operating Costs: After the issuance of branchless banking regulations in 2008, the SBP has been constantly motivating the industry to adopt branchless banking as an alternative delivery channel. The SECP as a regulator for NBMFCs is also steering this discussion forward for its regulatees, to reduce their operating costs and expand their access to rural and remote areas by leveraging modern technologies and banking channels. These services are also providing unprecedented convenience to customers.

In addition, the Pakistan Microfinance Network (PMN) is setting up its Digital Services Platform (DSP) which will speed up digitization of the players in the microfinance sector, especially NBMFCs. It is our view that unlike a capping decision taken by Bangladesh and India, where this happened only after economies of scales was achieved, we in Pakistan must continue to follow a market driven policy. This should ensure fair competition and proper disclosure of lending rates and other services that are packaged into a price for diverse financial services.

Credit Risk: The issuance of licenses by the SBP to the first two private Credit Information Bureaus (CIBs) will improve the portfolio quality and reduce the associated credit risk. The more efficient processing of new loans can improve long term financial sustainability of MFPs and clients while reducing transaction costs. Moreover, better quality of client data can allow MFPs to increase the scale and depth of outreach by identifying the untapped or the "riskier" segments of the potential microfinance market.

Conclusion

In conclusion we believe that the larger objective of achieving financial inclusion, through provision of diverse financial services should not be affected by a singular focus on lending rates. We have seen that in multiple countries a wrong decision of price caps can shrink markets and lead to exclusion. It is thus imperative that the current regime of market-based pricing, with strong regulatory oversight and a directional focus on building up cost efficiencies be pursued. We think the availability of credit bureaus and digital platforms can play a major role in risk reduction and operational efficiency going forward.

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Published in Pakistan in october 2019 by Pakistan Microfinance Network with financial UKAid, PPAF.

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