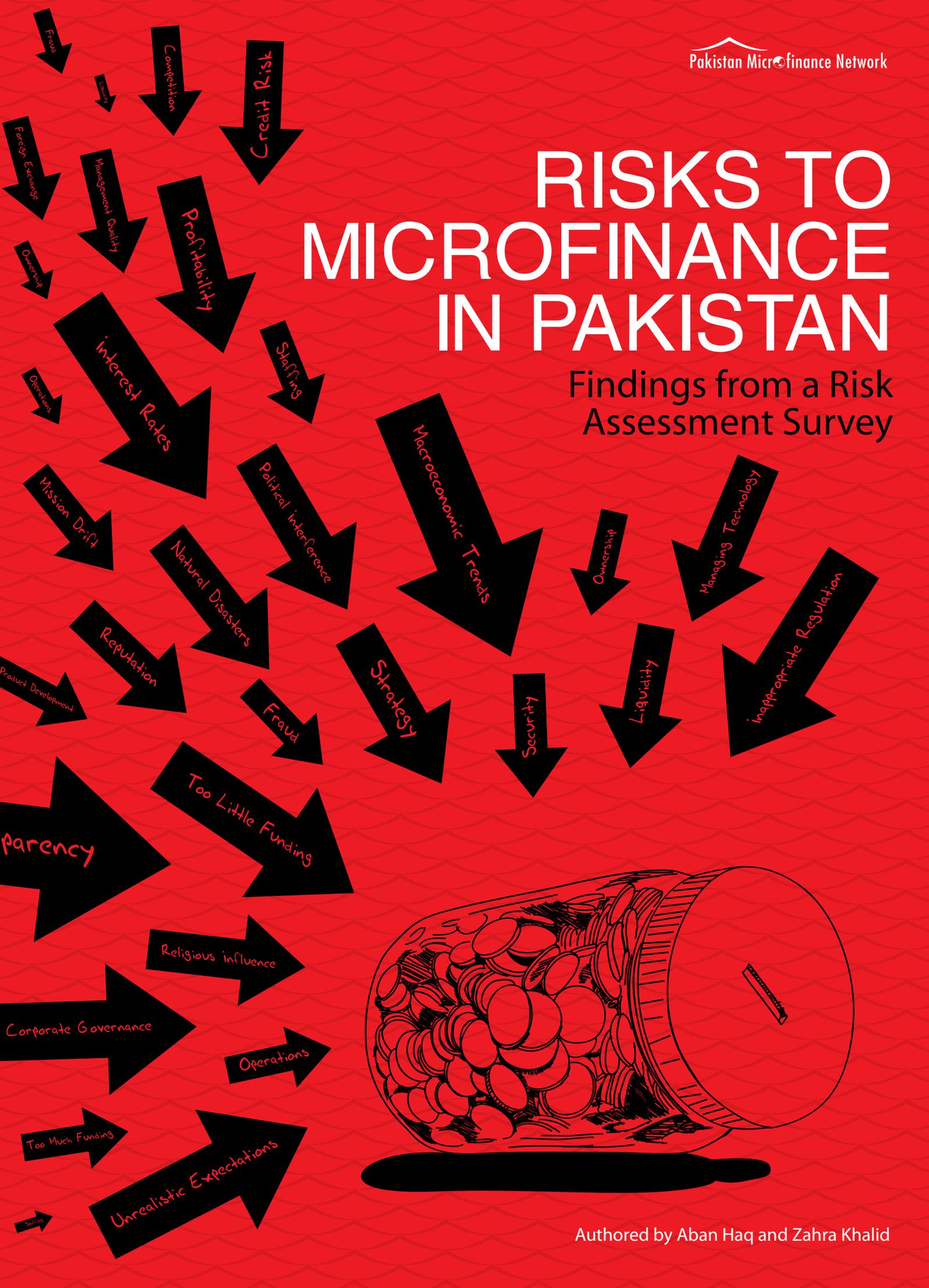


RISKS TO MICROFINANCE IN PAKISTAN

Findings from a Risk Assessment Survey



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 sector, especially retail microfinance institutions to enhance scale, quality, diversity and sustainability in order to achieve inclusive financial services.

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

Authored by Aban Haq and Zahra Khalid

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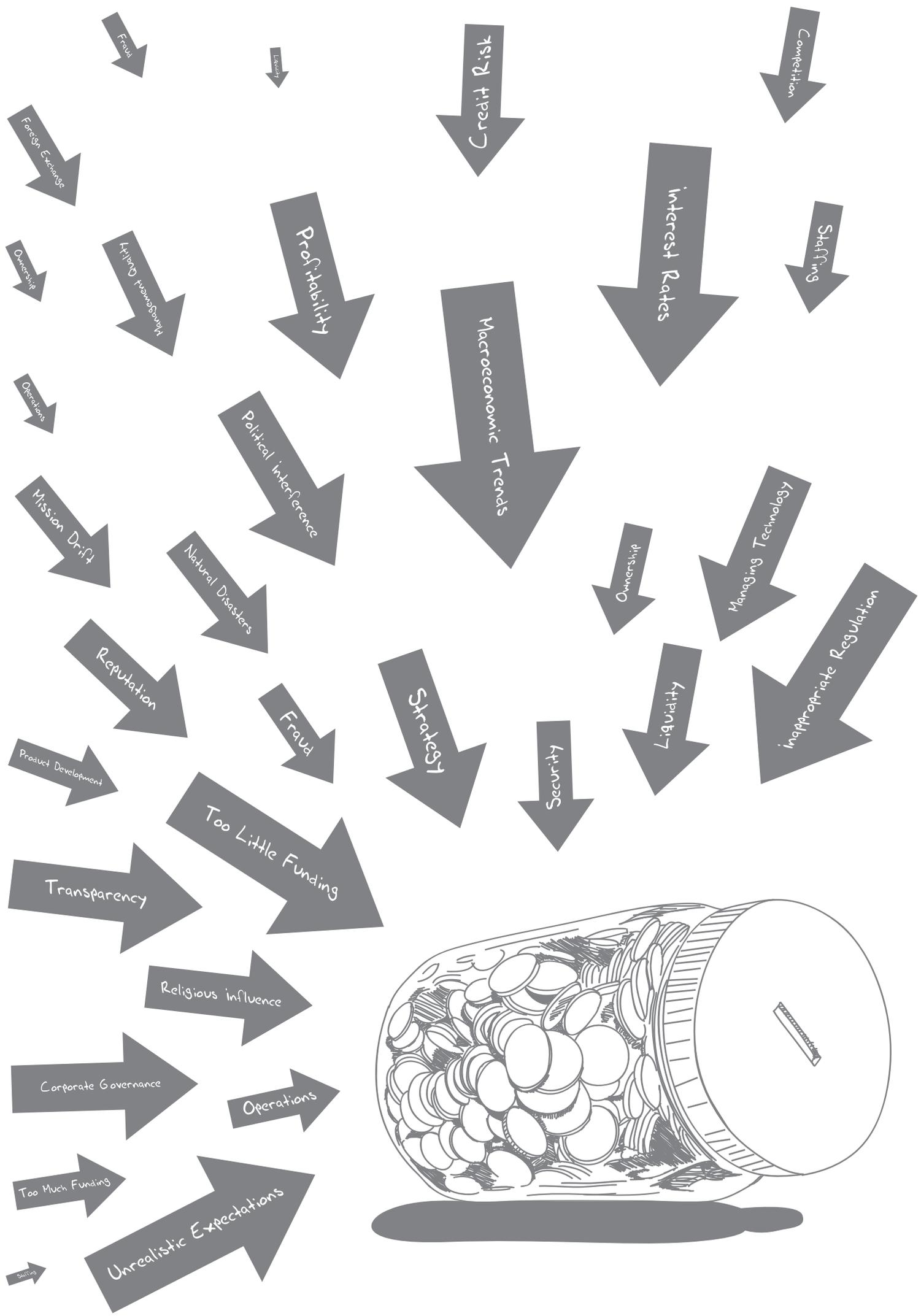
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Risks to Microfinance in Pakistan

Findings from a Risk Assessment Survey

OCTOBER 2011

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Aban Haq and Zahra Khalid

Survey management and data consolidation
Ayesha Tetlay



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Acronyms and Abbreviations

CGAP	Consultative Group to Assist the Poor
CSFI	Centre for Study of Financial Innovation
EIU	Economic Intelligence Unit
FATA	Federally Administered Tribal Areas
KIBOR	Karachi Interbank Offered Rate
MCGF	Microfinance Credit Guarantee Facility
MFB	Microfinance Bank
MFI	Microfinance Institution
MFP	Microfinance Provider
MIS	Management Information Systems
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
RSP	Rural Support Programme
SBP	State Bank of Pakistan

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1. Introduction

Microfinance in Pakistan is considered a risky business. Threats germinate from an unstable macroeconomic scenario, the state of security in the country, liquidity challenges, political and religious interference, and so on. However, there has been no attempt to systematically map the risks that the sector faces and understand the extent to which they pose a threat to a vibrant and healthy microfinance sector. This study aims to serve as a starting point on the discussions on risk in Pakistan's microfinance sector.

We begin, in this chapter, by examining why it has become so necessary to focus on risk management in microfinance, and by providing an overview of the methodology used for this study. The next chapter presents some headline findings from the data, which is followed by a more detailed analysis in [SECTION 3](#).

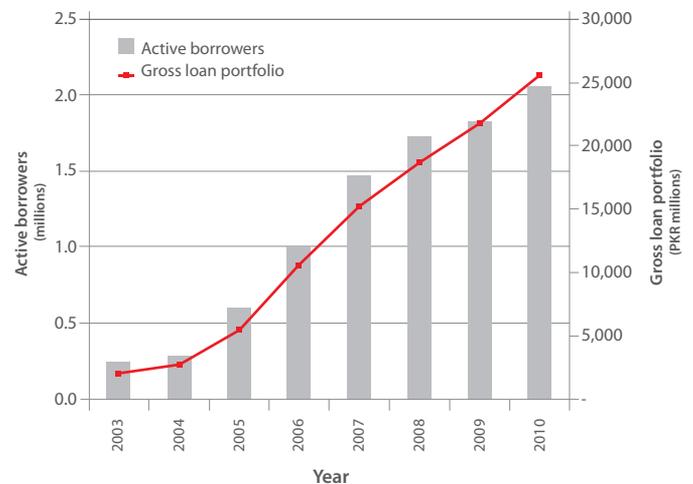
1.1 Why Risk Management is Crucial for Microfinance Today

The microfinance sector in Pakistan grew exponentially with outreach in credit jumping from 241,016 active borrowers in 2003 by six times, to almost 1.5 million in 2007. Average annual expansion stood at approximately 61% during this period ([FIGURE 1](#)). This growth trend has slowed down since then, with the sector adding barely 600,000 borrowers between 2007 and 2010. The annual growth rate dropped to 12% during this period. This loss of momentum comes from a number of sources such as macroeconomic slowdown, natural disasters, political crisis, security concerns, and delinquency problems. It is also said that this is a consequence of institutions' inability to grow beyond a certain size as they are not equipped to handle the risks and challenges that arise from expansion. Many of these explanations boil down to the issue of managing risks.

Most microfinance providers (MFPs) in Pakistan are unsustainable. They depend on donor funds and subsidized lines of credit from the Pakistan Poverty Alleviation Fund (PPAF). This makes them even more vulnerable to risks, especially unforeseen circumstances such as those that arose from the 2010 floods. It is thus vital that these institutions understand the risks they face and adopt a proactive approach in mitigating them.

Pakistan's microfinance sector has seen at least two delinquency crises in the past three years. The first mainly affected one of the largest microfinance institutions (MFIs), with some spillover to other MFPs operating in the Punjab province. Another affected Gilgit-Baltistan, though was limited to one MFP, while another affected nearly all MFPs operating in the Pattoki district of Punjab. An analysis of the underlying causes revealed issues such as weak controls in the face of rapid growth, interference from political agents, inappropriate lending and collection practices, and breakdowns in credit discipline. With these situations now becoming a common occurrence, institutions and other stakeholders need to assess how to mitigate risks that ultimately translate into repayment crises.

FIGURE 1: Trend in Microcredit Outreach (2003-2010)



An examination of India's microfinance sector shows how the face of microfinance is changing globally. The recent problems in Andhra Pradesh have created reputation risks for the sector across the world. Questions are being asked about MFPs becoming too commercial; it is said that they are 'drifting' from their mission – the ability of microfinance to lift people out of poverty (and thus justify financial inflows from donors and social investors) has been brought into doubt. Transparency and governance issues are often cited as major problems. The microfinance industry has only reached out to 180 million borrowers worldwide with over 2.7 billion people without access to the full range of formal financial services. At this stage, the

sector needs to take a serious look at these threats and develop strategies to defuse them, according to the Consultative Group to Assist the Poor (CGAP).¹

The first step in the process of managing risk is to understand what threatens the sector. This study seeks to map such risks as seen by sector stakeholders in Pakistan's microfinance industry.

1.2 Methodology

The Microfinance Banana Skins² 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 2011 report.

This report describes risks as viewed by a sample of stakeholders including practitioners, regulators, investors, donors, researchers and consultants, industry bodies and others (such as raters). Data was collected through an online survey (see SECTION 4) sent out to 147 potential respondents. The response rate was 38.7% with 57 complete responses received. 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:

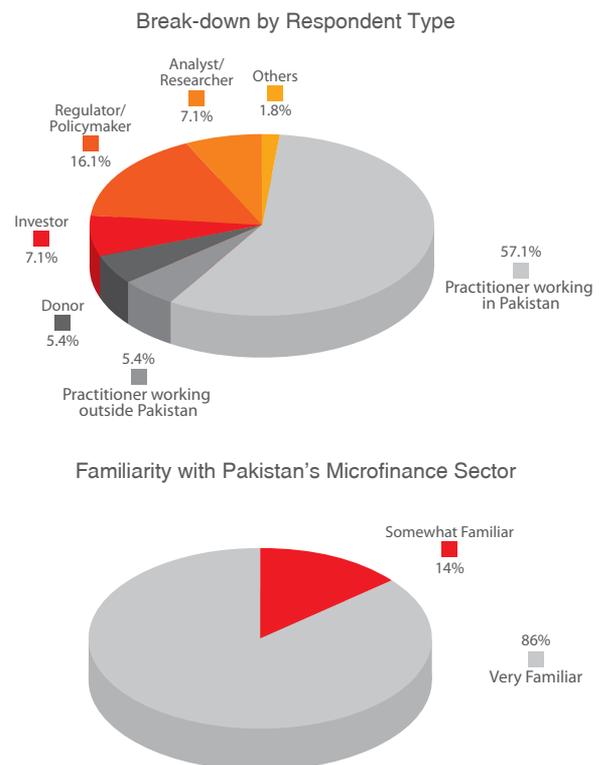
- Risk severity: Very high risk, high risk, average risk, low risk, or very low risk;
- Risk trend: Rising trend, steady trend, or falling trend;
- MFPs' ability to cope with risk: Excellent ability to cope, good ability to cope, average ability to cope, poor ability to cope, or no ability to cope.

Respondents also had the option of providing comments on each risk, if they so chose. They were also asked to rank their 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. The largest group of respondents was practitioners working in Pakistan. This was also the largest group that was reached out to in the survey sample (31 respondents). These included ten microfinance bank (MFB) respondents, 11 MFI respondents, eight rural support programme (RSP) respondents, and two respondents from other MFPs. Most responses were from top and senior management tiers, with some middle managers also filling out the survey. Other than local practitioners and researchers/analysts/consultants (referred to as 'analysts' from this point forward), the sample was nearly evenly distributed across remaining stakeholders. Over 85% of respondents said they were very familiar with the microfinance sector, while the rest felt they had some understanding of the sector.

FIGURE 2: Respondents' Profile



¹ <http://www.cgap.org/p/site/c/template.rc/1.26.15503/?page=print>

² The latest issue of this report (for 2011) can be viewed and downloaded at: <http://www.cgap.org/p/site/c/template.rc/1.9.49643/>

2. Analysis of Data

2.1 Headline Findings

This is the first 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 a high versus low risk to the sector. The key message that comes through is that domestic challenges are weighing more strongly on the minds of stakeholders in Pakistan compared to the international threats to microfinance.

We begin by examining what emerged as the biggest risks, how respondents perceived the trends, and what ability microfinance practitioners think they have to cope

with these risks. The rankings in **TABLE 1** are 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*.

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

Biggest Risks			Fastest Rising			Lowest Ability to Cope		
1	Macroeconomic trends	89%	1	Macroeconomic trends	76%	1	Macroeconomic trends	51%
2	Profitability	87%	2	Security	73%	2	Natural disasters	45%
3	Credit risk	75%	3	Credit risk	65%	3	Security	44%
4	Security	71%	4	Liquidity	65%	4	Liquidity	42%
5	Liquidity	69%	5	Profitability	58%	5	Too little funding	36%
6	Fraud	67%	6	Managing technology	53%	6	Profitability	35%
7	Interest rates	67%	7	Interest rates	53%	7	Corporate governance	35%
8	Too little funding	64%	8	Reputation	47%	8	Foreign exchange	35%
9	Corporate governance	64%	9	Unrealistic expectations	45%	9	Political interference	33%
10	Reputation	62%	10	Fraud	45%	10	Reputation	31%
11	Unrealistic expectations	62%	11	Competition	44%	11	Religious influence	20%
12	Political interference	62%	12	Political interference	42%	12	Ownership	25%
13	Natural disasters	60%	13	Religious influence	42%	13	Credit risk	24%
14	Operations	55%	14	Staffing	40%	14	Managing technology	22%
15	Staffing	55%	15	Transparency	38%	15	Product development	20%
16	Strategy	51%	16	Mission drift	36%	16	Competition	18%
17	Managing technology	47%	17	Corporate governance	36%	17	Interest rates	18%
18	Mission drift	47%	18	Too little funding	36%	18	Management quality	18%
19	Ownership	47%	19	Natural disasters	35%	19	Transparency	18%
20	Transparency	44%	20	Product development	35%	20	Unrealistic expectations	16%
21	Management quality	44%	21	Management quality	31%	21	Too much funding	16%
22	Religious influence	42%	22	Ownership	31%	22	Inappropriate regulation	16%
23	Too much funding	40%	23	Foreign exchange	31%	23	Strategy	16%
24	Competition	36%	24	Strategy	29%	24	Operations	16%
25	Inappropriate regulation	35%	25	Operations	25%	25	Staffing	15%
26	Foreign exchange	33%	26	Too much funding	18%	26	Mission drift	11%
27	Product development	25%	27	Inappropriate regulation	13%	27	Fraud	11%

A key message emerging from the survey is that stakeholders are worried about the economic and security environment in Pakistan. *Macroeconomic* trends emerged as the largest threat. Although there has been evidence in the past suggesting the resilience³ of microfinance clients to overall economic conditions, this no longer appears to hold true. Inflation, a slowdown in economic activity, and a severe energy shortage are serious risks (especially in urban areas) which show no signs of abating and are, in fact, viewed as risks that may rise in the coming years. Coupled with MFP reliance on debt financing, rising *interest rates* in an inflationary environment are potential threats to service providers. In the absence of an asset and liability management capacity, institutions' balance sheets are exposed to movements in interest rates. However, given that most loans in the sector tend to be for one year, a greater risk may arise from the clients' side and their ability to service debt.

Risks arising from the macroeconomic scenario are also seen as ones that MFPs tend to underestimate and clearly lack the ability to handle. The second largest external threat to the sector is *security*. An increasingly volatile security situation threatens not only microfinance, but all investment and economic activity in the country. MFPs are seen as soft targets, and stakeholders view the situation with extreme caution, hoping that the security issues currently contained within certain regions do not spill over to the rest of the country.

Profitability and *credit risk* are high on the list of risks. As most MFPs struggle to achieve sustainability, being in the red poses a danger to the growth and commercial viability of microfinance in Pakistan. However, many practitioners see profitability as an uphill task in the current situation of the country. Credit risk, as in most global surveys of risks in microfinance, remains a concern. Two main sources of this risk are:

- Bleak macroeconomic conditions that erode clients' ability to service debt;
- Weak internal controls coupled with growth in a competitive market.

Over-indebtedness, weakening relationships between clients and MFPs, and poor credit management and client appraisal systems lie at the heart of credit risk increases. Interestingly, most MFPs consider themselves well-equipped to handle this risk – thus its relatively high ranking in terms of MFP ability to cope with risk. Other stakeholders disagree – nearly all other groups of respondents ranked MFPs' ability in dealing with this threat much lower.

There is an inherent link between the 'macro' and the 'micro'. Macroeconomic instability slows down economic activity and reduces new opportunities for investment, hence hampering growth. Without growth, income-generating opportunities for MFP clients are reduced, and a vicious spiral is set in motion.

Khaleel Tetlay, RSPN.

Funding and *liquidity* concerns remain important. Unlike some markets where excess liquidity is seen as a concern, Pakistan's sector views funds shortage and liquidity crunches as major challenges. However, some respondents viewed this as a function of an MFP's strength and sustainability i.e. a strong institution will be able to access commercial funding whereas weak institutions that remain donor-dependent will take a hit as this source of subsidized credit dries up.

Reputation risk is not seen as a major threat at the moment; it is holding steady in terms of trend. This is quite contrary to the international reaction after the crisis in the Indian microfinance sector and the resulting negative press – it was ranked as the second highest risk and the fastest riser in the Microfinance Banana Skins 2011. Closely tied to reputation is the risk of *political interference*, which is also not viewed as a major concern in Pakistan. *Mission drift*, i.e. a greater focus on the financial rather than social bottom line, has been a key criticism levied on the sector, globally. Those familiar with Pakistan's sector do not consider this a major issue, and feel MFPs have a strong ability to counter this risk.

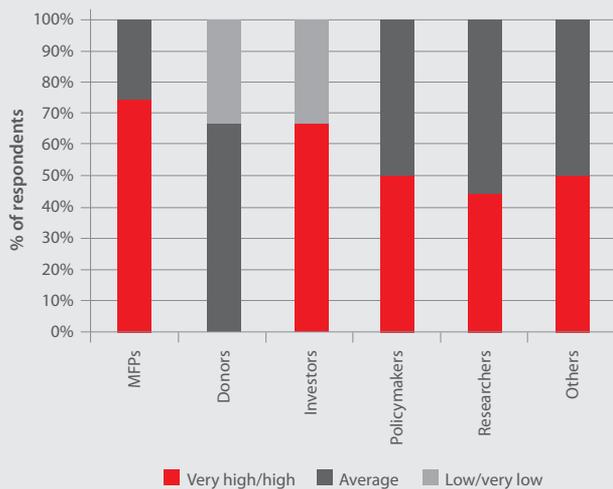
Risks emanating from *foreign exchange* due to currency fluctuations, *inappropriate regulation* and irresponsible

³ Zaidi, A. et al. 2008. *Impact of Inflation on Microfinance Clients and Its Implications for MFPs*. PMN.

behaviour due to *too much funding*, are ranked low in terms of severity and trend.

BOX 1: Are Expectations from Microfinance too High?

MFPs certainly think so, but others disagree. Nearly 75% of MFP respondents said people expect too much from them, and this is a risk. None felt the risk from unrealistic expectations was low. At the other end are donors and investors who do not feel that expectations and MFPs' inability to match them, is a risk.



Generally, all stakeholders take a similar view of the risks faced by the industry. While nearly everyone is concerned about the macroeconomic environment and profitability of the sector, some differences are obvious. MFPs and investors seem less concerned about issues of corporate governance than other stakeholders. MFPs seem to be the only group that think failure to deliver against expectations is a serious risk to the sector. Donors, unlike the other respondents, rate the failure to develop the right products and manage them successfully, above all other risks faced by the sector.

Areas where practitioners feel they lack the most risk management capacity, are mostly external, such as *natural disasters*, *macroeconomic trends*, and *security*. Most other stakeholders rate risk management capacity weaker in areas such as *profitability*, *liquidity management*, *credit risk*, and *technology management*.

Borrowing the health warning issued by the Microfinance Banana Skins 2011: a number of points should be borne

in mind when taking messages from this report. One, the results reflect the perceptions of respondents and are not forecasts or measures of likelihood. Two, there is also a tendency in surveys like this to focus on the negative and overlook the positive, of which there is still a lot in microfinance. Linked to this is the risk of generalization: microfinance is an enormous and varied business, and its conditions differ greatly from one region to another.

2.2 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, and other key stakeholders such as networks.

TABLE 2 shows an interesting mapping of the top risks by stakeholder group. Risk ranking is based on how many stakeholders identified something as a top risk. For example, *macroeconomic trends* and *profitability* appear at the top of the table as all stakeholders believed these were major threats. Risks like *unrealistic expectations*, *competition*, and *mission drift* appear at the bottom as only one of the six groups identified it as a high risk. A check appears under the stakeholder group if a risk emerged as high in severity based on its respondents' perceptions.

Most MFPs are up the curve in managing people-related frauds, but the push for scale and large volumes will pose a risk due to the limited depth and experience of the sector.

Tariq Mohar, Tameer Bank.

Some results are not surprising – one would expect security, macro-economy, and credit risk to rank high given the overall situation in Pakistan and the recent

(2.1) Headline Findings (2.2) Different Perspectives — Views of Stakeholder Groups

episodes of delinquency in Punjab. What is more interesting is the identification of *fraud* as a key risk by four of the five groups. Globally, this risk ranks quite low, relative to others, but corruption amongst staff is seen to be on the rise within MFPs in Pakistan as they push for growth. Also interesting is the concern around *corporate governance* with practitioners (not surprisingly!) and investors. These two groups were the only ones that do not see this as an

urgent threat. One respondent went as far as saying “MFIs are ‘white boards’ – one can write whatever one wants”. Concerns are high about institutions in the unregulated sector being run like family businesses with boards and governance structures dominated by family and friends. However, the mood is optimistic as the sector moves towards largely being regulated.

TABLE 2: Most Severe Risks by Stakeholder Group

	Practitioners	Donors	Investors	Policymakers	Researchers	Others
Macroeconomic trends	✓	✓	✓	✓	✓	✓
Profitability	✓	✓	✓	✓	✓	✓
Security	✓		✓	✓	✓	✓
Liquidity	✓	✓	✓		✓	
Credit risk	✓	✓	✓		✓	
Corporate governance		✓		✓	✓	✓
Fraud	✓	✓			✓	✓
Interest rates	✓	✓		✓		
Too little funding	✓		✓		✓	
Operations			✓	✓	✓	
Reputation				✓		
Product development		✓		✓		
Ownership		✓	✓			
Management quality		✓		✓		
Natural disasters			✓	✓		
Religious influence			✓			✓
Political interference					✓	✓
Competition			✓			
Strategy				✓		
Staffing						✓
Mission drift						✓
Unrealistic expectations	✓					

2.2.1 Practitioners — Including Those Employed by MFPs

Biggest Risks	Fastest Risers	Least Ability to Cope
Macroeconomic trends	Macroeconomic trends	Natural disasters
Profitability	Security	Macroeconomic trends
Liquidity	Liquidity	Security
Unrealistic expectations	Credit risk	Liquidity
Credit risk	Managing technology	Political interference
Interest rates	Profitability	Reputation
Security	Interest rates	Too little funding
Reputation	Reputation	Profitability
Fraud	Fraud	Foreign exchange
Too little funding	Unrealistic expectations	Religious influence

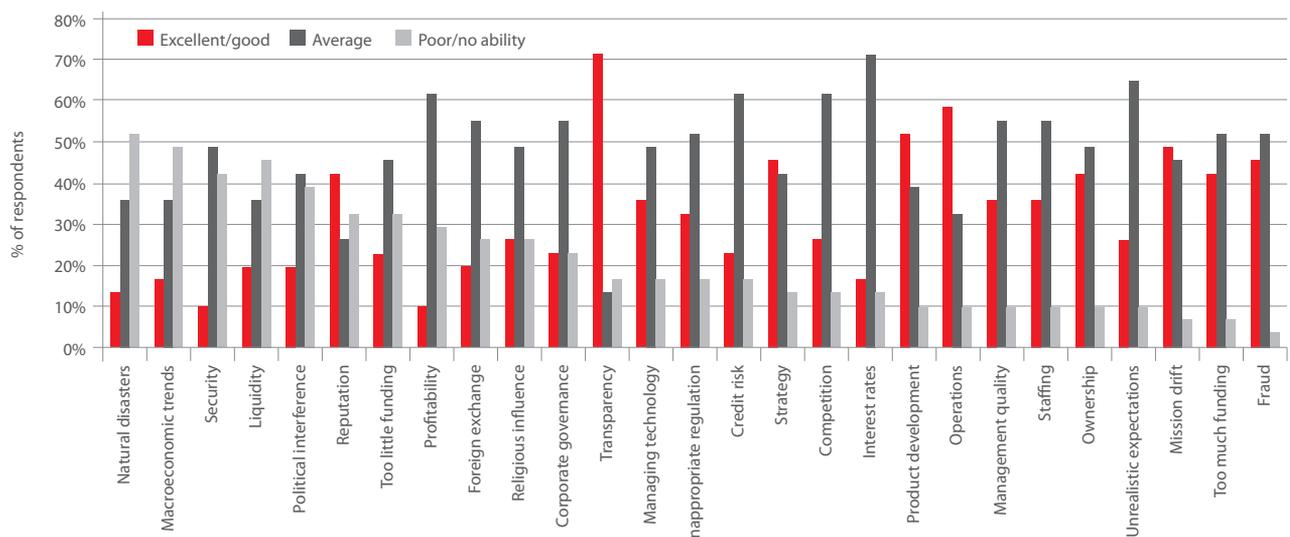
Generally, large-scope risks seem to be worrying practitioners more than micro-risks that relate to their own institutions. As they worry about *credit risk* or the availability of *liquidity*, they are equally worried about factors such as *security*, inflation and *interest rates*, the *reputation* of microfinance, and *political interference*. Sustainability seems to be a key concern as most MFPs remain unprofitable and vulnerable

to shocks. Issues around *staffing*, *operations*, *management quality*, and *corporate governance* remain low.

Contrary to popular opinion, MFPs rated risks arising from *religious influence* far below others. Similarly, they seem comfortable with regulation as they think this is the least of their problems. Unlike some other stakeholders who ranked development and the delivery of *appropriate products* as key risks, MFPs 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 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 managing risks such as *natural disasters*, *political interference*, and *security*. That said, compared to risk severity and trends, we find a lot less agreement within MFPs about their ability to cope with risks (FIGURE 3).

FIGURE 3: Distribution of MFPs' Perceptions About Their Ability to Cope with Risks



2.2.2 Donors — People who Fund MFPs for Social Return Only

Biggest Risks	Fastest Risers	Least Ability to Cope
Product development	Transparency	Profitability
Profitability	Profitability	Too little funding
Credit risk	Credit risk	Transparency
Corporate governance	Interest rates	Credit risk
Ownership	Macroeconomic trends	Product development
Fraud	Foreign exchange	Macroeconomic trends
Interest rates	Product development	Corporate governance
Liquidity	Staffing	Foreign exchange
Macroeconomic trends	Liquidity	Security
Management quality	Corporate governance/fraud	Natural disasters

All respondents in this category rated risks in areas of *product development*, *profitability*, *credit risk*, *corporate governance*, and *ownership* as either very high or high. This is in stark contrast with MFPs, who do not see corporate governance, ownership, or products as a risk to the sector. This ties in with the identification of *transparency* by all respondents as a risk that is rising. It is quite alarming 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.

Similar to other stakeholders, donors seem comfortable with the regulation framework and do not foresee any threat to the sector from this front; this is important as the majority of players are currently unregulated. Similarly, *foreign exchange*, *competition*, and *religious influence* do not rate high in terms of risk from the donors' perspective.

2.2.3 Investors — People who Invest in MFPs

Risk perceptions of investors matter greatly for any institution or sector that is looking for funding, especially commercial funds. Although the sample size of investors in our study is small, it does offer some insights into what this group is thinking. It is encouraging to see that overall, investors are

more optimistic compared to donors in terms of MFPs' ability to handle the risks they face. However, they seem more worried that risk trends are moving up rather than falling. Like MFPs, they are more concerned about external factors. *Macroeconomic trends*, *security*, *natural disasters*, and *religious influence* are four out of the six risks that all investors rated very high or high in terms of severity.

Biggest Risks	Fastest Risers	Least Ability to Cope
Macroeconomic trends	Credit risk	Liquidity
Security	Competition	Credit risk
Credit risk	Liquidity	Foreign exchange
Natural disasters	Ownership	Natural disasters
Profitability	Security	Religious influence
Religious influence	Macroeconomic trends	Product development
Competition	Natural disasters	Too little funding
Liquidity	Operations	Competition
Operations	Profitability	Corporate governance
Ownership/too little funding	Religious influence	Fraud/inappropriate regulation

A key concern across all respondents in this category is *over-indebtedness*. Although the credit information bureau that is in the pipeline is looked upon as a positive development and a strong tool in addressing this issue, investors remain concerned that competition will lead to over-indebtedness in urban and semi-urban areas, while rural areas will remain under-served. If MFPs continue to serve the same markets with similar products, this risk remains high for investors.

2.2.4 Policymakers — People who Make or Drive Policy in Microfinance

All policymakers agreed on the top five risks to the sector – *profitability*, *macroeconomic trends*, *management quality*, *natural disasters*, and *corporate governance* were rated as areas of very high or high risk by all respondents in this group. There was less agreement, however, on MFPs' ability to cope with these risks. All respondents felt that practitioners are well-positioned to handle *transparency* risk, but were not as confident about their ability to cope with the challenges of *managing technology* or *too much funding*.

Biggest Risks	Fastest Risers	Least Ability to Cope
Profitability	Macroeconomic trends	Managing technology
Macroeconomic trends	Interest rates	Too much funding
Management quality	Natural disasters	Unrealistic expectations
Natural disasters	Reputation	Security
Corporate governance	Security	Macroeconomic trends
Product development	Credit risk	Corporate governance
Operations	Competition	Management quality
Reputation	Managing technology	Interest rates
Strategy	Mission drift	Ownership
Interest rates/security	Product development	Strategy

“A failure to transition from Pakistan’s first decade of subsidized microfinance industry development towards a longer-term deposit-based sustainable model independent of government and donor subsidies [is a risk]. If there is either a lack of recognition of this transition or insufficient efforts to manage the transition, there could be a loss to the industry as a whole if there are pockets of the industry that fail to make this transition.”

Greg Chen, CGAP.

Concerns were also voiced regarding the sector’s ability to attract and retain quality human resources at an affordable cost. Interestingly, policymakers are also beginning to think of the lack of financial literacy as a risk to the sector’s long-term growth.

2.2.5 Researchers and Consultants — People who Work Closely with Other Stakeholders on a Range of Issues

Biggest Risks	Fastest Risers	Least Ability to Cope
Macroeconomic trends	Liquidity	Macroeconomic trends
Credit risk	Macroeconomic trends	Too little funding
Corporate governance	Credit risk	Corporate governance
Liquidity	Security	Ownership
Profitability	Fraud	Operations
Fraud	Interest rates	Credit risk
Too little funding	Managing technology	Competition
Political interference	Operations	Interest rates
Security	Mission drift	Liquidity
Operations	political interference	Management quality/security

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, investors, and policymakers who may view the sector through their own particular lenses, researchers and consultants have a broader

“Weak governance structures of microfinance institutions: since the strategic direction comes from the governance level, a strong, un-biased, and professional contribution at the board level ensures that the organization is moving in the right direction.”

Afsheen Shakoor,
Shorebank International.

view of sector issues. In terms of risk profiling, this group agrees with donors and rates risks from weaknesses in *corporate governance* as quite high. They also agree with practitioners and rate risks from lack of *liquidity* as quite high, and, in fact, feel this is an area that is rising the fastest

in terms of riskiness along with the *macroeconomic* challenges. Respondents in this group also appear more pessimistic in terms of MFPs' ability to cope with the various risks they face.

Researchers and consultants appear less concerned about issues of *transparency*, *religious influence*, and *technology*. They feel these are areas that institutions have the capacity to handle. Like most stakeholders, they regard the risk of inappropriate regulation stifling the sector, as remote.

BOX 2: How does Pakistan Fare Against Global Perceptions on Risks to Microfinance?

Comparing our findings to the Microfinance Banana Skins, 2011, we find that the concerns of microfinance stakeholders reflect more in the way of local issues than global trends. For example, reputation risk has risen sharply across the microfinance world in the wake of the India crisis, but is less prominent in Pakistan. Similarly, mission drift and unrealistic expectations remain a minor concern. Unlike in the global survey, profitability is a big concern in Pakistan, and macroeconomic trends are the obvious winner in terms of what is seen as most threatening.

However, like the global survey, credit risk remains high on the list. Corporate governance issues are also starting to gain weight. Foreign exchange risks remains low as in other countries because most MFPs depend on funding in local currency.

(3.1) Macroeconomic Trends (3.2) Profitability (3.3) Credit Risk (3.4) Security (3.5) Liquidity (3.6) Fraud (3.7) Interest Rates (3.8) Too Little Funding (3.9) Corporate Governance (3.10) Reputation (3.11) Unrealistic Expectations (3.12) Political Interference (3.13) Natural Disasters (3.14) Operations (3.15) Staffing (3.16) Strategy (3.17) Managing Technology (3.18) Mission Drift (3.19) Ownership (3.20) Transparency (3.21) Management Quality (3.22) Religious Influence (3.23) Too Much Funding (3.24) Competition (3.25) Inappropriate Regulation (3.26) Foreign Exchange (3.27) Product Development

3. Risks and Possible Mitigation Strategies — A Deeper Look

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.

3.1 Macroeconomic Trends

Unsurprisingly, the greatest perceived threats to microfinance in Pakistan are *macroeconomic trends* in the country. The country is beset by a range of economic challenges – steep and persistent inflation, stagnating economic growth, a serious energy crisis, and a rising fiscal deficit. According to one respondent, MFPs are more sensitive to macroeconomic shocks as they “lack the reserves” to shield against such trends. One cannot emphasize enough the importance of the link between the macro-economy and MFPs. The overall performance of the economy has a profound impact on the level of investment and employment opportunities, which in turn affects small-scale enterprises. These enterprises are then unable to perform well in the face of negative macroeconomic indicators. Given that food inflation has been rising at a faster rate than overall inflation, poor and low-income groups (the target market for microfinance) are suffering proportionately more.

The threat from *macroeconomic trends* was ranked the highest from all perspectives – 89% of respondents rated the severity of this risk as high, 76% perceived the risk to be rising, and over half of the respondents regarded MFPs’ ability to cope with this threat as poor or non-existent.

Macroeconomic trends affect MFPs in various ways:

- Persistent inflation leading to increased interest rates makes the cost of funds rise, and in turn increases the cost of loans to the end client who is already stressed by the stagflationary environment;
- A fiscal deficit funded by the financial sector crowds out funds for the private sector, including MFPs;
- Reduced opportunities for self-employment or investment enhance chances of business failure. In

turn, credit risk increases in the shape of client default due to bankruptcy and decreased demand for microcredit;

- The risk of default also increases if business owners find themselves unable to invest loans in the small amounts received in an inflationary environment. The result is loan diversion to consumption purposes or to the patching of loans from multiple MFPs.

Moreover, in such situations, the microfinance industry may also face increased vulnerability from political quarters, which can lead to mass delinquency and the disruption of carefully developed credit discipline. A practitioner stated, “The macro-environmental impact, especially inflation and food inflation, restricts the ability of low-income households to use loans for productive purposes. This increases the risk to MFPs. This may also result in targeting relatively better segments within low-income communities, resulting in a mission drift”.

Unfortunately, little can be done by the microfinance industry to turn the macro-economy around. However, MFPs can mitigate its impact on themselves through various defence mechanisms:

- Building up equity;
- Assessing client needs and focusing on building relationships with clients by providing diversified products;
- In case of economic stress, engaging with clients to reschedule or refinance loans, based on a standard due diligence process;
- Diversify by sector, geography, and income groups;
- Setting up a risk fund at the sector level for the microfinance industry in collaboration with policymakers, regulators, and donors. The apex can help build a resource pool that would then be available for access in detrimental circumstances.

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3.2 Profitability

Since most of the MFPs in Pakistan are donor-driven and financially unsustainable, the *profitability* risk is very high. Even so, we see reluctance in outright admission by practitioners of the need for profitability for survival beyond donor funding. Khaleel Tetlay of the Rural Support Programmes Network (RSPN) argued that “MFPs can only be sustainable if they are profitable enterprises. Microfinance clients require sustainable access to services and products, and this is only possible if MFPs are profitable. These profits can be used for research on new products, accessing new technology, building capacity, building up reserve funds, etc. The bottom line is that driven MFPs have to be profit driven”.

“...driven MFPs have to be profit driven.”

Khaleel Tetlay, RSPN.

Again, this is not surprising, as many fingers are being pointed at microfinance globally for making profits off the poor, with reputation risk ranking as the tenth highest risk microfinance faces in Pakistan. With the recent microfinance crisis in Andhra Pradesh, microfinance globally, has suffered on account of its reputation, which ranked as the second highest risk on the Microfinance Banana Skins 2011. This risk poses a great threat to the outreach and sustainability of institutions, given respondents’ views – while they ranked this as the second most severe risk, more than half perceive it to be a rising trend. Coupled with this, it is troubling that most respondents perceive MFPs’ ability to cope with this risk as average.

What is interesting to note is that there are divergent views on profitability within the practitioners’ community. On the one hand, a practitioner complained that “external factors are badly trimming profitability” and another stated “deep down, scale and profitability are the two main issues of the sector, which on the whole, is on a low beat because of these”. Conversely, another practitioner felt that “profitability and poverty alleviation through non-profit programmes are self contradictory”.

MFPs 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. There is an upside available to the industry as average pricing at this point in the lifecycle curve should be at 30%. 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, but this requires a change in mind sets: neither sole concentration on social objectives, nor a single focus on financial returns, are a good strategy for a serious MFP.

3.3 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 principle resulting from loan defaults.

With the first microfinance crisis only a few years behind us and the industry having faced two more pockets of delinquency since, it is no surprise that credit risk ranks high in the list of threats. The severity of this risk points towards recklessness among borrowers as well as among MFPs, and is further proof of difficult economic conditions.

Globally, this risk ranks the highest, owing to client over-indebtedness, the cluttering of branches due to competition in some regions, and weak internal controls at MFPs. In Pakistan, the same reasons apply as there is sufficient evidence that multiple borrowing exists, and is especially widespread in high competition areas⁴. Growth in outreach has closely followed existing high-density areas, leading to these regions become more and more saturated. Multiple borrowing is therefore inevitable in the absence of a fully-functioning centralized database that records clients by their national identity card numbers. Clients thus borrow from multiple organizations, where one loan is used to finance the repayment of another. This creates a vicious cycle until MFPs have no choice but to write the loan off, or a delinquency wave emerges as was seen in the Punjab and Pattoki crises.

⁴ Burki, Hussan-Bano. 2010. *Microcredit Loan Utilization: Shifting from Production to Consumption?* PMN.

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There seems little hope of this risk abating in future – 65% of survey respondents felt that this risk would continue to rise. More than half of the respondents felt that the ability of MFPs to cope with this risk was average. One practitioner raised the point “MFPs destroy the market due to competition to grasp market share. This impairs good practices that currently exist within the industry”. This signifies that the MFPs that do want to put in place good practices, suffer due to growth drives by more aggressive players in the market.

The mitigation of this risk demands a drastic change in credit delivery methodology. Potential measures could include employing quality human resources and revisiting incentive systems, adopting a ‘know-your-customer’ philosophy, developing due diligence procedures with uniform application, rethinking loan sizes, employing strict measures to control multiple borrowing that does not lead to indebtedness, the use of across-the-board credit bureaus, 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, 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.

MFPs would also do well to invest in client education and set up formal mechanisms of client grievance redress at individual institutions, and also at a broader sector-level.

3.4 Security

The risk rated the fourth most severe is unique to the Pakistani context. Since 2007, over 35,000 civilians⁵ have been killed and injured in terrorist attacks and others incidents of violence like sectarian strife, ethnically motivated target killings, the nationalist separatist insurgency in Balochistan, and criminal violence across the country.

There is no doubt that MFPs operating in conflict zones within Pakistan are a soft target, but the effects go beyond these regions. The *security* situation in the country affects

MFPs directly and indirectly – indirectly, by affecting the macro-economy, and directly by hindering MFP operations. A case in point: branches of Khushhali Bank, the only MFP in the Federally Administered Tribal Areas (FATA), have been closing down over the past two years. Microfinance outreach in the area stands at zero as of the beginning of 2011.

Recognizing that the risk may seem localized to conflict-prone regions but had wider implications, one analyst expressed the concern that “[while] the current security threats are localized to specific regions, it will not take long for them to spread to ‘peaceful’ regions. For example, if the security forces initiate serious action in southern Punjab, this region may also create problems for MFPs [...]” On the other hand, Masood Gill, representing a practitioner with a large presence in Punjab, held the view that “there are some issues [...] but they are not to the extent as one would infer from the Pakistani media. I don’t see any immediate threat to the microfinance industry from the prevailing security situation”. Other practitioners’ fears were related to the security situation’s impact on the industry’s sustainability – Zareen Aamir of *Asasah*, a practitioner, feared that it “had a direct effect on international [donor] funding to the sector”.

While this variety of views on the impact of deteriorating security is seen among respondents, the practitioner group has ranked *security* the second most severe risk. What is even bleaker is that 76% of survey respondents perceived this risk to be rising, and only 16% had an optimistic view of MFPs’ ability to deal with the threat that a deteriorating security situation poses to the sector.

In terms of risk mitigation at the individual MFP level, attaining a diverse geographic spread can help allay risk. 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 help protect MFPs.

⁵ Pakistan Institute of Peace Studies

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3.5 Liquidity

While *liquidity* risk has decreased significantly in the global setting in 2011 from a high in 2009, Pakistani microfinance industry stakeholders perceived it to be the fifth most severe risk. It is closely tied to, and has implications for the scalability of microfinance businesses, which ultimately affects sustainability. As would be expected, this risk comes out most strongly from the practitioner group, which ranked it third in terms of severity. The availability of financing factors into an MFP's strengths in a variety of ways – from balance sheets to business models, and from governance structures to internal controls. The severity of liquidity as a risk was voted high or very high by 69% of respondents. About 65.4% considered it to be a rising trend, and 41% felt MFPs lacked the capacity to deal with the issue.

The table below shows rankings attributed to the trend in severity as well as MFPs' ability to cope with *liquidity risk*.

Stakeholders	Trend	MFPs' Ability to Cope
Practitioners	1	3
Donors	9	17
Investors	3	1
Policymakers	20	15
Analysts/researchers	1	9

The starkest difference seems to be in the responses of practitioners and policymakers. This is worrisome, as it seems policymakers do not have a clear picture of the immediacy with which practitioners feel the need for liquidity. One of the respondents said that liquidity would be a major problem for ambitious MFPs aiming to increase their scale of operation and improve sustainability. One of the practitioners working in Pakistan also said that MFPs offering savings products would be more vulnerable to the risk of a lack of ready liquidity. Gregory Chen at CGAP offers the view that "this [risk] depends heavily on individual MFPs. Some keep large liquid asset cushions, while others deploy their assets more aggressively towards loan portfolio".

MFPs can take a number of steps to protect themselves against this risk:

- Increase focus on deposit mobilization;

- Conduct a phased spinning-off of PPAF-funded microfinance operations and focus on financing for microfinance operations from blended sources;
- Carry out institutional strengthening for improved performance through better financial performance, balance sheet strength, a seasoned senior management team, and improved governance and operations.

At the sector level:

- Push for non-bank segment regulation so that they are allowed to take deposits from members with a net credit balance;
- Create synergies between the Microfinance Credit Guarantee Facility (MCGF) and PPAF as funding sources for microfinance providers, and initiate a tiered approach of lending to bigger and aggressive players versus niche players.

3.6 Fraud

Fraud refers to the honesty of MFP staff as well as that of clients. While many respondents felt that the threat from this risk has been steady, fraud still ranked sixth in terms of severity. More than half of the respondents regarded MFPs' capacity to deal with this risk as average while 34% thought of it as ranging between good and excellent. 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.

Fraud remains a reality, especially at the loan-staff level. The implications are dire as it breeds loan losses for the institution in the form of wilful default at the client level. Cash in the hands of corrupt staff leads to major problems in the smooth flow of disbursement and recovery. Naturally, profitability and client relationships suffer, as well. One practitioner expressed the strong view that "dishonest clients and staff can fail the institution", and Greg Chen at CGAP went as far as to state "a few MFPs are fundamentally compromised by dishonesty among staff and management. It may be best for some of these institution to exit microfinance". Another practitioner raised the concern that while fraud is containable at the current

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stage of the industry's evolution, the push for scale will make this risk much more severe.

A number of risk mitigation strategies are available as this particular risk is internal and hence, very controllable. At the practitioner level, steps include:

- Ensuring the existence of robust risk mitigation strategies and internal control measures;
- Reviewing staff incentive and salary structures to pre-empt corruption in staff who are pressed to resort to such measures due to harsh economic conditions;
- Adding psychological testing to staff hiring processes to gauge the inclination to cheat;
- Making a strong example of corrupt staff when their fraud is exposed. Resorting to litigation should be considered in at least some instances to convey a strong message of zero tolerance towards fraud;
- Setting up an internal audit function and ensuring that it reports directly to the audit committee.

At the sector level, a staff reference bureau initiative is already underway as a result of industry players coming together. This will help strengthen human resource practices as the bureau will allow for employees with fraudulent employment records to be flagged on a centralized database. All practitioners, however, need to take collective responsibility to not hire such individuals.

3.7 Interest Rates

Market conditions in Pakistan have been stressed in the past four years. The central bank has maintained a tight monetary policy with discount rates aimed at mopping up financial liquidity in order to rein in inflation. Moreover, a large devaluation of the Pakistani rupee caused it to weaken against all major currencies. However, after the volatility experienced in 2007, 2008, and 2011, we see lower and more stable inflation and interest rate fluctuations. There is no doubt that MFPs are vulnerable to changes in interest rate as the apex lender, PPAF, also has its lending rate tied to that of the Karachi interbank offered rate (KIBOR).

This risk stands seventh in terms of severity. About half of the respondents perceived its severity to be rising, and felt that MFPs' ability to cope with this risk was average. Keeping in view the double impact this risk has, first on MFPs and then on clients, this risk is especially detrimental to the sector. It is worrisome that so many perceive its threat to be rising.

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. This exercise can help protect MFPs from this risk. However, there are negative consequences of doing so as well, as the client is ultimately affected adversely in the face of increasing interest rates and harsh economic conditions, overall. Additionally, asset and liability management in terms of duration gaps and rate sensitivity can be applied to hedge microfinance practitioner portfolios from interest rate risk.

In the long-term, the sector would do well to move towards 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.

3.8 Too Little Funding

Intuitively, funding seems to be a legitimate problem for MFPs. While ranked the eighth most severe in the Pakistani microfinance industry, this risk ranks quite low internationally. The risk of inadequate funds and the risk of excessive funds were ranked 22 and 23, respectively, out of a total of 24 risks in the Microfinance Banana Skins 2011. The risk of *too little funding* is quite high compared to that of *too much funding* in the case of Pakistan, which stands at 23 out of 27 risks. Severity seems to be on the increase for issues related to a dearth in funding for the sector. One-third of respondents felt this risk was rising and that MFPs' ability to cope with it was weak.

A practitioner working in Pakistan remarked "given the

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potential number of microfinance clients in Pakistan, limited access to capital is the key constraint. There are several MFPs that are relatively well-placed to grow, but cannot, due to a lack of funding. The State Bank of Pakistan (SBP) has to take the lead in providing access to 'proven' MFPs. In terms of what else can be done, another practitioner felt "to secure a sufficient flow of funding in the sector, MFPs need to make their case as profitable businesses to the commercial sector. Subsidized donor funding is likely to erode credit discipline".

MFPs are examining options to borrow from commercial sources because donor funding may not last in the long-term. The central bank has eased the process by setting up and administering the MCGF, which helps banks and development finance institutions by extending credit facilities to them.

While the sector is currently served preferentially in terms of funding, sustainability remains an issue. MFPs must find a way to be going concerns – possibly by efficiently utilizing their deposit base and putting in place contingency plans for funding in the short-term.

3.9 Corporate Governance

While the risk faced by microfinance due to *corporate governance* stands at the ninth most severe, it is interesting to look deeper into respondents' rankings by stakeholder group.

The table shows that donors, policymakers, researchers, and others all consider this risk to be a grave one, whereas those with a direct stake in the MFP – the practitioners themselves and their investors, rank this risk lower, at 19 and 26, out of 27. A similar pattern was seen on an international level in the Microfinance Banana Skins 2011. It is worrisome if practitioners themselves do not see this as a

Stakeholder	Ranking of Severity
Practitioners	19
Donors	4
Investors	26
Policymakers	6
Researchers	3
Others	1

risk, as corporate governance is intrinsic to an MFP. The risk can be completely controlled if MFPs realize that it exists. This ties-in with survey statistics as well. Thirty-four percent of all respondents perceived MFPs to have minimal or no ability to cope with this risk, while 53% felt ability was average. In terms of trend in this risk, the majority of respondents consider this risk to be steady.

Salim Jiwani, an analyst at ShoreBank International-Pakistan feels that "a lack of proper governance structures supplemented with a lack of vision about microfinance services provision, is the second biggest challenge the industry faces". Syed Mohsin Ahmed, CEO of PMN was of the opinion that corporate governance risk in the form of a trade-off between growth and the dilution of founder's stake, was the second biggest risk faced by the industry. A policymaker felt that with the industry "not being able to develop and deploy enough new leadership from a younger generation" was the third biggest risk the sector faced. Additionally, many respondents pointed towards 'weak institutions' as a major concern, which again, points to these institutions' corporate governance.

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 calibre. 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.

3.10 Reputation

Reputation is ranked the tenth most severe risk faced by Pakistan's microfinance industry. Internationally, it is the second most severe risk in 2011. This is due primarily to the crisis in Andhra Pradesh, India, which has shaken the confidence of industry stakeholders in India and abroad. Having faced more than one delinquency wave since 2008, Pakistani practitioners consider this a risk, though one not as severe as macroeconomic risk and credit risk. This may be due to the nature of the crises faced, as they have been institution or region-specific. Thus, practitioners who have not experienced such situations

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firsthand may not feel the immediacy of this risk. One practitioner respondent felt that “after what has happened in India and also with Grameen, its impact may be high, but so far, our industry has kept aside [from] this [risk]”. Sixty-two percent of the respondents perceived it to be a high risk in terms of severity, and 47.3% think the threat will continue to rise in future. As far as MFPs’ ability to cope with it is concerned, 30% of respondents rated ability as average, while another 30% felt MFPs have poor or no ability to deal with it.

MFPs around the world are increasingly suffering from notoriety due to the sector’s inclination towards commercialism. There is no doubt that “sustainability”, “profitability”, and “outreach” have been used increasingly as measures of the sector’s performance. Mr. Masood Gill, a practitioner, felt that the industry would need to work on building transparency to regain a good reputation.

An apt summary is given by Tariq Mohar of Tameer Bank in his comment, “the sector was given due importance under the Millennium Development Goals as a vehicle for poverty alleviation. However, its take-off trajectory does not match this vision, which has threats for industry reputation. Under political influence, it gets further exacerbated due the norm of exploitation [by practitioners]”.

MFPs must internalize the concept of the ‘double bottom line’ and realize that like in any other industry, a client-centric approach makes commercial sense as well. Growth at the expense of clients is not sustainable and does more harm than good. Adopting client protection best practices (especially those focusing on avoidance of over-indebtedness) and ethical operational practices are vital to restore industry image. Initiatives already underway at the sector level are trying to contain the risk of a poor reputation. This can be done with the establishment of a microfinance credit information bureau, a sector-level client grievance redressal mechanism, and client awareness initiatives.

3.11 Unrealistic Expectations

In line with the global view on this risk where it ranked tenth, survey respondents felt this risk to be high.

Respondent views as to the trend were evenly divided between ‘rising’ and ‘steady’. Respondents did feel that expectations were very high because of the rhetoric surrounding microfinance, which led to the inevitable disappointment of various stakeholders, which in turn can eventually lead to *reputation* risk. The promise of

“MFPs need to talk reality [to avoid raising expectations to an unrealistic level]. Competition for different kinds of awards for successful clients promotes fiction in the sector.”

Masood Gill, National Rural Support Programme — Urban Poverty Alleviation Programme.

microfinance having big proportions in the past has now turned into a strong view by practitioners and other industry supporters that microfinance is only part of the poverty alleviation puzzle, and that viewing it as a panacea is dangerous. One practitioner complained of the government and regulator expecting much more from microfinance than can be delivered. However, one policymaker was of the view that *unrealistic expectations* are much less of a risk in Pakistan than in the rest of the world because financial inclusion has already become the main agenda, and the central bank is providing an environment where this risk becomes much more manageable. The key would be to continue in this direction and reduce the expectations of the general public (including watchdogs such as the media) as well as donors.

3.12 Political Interference

With local politicians playing a part in causing the first delinquency wave in the country in 2008, the potential risk of *political interference* is not lost on the industry. The time lag since the crisis has caused the perception of the severity of this risk to go down, which could be because

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Political risk will increase with scale.

Donor

the sector went through it and overcame it. At the more macro-political level, however, respondents generally felt that this had not been a problem in the past and that the regulator had a role to play in pre-empting political interference at a higher level. Overall, 52% of respondents felt that the trend in this risk was steady, while 41% thought it was rising. Generally, it was felt that this risk would increase as the sector grows.

response was divided between ‘no ability’ and ‘average ability’. Looking at responses by stakeholder groups, we find that while practitioners are greatly concerned and regard themselves unable to cope with the risk of *natural disasters* (higher than *macroeconomic trends*, *profitability*, and *credit risk*), other stakeholders take a different view. This reflects an over-expectation which needs to be addressed. Tariq Mohar of Tameer Bank stated “the sector has limited capacity to cope with disasters. Most of the MFPs are single-engine revenue machines based on the loan book, thus there are no practical alternatives except help/support from the government”. Again, this emphasizes the disconnect in practitioner and policymaker perceptions of the manageability of this risk.

3.13 Natural Disasters

With two major natural disasters in the past five years – the earthquake in the north in 2005 and the floods in 2010 affecting the entire country, the authors of this report wanted to gauge the extent to which the industry feels

MFPs lack the resilience to cope with another disaster like the [2010] floods.

Practitioner working in Pakistan

this is a major risk. Most respondents (59%) felt that while the severity of risk of *natural disasters* was high to very high, the trend was steady (63%). A number of respondents also felt that the threat of this risk was rising (32%).

3.14 Operations

Managing *operations* is crucial as an MFP’s size grows. Globally, industry stakeholders are concerned that many institutions are growing faster than their operational capacities, which leads to problems like *fraud* and *credit risk*. Views amongst our survey respondents were mixed – an analyst stated that MFPs had learnt their lessons and were strengthening their back offices, while another felt that a dichotomy exists between the regulated and non-regulated sector, with the former having sound systems that are less risky. Yet another raised the point for a need for better internal controls, especially in large, geographically-dispersed organizations. While the majority of respondents viewed this risk to be severe, they thought the trend was steady. This may be due to the moderate growth in the sector, at present. Fast-paced growth in the future may make this risk increase in severity. Of all stakeholder groups, practitioners seemed the most confident about their ability to cope with this risk, again, suggesting myopia amongst MFPs regarding their strengths in the face of other industry stakeholders taking a less optimistic view.

Stakeholder	Riskiness in Terms of MFPs' Ability to Cope
Practitioners	1
Donors	10
Investors	4
Policymakers	16
Researchers	20
Others	11

3.15 Staffing

Overall, the sector does not consider the risk of attracting and retaining good staff as a high-risk area. This is in contrast to the global survey, which showed that *staffing* was a major concern, especially amongst MFPs. However,

In terms of MFPs’ ability to cope with this risk, the overall

(3.1) Macroeconomic Trends (3.2) Profitability (3.3) Credit Risk (3.4) Security (3.5) Liquidity (3.6) Fraud (3.7) Interest Rates (3.8) Too Little Funding (3.9) Corporate Governance (3.10) Reputation (3.11) Unrealistic Expectations (3.12) Political Interference (3.13) Natural Disasters (3.14) Operations (3.15) Staffing (3.16) Strategy (3.17) Managing Technology (3.18) Mission Drift (3.19) Ownership (3.20) Transparency (3.21) Management Quality (3.22) Religious Influence (3.23) Too Much Funding (3.24) Competition (3.25) Inappropriate Regulation (3.26) Foreign Exchange (3.27) Product Development

this is probably the result of the fact that risks such as *security*, *macroeconomic trends*, and *religious influence* are more relevant to Pakistan than other countries, thus pushing some risks down the list despite them being valid concerns. This view is confirmed by the fact that only four practitioners responding to the survey out of 31, felt this was actually a low-risk area. Some practitioners consider this an issue of organizational culture while others (especially MFBs) feel that since the

“The sector does not have glamour like other banks to provide long-term careers. Microfinance is, at best, a transitory stage for good resources who ultimately want to join mega banks.”

Tariq Mohar, Tameer Bank.

sector competes with commercial banks in terms of staffing and is not able to offer comparable compensation, human resource quality suffers. While the dearth of employment opportunities for young professionals does create a window for MFPs to recruit, it has to struggle with retaining good staff as most professionals see their time in microfinance as temporary and usually have their eyes on more lucrative commercial banking careers. 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 constantly dealt with.

3.16 Strategy

Risks in terms of *strategy* address the issue of MFPs' ability to map strategies to survive and grow in today's challenging environment. Policymakers seem to be the most concerned and rank this as one of the top ten risks the sector faces today. It is also one that seems to be holding steady, and stakeholders do not foresee much change in terms of its ability to hurt the sector. 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. Nonetheless, this does not seem like a major concern in the medium-term.

3.17 Managing Technology

Generally, MFPs have low levels of technological integration. 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. Currently, only a handful of players have sought the synergies that technology provides, as this is a high investment

“Difficult. New technology is costly.”

Naveed Qazi, First
MicroFinanceBank Ltd.

proposition only few can afford. Syed Mohsin Ahmed, an industry representative, stresses that though technology can play a major role, “it is more important to have a strong business model to increase access and build efficiency”. Practitioners were of the view that this risk was manageable for MFPs that looked at it seriously enough. The majority of respondents felt that this risk would see an increase in future.

3.18 Mission Drift

This depends on what the mission is. “Do all organizations within the microfinance realm share the same mission? Are all of them primarily tied to a poverty discussion?” asks a policymaker. Many respondents hint that to avoid *mission drift*, institutions need to stay true to their mission. Others seemed to defend mission drift. Naveed Qazi of the First MicrofinanceBank, argued “the high cost of operations and high default rates affect sustainability.

“MFPs will continue to serve the existing markets.”

Practitioner working in Pakistan

(3.1) Macroeconomic Trends (3.2) Profitability (3.3) Credit Risk (3.4) Security (3.5) Liquidity (3.6) Fraud (3.7) Interest Rates (3.8) Too Little Funding (3.9) Corporate Governance (3.10) Reputation (3.11) Unrealistic Expectations (3.12) Political Interference (3.13) Natural Disasters (3.14) Operations (3.15) Staffing (3.16) Strategy (3.17) Managing Technology (3.18) Mission Drift (3.19) Ownership (3.20) Transparency (3.21) Management Quality (3.22) Religious Influence (3.23) Too Much Funding (3.24) Competition (3.25) Inappropriate Regulation (3.26) Foreign Exchange (3.27) Product Development

This changes the focus from a [social] mission to profitability/sustainability". On the other hand, many stakeholders were optimistic that the industry in Pakistan faces little mission drift. While about half of the respondents felt that the severity of this risk was high, 59% felt its trend was steady and the ability of MFPs to cope with it was average.

3.19 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. When just a few firms dominate a sector – which is common in microfinance – this risk can have a sector-level effect.

Stakeholder	Ranking of Ownership
Practitioners	26
Donors	5
Policymakers	21
Investors	10
Researchers	18
Others	4

This is one area where there is considerable variance in stakeholder views. Practitioners rank this as the second least important threat to the sector – higher only than *inappropriate regulation* – whereas donors and 'others' think it deserves a spot in the top five, and investors place it in the top 10 (see Table). There appears to be a disconnect between practitioners' views of the appropriateness and stability of MFP ownership structures, and other key stakeholders' views. Similarly, most stakeholders are not confident about these institutions' ability to handle risks that emanate from the structure of *ownership* in the sector today. One view is that owners of non-profits do not have a financial stake in their institutions, which causes ownership structures to remain weak. In terms of MFBs, changes in capital requirements are expected to drive change in their ownership structures.

This area ranks low in the overall ranking of risks. This is mostly a result of the sample being dominated by practitioners. Analysis across stakeholder groups shows this is an area of concern for many.

3.20 Transparency

Stakeholder	Ranking in Trend
Practitioners	12
Donors	1
Policymakers	27
Investors	27
Researchers	25
Others	5

For donors, the risk that will see the biggest increase in future will be a lack of *transparency*. Other sector stakeholders have a different view, perceiving it to be a steady trend, but ranking it amongst the least dire of risks. This is perhaps because the sector collectively encourages fuller reporting. This is one risk where practitioners themselves perceive it to be rising. While other stakeholders' views are surprising, it is heartening to note that practitioners are aware of this risk and rank it relatively higher. 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. That said, many industry stakeholders felt that this was not a major risk area. However, responses differed for bank and non-bank practitioners. The regulator and other stakeholders have

“[Institutions] do not provide reliable data.”

Farida Tariq, Centre for Women
Cooperative Development.

developed well-defined ratios and have ensured transparency across the industry, said one analyst. A practitioner however, expressed the concern that many institutions do not report reliable data.

3.21 Management Quality

This is also an area where opinions vary considerably across stakeholders, with practitioners and investors being the most optimistic (ranked 24 and 27, respectively, by the two groups) and policymakers and donors being

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the least optimistic (ranked 3 and 10, respectively, by the two groups). This is also amongst the top ten risks identified globally.

Management quality and skills are recognized as crucial elements in the success of any institution. Some survey respondents felt that although the situation is improving, there is still considerable effort that needs to be put in to build strong and capable management teams. As Mehr Shah, an analyst at the PMN, stated “risks are increasing as businesses expand. The NGO-MFIs specifically, need to re-assess management capacity”. There was also concern that top management is losing touch with the basics and is quite removed from the realities in the field. Optimism, however, in this regard was also evident and respondents felt that MFPs are aware of this gap, and have developed strategies to address it. This however, will remain a challenging area given the concerns raised in terms of the sector’s ability to attract and retain good human resources (see *staffing*).

3.22 Religious Influence

“Risk associated with religious influences in certain areas is extremely high, especially in Punjab and Khyber Pakhtunkhwa, and is rising with people trying to hide under the veil of religion so as not to perform” warns Hameeduddin Ahmed of Pak-Oman Microfinance Bank. Generally, our survey responses suggest that this risk is a reality, but in certain geographic areas only, especially the western border of the country. Those operating in non-sensitive areas do not consider it a real threat, with one practitioner stating that “there is talk that some religious elements pose risk to the sector. In my opinion, there is more story than reality in this”. In sum, the threat from this risk cannot be ignored as it is divergent to the basic premise of conventional finance on which the microfinance model is built. There is a need to proactively seek Islamic financial solutions where there is a market for these, especially in sensitive regions.

BOX 3: A Case Against Islamic MFPs

“All organizations face risks. Innovative organizations face more risk from conservative forces and invariably, conservative forces want status quo. They use various means including religion, for its maintenance. The rise of ‘Islamic Microfinance’ represents a major

risk, not so much in the sense of competition, but in the sense of the negativity that Islamic microfinance organizations spread about ‘sood (riba)-based’ MFPs. Instead of highlighting the virtues of their own approach and products, they spend more energy ‘sood-bashing’.

Analyst/researcher

3.23 Too Much Funding

With *too little funding* posing a much more severe risk to the industry as perceived by respondents, the risk of *too much funding* becomes irrelevant. This is contrary to what is seen internationally in the Microfinance Banana Skins 2011, where *too much funding* ranks a step above *too little funding*.

“ I think donors should back off. ”

Policymaker

There is a consensus that as subsidies to the industry fall, a healthy transitioning process to the new structure of the industry will be key. A few respondents, however, did express the concern that institutions should be wary of this risk. An analyst stated, “a disbursement-oriented approach always creates risk, funds must be available in a controlled and well-monitored environment”.

3.24 Competition

In contrast to global perceptions as evidenced in the Banana Skins, 2011, where it ranks third in severity, the competitive environment in Pakistan is not considered to be a major threat. This is primarily because only a handful of geographic markets in Pakistan currently face competitive pressures, where multiple MFPs operate. For

“ Competition exists in a few urban pockets, only. ”

Muhammad Awais, Plan Asia.

(3.1) Macroeconomic Trends (3.2) Profitability (3.3) Credit Risk (3.4) Security (3.5) Liquidity (3.6) Fraud (3.7) Interest Rates (3.8) Too Little Funding (3.9) Corporate Governance (3.10) Reputation (3.11) Unrealistic Expectations (3.12) Political Interference (3.13) Natural Disasters (3.14) Operations (3.15) Staffing (3.16) Strategy (3.17) Managing Technology (3.18) Mission Drift (3.19) Ownership (3.20) Transparency (3.21) Management Quality (3.22) Religious Influence (3.23) Too Much Funding (3.24) Competition (3.25) Inappropriate Regulation (3.26) Foreign Exchange (3.27) Product Development

the rest of the country, with financial access limited due to few players operating here, competition does not exist. An analyst commented, “competitive pressures may be increasing in already microfinance-dense locations, however the severity may be deflected by focusing on untapped markets. The lack of financial and operational sustainability of Pakistan’s microfinance sector as a whole, renders an average MFP less capable of competing with existing competitive pressures”. Many respondents felt that increased competition would actually help the market in terms of pushing practitioners to offer more differentiated products, encouraging innovation, and attempting to serve client needs better.

3.25 Inappropriate Regulation

Concerns about *inappropriate regulation* stifling the growth and sustainability of MFPs have risen globally. It rose from being the 13th most severe risk in 2010 to the sixth most severe risk in 2011⁶. The crisis in India and the reaction from state governments and the central bank have raised red flags with microfinance stakeholders, making them wary of how regulators may react in their own countries if similar circumstances were to arise. This is not the case in Pakistan. The last thing on MFPs’ minds is a threat from inappropriate regulation. Although other stakeholders do not think this is the least threatening, they do not consider it a major concern either – today, or in the near future. Pakistan’s microfinance regulation is viewed as one of best in the world and respondents had considerable praise for the role of the SBP in this regard (see **BOX 4**). The area where concerns were voiced mostly relate to the unregulated MFPs. Respondents urged that consumer protection measures and some protection for such institutions against *political interference*, were essential.

BOX 4: The Microfinance Regulatory Environment in Pakistan

In its 2010 report, the Economic Intelligence Unit (EIU) of the Economist Group rated Pakistan’s microfinance regulatory framework as the best in the world, along with the Philippines and Cambodia. The report recognized the strong role played by the SBP in developing rules in 2010 that enabled the MFB sector. These included lifting regulations that prevented the MFBs from accessing foreign currency loans from international investors, aligning loan

classification criteria with international best practices, revising loan limits, and defining microfinance borrowers.

Pakistan was ranked fifth for overall business environment for microfinance, 12th for institutional development, and 20th for investment climate, out of the 54 countries included in the report.

Source: EIU. 2010. *Global microscope on the microfinance business environment*.

3.26 Foreign Exchange

Forex is not a significant risk faced by the industry as little borrowing in foreign currency from off-shore sources has occurred so far⁷. This risk would apply in case MFPs grow and require financing from external sources, and as industry structures change towards foreign currency commercial exposure. A practitioner exhorted the industry to “not take on foreign currency exchange risk. Investors are better equipped to bear this risk”.

3.27 Product Development

It is quite surprising that this risk would fare so low. A closer look shows that this ranking is influenced by the heavy presence of MFPs in the sample. This is evident from the severity ranking placed on this risk by other industry stakeholders (see Table).

Stakeholder	Severity Ranking
Practitioners	19
Donors	1
Policymakers	1
Investors	19
Researchers	15
Others	18

While being the foremost concern of donors and policymakers alike, practitioners and investors are less concerned about product development. This is a rather worrisome scenario, seeing how there has been much talk

⁶ CSFI. 2011. *Microfinance Banana Skins 2011*.

⁷ PMN. 2009. *Pakistan Microfinance Review 2009*.



(3.1) Macroeconomic Trends (3.2) Profitability (3.3) Credit Risk (3.4) Security (3.5) Liquidity (3.6) Fraud (3.7) Interest Rates (3.8) Too Little Funding (3.9) Corporate Governance (3.10) Reputation (3.11) Unrealistic Expectations (3.12) Political Interference (3.13) Natural Disasters (3.14) Operations (3.15) Staffing (3.16) Strategy (3.17) Managing Technology (3.18) Mission Drift (3.19) Ownership (3.20) Transparency (3.21) Management Quality (3.22) Religious Influence (3.23) Too Much Funding (3.24) Competition (3.25) Inappropriate Regulation (3.26) Foreign Exchange (3.27) Product Development

in industry circles regarding the strong need for product diversification and a shift to more innovative credit delivery mechanisms, as well as more attractive savings mobilization schemes in order to better address client needs and offer effective financial inclusion.

Though not considering this risk to be a major one, practitioners' views on it differed, with one warning that "this [risk] will lead to credit risk as institutions go for products sustainable only in the short-term". Another chastised the industry for developing marketing themes rather than products. In contrast, another practitioner believes in following basic rules of thumb: "Keep it basic and simple. That should be the rule".



4. Appendix

4. Appendix: Survey Questionnaire

Section I: Who you are

1. Who you are:

Name _____

Position _____

Institution _____

2. Are you willing to be quoted from the writing sections of this survey?

- I am willing to be quoted
 I am not willing to be quoted

3. 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) _____

4. 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.

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 No ability

Please write additional comments in the following space:

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

Severity: Very high High Average Low Very low

Trend: Rising Steady Falling

MFPs' ability to cope: Excellent Good Average Poor No ability

Please write additional comments in the following space:

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 No ability

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 No ability

Please write additional comments in the following space:

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

Severity: Very high High Average Low Very low

Trend: Rising Steady Falling

MFPs' ability to cope: Excellent Good Average Poor No ability

Please write additional comments in the following space:

6. 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 No ability

Please write additional comments in the following space:

7. 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 No ability

Please write additional comments in the following space:

8. 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 No ability

Please write additional comments in the following space:

9. 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 No ability

Please write additional comments in the following space:

10. 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 No ability

Please write additional comments in the following space:

11. 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 No ability

Please write additional comments in the following space:

12. 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 No ability

Please write additional comments in the following space:

13. 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 No ability

Please write additional comments in the following space:

14. 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 No ability

Please write additional comments in the following space:

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

Severity: Very high High Average Low Very lowTrend: Rising Steady FallingMFPs' ability to cope: Excellent Good Average Poor No ability

Please write additional comments in the following space:

16. 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 lowTrend: Rising Steady FallingMFPs' ability to cope: Excellent Good Average Poor No ability

Please write additional comments in the following space:

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

Severity: Very high High Average Low Very lowTrend: Rising Steady FallingMFPs' ability to cope: Excellent Good Average Poor No ability

Please write additional comments in the following space:

18. 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 No ability

Please write additional comments in the following space:

19. 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 No ability

Please write additional comments in the following space:

20. 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 No ability

Please write additional comments in the following space:

21. 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 No ability

Please write additional comments in the following space:

22. 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 No ability

Please write additional comments in the following space:

23. 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 No ability

Please write additional comments in the following space:

24. 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 No ability

Please write additional comments in the following space:

25. TOO MUCH FUNDING: Alternatively, does an overabundance of funding encourage MFPs to take unnecessary risks?

Severity: Very high High Average Low Very low

Trend: Rising Steady Falling

MFPs' ability to cope: Excellent Good Average Poor No ability

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 No ability

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 No ability

Please write additional comments in the following space:

28. If you feel that the Pakistani Microfinance sector faces any significant risk(s) in addition to the ones listed above, please describe them below.

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The logo for the Pakistan Microfinance Network is centered on a red background with a repeating pattern of overlapping, light-colored, semi-circular shapes. The logo itself consists of a white, stylized roof-like shape above the text "Pakistan Microfinance Network". The word "Micro" is written in a smaller font size than "Pakistan" and "finance Network".

Pakistan Microfinance Network