RISKS

TO MICROFINANCE IN PAKISTAN

Pakistan Microfinance Network

RISKS TO MICROFINANCE IN PAKISTAN

Findings from a Risk Assessment Survey

ALI BASHARAT &
ZEENOOR S. SHEIKH

ACKNOWLEDGEMENT

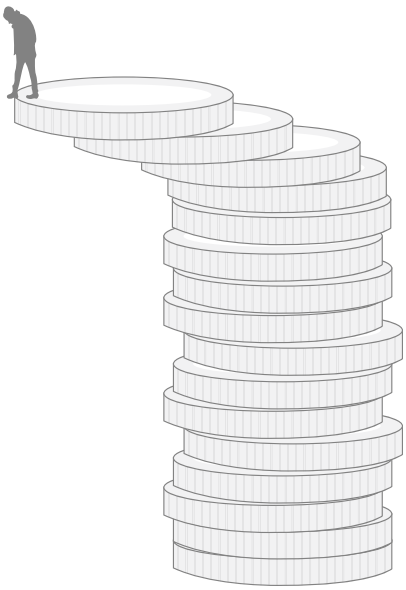
This report would not have been possible without the contributions of PMN's members, supporters, strategic partners and donor, DFID. We would like to thank them for their continuous support.

PMN would also like to thank the respondents of the survey for their time and cooperation for this study. We extend our deepest gratitude to them! We hope that the results and insights from this study will provide a detailed understanding about the risks to the microfinance sector in the country and help formulate appropriate future strategies.

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 our mission is to support the financial sector, especially retail financial service providers, to enhance their scale, quality, diversity and sustainability in order to achieve inclusive financial services.

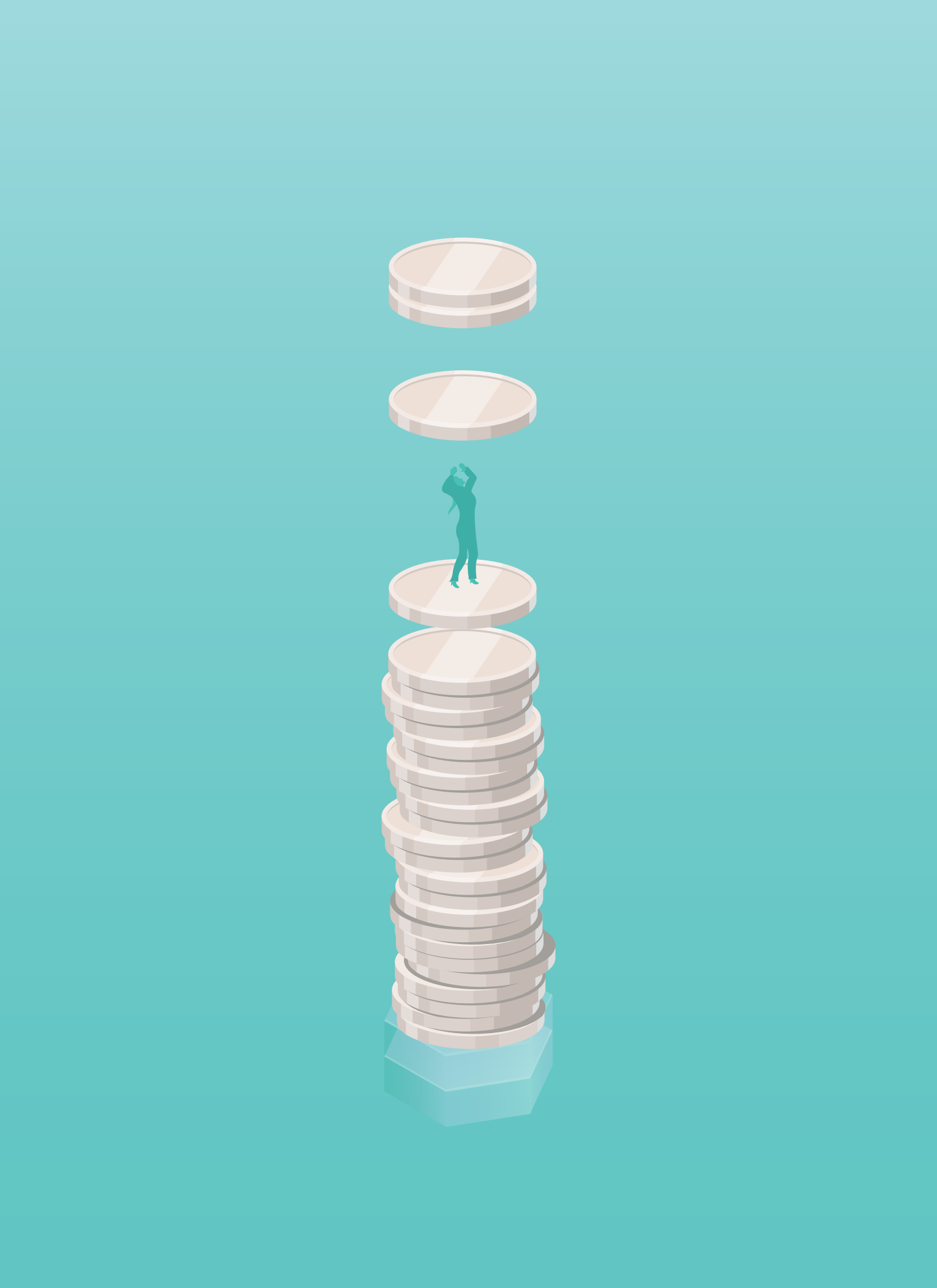
Assessing Risks to Microfinance in Pakistan: Findings from a Risk Assessment Survey

Pakistan Microfinance Network
3rd Floor, Plot # 12-C/2, G-8 Markaz, Islamabad
Tel: +92 (51) 2266214, Fax: +92 (51) 2292230
Email: info@pmn.org.pk
www.pmn.org.pk



ACRONYMS & ABBREVIATIONS

CAGR	Cumulative Average Growth Rate
CGAP	Consultative Group to Assist the Poor
CSFI	Centre for Study of Financial Innovation
DFID	Department for International Development
DRF	Disaster Risk Fund
EIU	Economic Intelligence Unit
KIBOR	Karachi Inter-bank Offered Rate
LIBOR	London Inter-bank Offered Rate
MCGF	Microfinance Credit Guarantee Facility
MFB	Microfinance Bank
MF-CIB	Microfinance Credit Information Bureau
MFI	Microfinance Institute
MFP	Microfinance Provider
MIS	Management Information System
MNO	Mobile Network Operator
NBMFI	Non-Bank Microfinance Institute
PAR	Portfolio At Risk
PMIC	Pakistan Microfinance Investment Company
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
ROA	Return on Assets
RSP	Rural Support Programme
SBP	State Bank of Pakistan

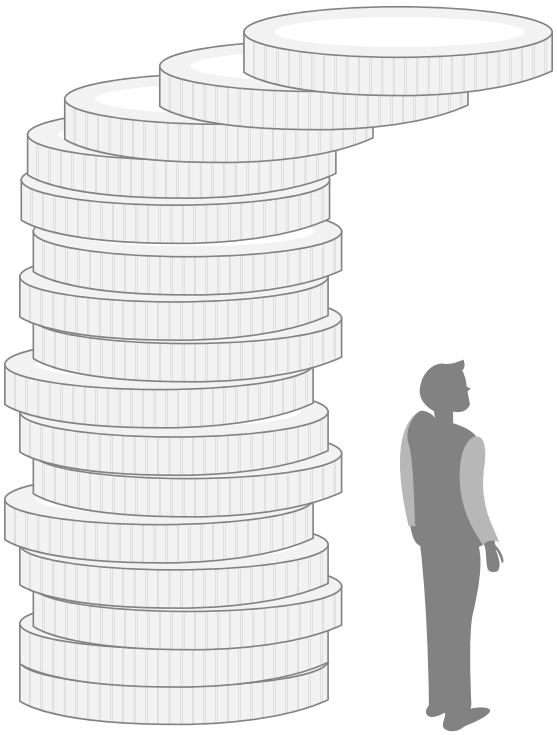


CONTENT

PREFACE

Risks to Microfinance in Pakistan is the fourth edition of a study that seeks to map the risks being faced in the Pakistan microfinance sector as perceived by various stakeholders. The first study, conducted in 2011 by the Pakistan Microfinance Network (PMN), served as a starting point for the discussion on risks and threats encompassing the Pakistan microfinance sector. This study aims to update the risks highlighted in the initial publication in the face of the changing business and macroeconomic environment, as well as, new initiatives and developments in the microfinance sector.

The study is categorized into three main sections: Introduction, Analysis of Data and Risk Mitigation Strategies. The first section, Introduction, examines why risk management is crucial for microfinance institutions and provides an overview of the methodology used for this study. The following chapter, Analysis of Data, describes the headline findings and showcases the responses and perceptions of the participants. The third section briefly discusses the Details of Risks and Possible Mitigation Strategies for risks and threats highlighted in Section Two.



Introduction

Risk Management for Microfinance

The microfinance industry in Pakistan is recognized as a key player in the financial inclusion arena in the country. With nearly fifty players, big and small, operating in the country, the industry is striving to provide financial services to the unbanked segment of the population. Building on sustainability, microfinance industry is not only spreading geographically but also catering to specific market segments. It is increasingly relying on commercial funding sources to fuel its growth. Moreover, the industry is keenly adopting digitization to bring down its costs and expand outreach.

As the industry matures, new challenges and risks are emerging. With growth rates in double digits for more than five years now, the rapid growth can pose serious challenge for the players. Despite the progress so far, there remains a huge upside potential in the market that is yet untapped. Consequently, service providers are enhancing their scope of operations by offering a wider range of financial services and exploring more distinctive market niches, while, at the same time, increasing their appetite for risk in order to capitalize on growth opportunities.

Global best practices are placing increasing emphasis on proactive risk management as an essential element of long-term success and sustainability. Rather than just focusing on current or historical performance, stakeholders now need to focus on an organization's ability to identify and manage future risks as the best predictor of long-term success. Moreover, as the microfinance sector evolves, new types of risks are emerging which require more sophisticated forms of management.

The objective of the study is to develop a risk framework for the industry and serve as a key information source for all stakeholders for identifying the risks faced by the players, their severity and ability of the practitioners to manage and mitigate risks.

Methodology

The Microfinance Banana Skins[1] 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 emulates the methodology of the Microfinance Banana Skins 2018 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 (sample in Section 4) sent out to 200 potential respondents. The response rate was 34% with 68 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 26 risks and asked them to rate:

- Risk severity: very high risk, high risk, average risk, low risk, or very low risk;
- Risk trend: very high, high, average, low, or very low;
- MFPs' ability to cope with risk: very high ability to cope, high ability to cope, average ability to cope, low ability to cope, or very low ability to cope.

Respondents had the option of providing comments on each risk, if they chose to. They were also asked to rank their familiarity with Pakistan's microfinance sector (very familiar, somewhat familiar, or not familiar) to enable the

[1] The latest issue for this report (2018) can be viewed and downloaded at: https://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/5b7c1f2d562fa704995d02d7/1534861133477/Banana+Skins_08-18_v5.pdf

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 Network.

A breakdown of respondents by stakeholder group and by respondents' familiarity with the sector is shown in Figure 1: Break-up of Respondents and Figure 2: Familiarity of Respondents with Pakistan's Microfinance Sector. 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 (65%). These included 11 microfinance bank (MFB) respondents, 23 Non-bank Microfinance Institute (NBMFI) respondents, 5 Rural Support Programme (RSP) respondents, and respondents from Regulatory bodies, Donors and Investors. 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, the sample was nearly evenly distributed across remaining stakeholders. Over 53% of respondents said they were very familiar with the microfinance sector, over 36% considered themselves as extremely familiar, while the remainder, 10%, felt they had some understanding of the sector.

Figure 1: Break-up of Respondents

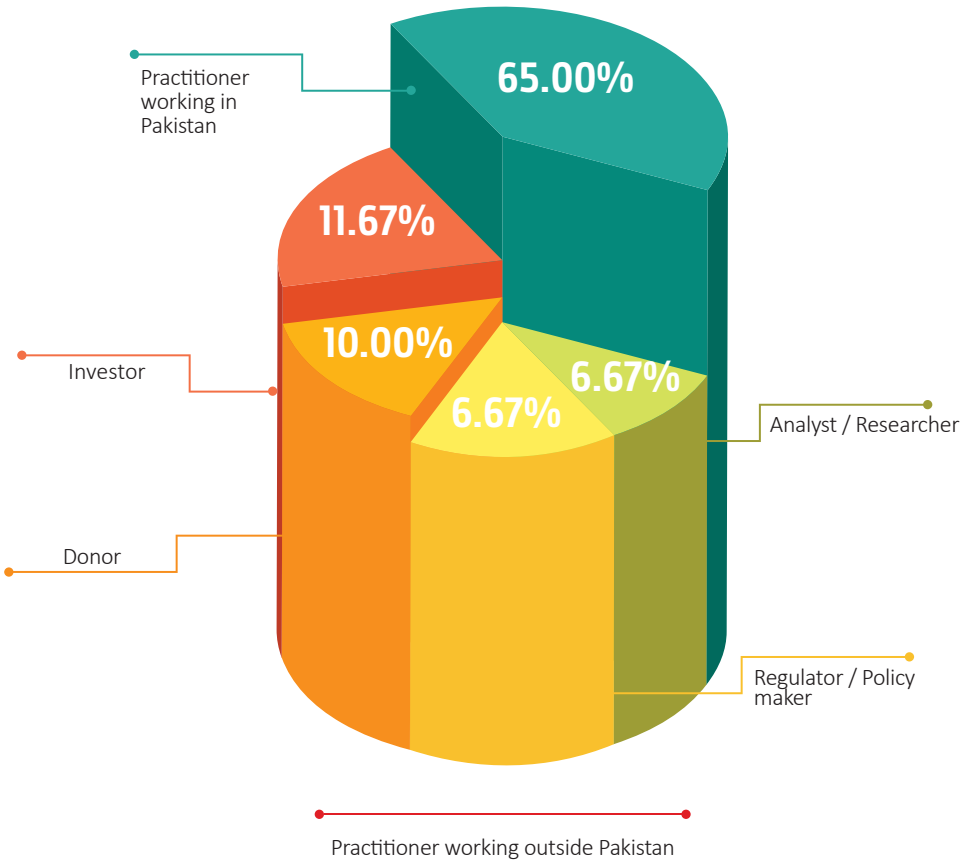
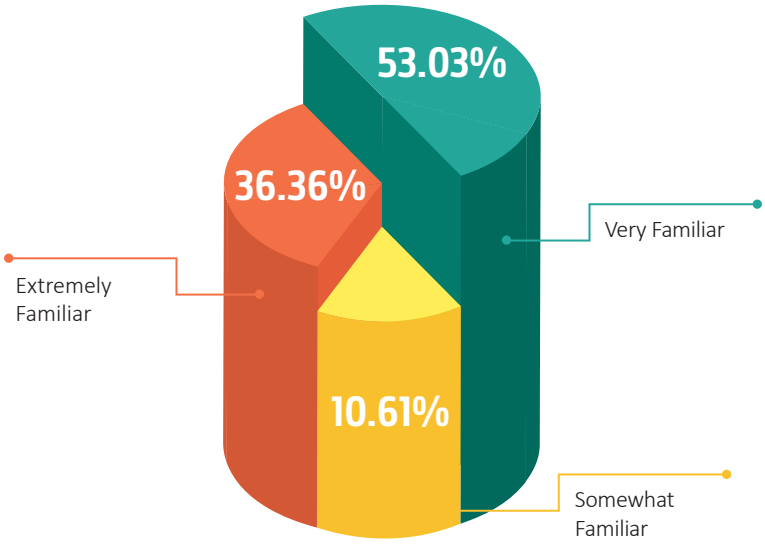


Figure 2:
Familiarity of Respondents with Pakistan's Microfinance Sector



Analysis of Data – Headline Findings

In accordance with the previous editions of this report, the cornerstone of this year's survey is the identification and ranking of risks faced by the industry. The results of this study are solely based on the views of the respondents of the survey who evaluate the level of threat emerging from diverse classifications of risks.

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

- Biggest Risks/Severity: 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 the MFPs' ability to cope with a risk as poor or as having no ability.

The findings of the survey indicate that the threat arising from Interest Rates (previously sixth) and Credit Risk (previously fourth) are the two biggest risks this year. Talent jumped to third place (previously twenty-one) and external threats, such as Marco-Economic Trends, Natural Disasters, Technology and Political Risks, continue to remain one of the major challenges for the stakeholders of the industry, after the first three, in that order.

Table 1:
Top Rated Risks

BIGGEST RISKS/SEVERITY		FASTEST RISING		LOWEST ABILITY TO COPE	
Interest Rates	73% (63 %)	Talent	52% (25 %)	Interest Rates	47% (21 %)
Credit Risk	71% (68 %)	Macro-Economic Trends	47% (42 %)	Natural Disasters	44% (46 %)
Talent	67% (46 %)	Management Quality	46% (38 %)	Political Risk	43% (40 %)
Macro- Economic Trends	67% (46 %)	Competition	45% (65 %)	Macro-Economic Trends	43% (29 %)
Natural Disasters	65% (77 %)	Interest Rates	44% (46 %)	Regulation	41% (13 %)
Technology Risk	57% (58 %)	Strategy	41% (44 %)	Religious Influence	40% (38 %)
Political Risk	53% (63 %)	Credit Risk	40% (56 %)	Security	37% (33 %)
Regulation	53% (54 %)	Technology Risk	40% (54 %)	Liquidity	31% (19 %)
Profitability	52% (71 %)	Transparency	40% (23 %)	Technology Risk	29% (09 %)
Competition	51% (65 %)	Natural Disasters	35% (41 %)	Funding	29% (21 %)
Management	50% (56 %)	Foreign Exchange Risk	34% (23 %)	Product Development	29% (15 %)
Strategy	48% (52 %)	Regulation	31% (36 %)	Foreign Exchange Risk	28% (23 %)
Foreign Exchange Risk	48% (31 %)	Political Risk	30% (44 %)	Competition	27% (07 %)

BIGGEST RISKS/SEVERITY		FASTEST RISING		LOWEST ABILITY TO COPE	
Funding	47% (49 %)	Liquidity	30% (40 %)	Reputation	27% (19 %)
Transparency	44% (54 %)	Mission Drift	29% (29 %)	Talent	27% (17 %)
Internal Fraud	44% (50 %)	Corporate Governance	27% (42 %)	Corporate Governance	24% (15 %)
Liquidity	42% (60 %)	Funding	26% (52 %)	Mission Drift	22% (09 %)
Product Development	38% (46 %)	Profitability	25% (38 %)	Credit Risk	20% (09 %)
Corporate Governance	37% (54 %)	Unrealistic Expectations	25% (19 %)	Profitability	19% (13 %)
External Fraud	37% (50 %)	Product Development	20% (31 %)	Internal Fraud	17% (06 %)
Mission Drift	36% (42 %)	Internal Fraud	18% (27 %)	Unrealistic Expectations	16% (11 %)
Reputation	34% (56 %)	Religious Influence	15% (29 %)	External Fraud	15% (07 %)
Unrealistic Expectations	34% (46 %)	Reputation	15% (27 %)	Transparency	15% (06 %)
Religious Influence	33% (35 %)	Security	13% (40 %)	Operations	13% (04 %)
Security	30% (60 %)	Operations	11% (38 %)	Management	11% (13 %)
Operations	30% (56 %)	External Fraud	11% (33 %)	Strategy	08% (11 %)

Figures in the brackets represent the responses from the previous survey conducted in 2015

Table 2:
Top Ten Biggest Risks/Severity

TOP 10 RISKS – SEVERITY		
CURRENT POSITION	RISK	PREVIOUS POSITION
1	Interest Rates	06
2	Credit Risk	04
3	Talent	21
4	Macro-Economic Trends	03
5	Natural Disasters	01
6	Technology Risk	10
7	Political Risk	07
8	Regulation	17
9	Profitability	02
10	Competition	05

Risks associated with Interest Rates have been characterized as the highest this year. The jump from sixth place previously to first place this year, outranking Natural Disasters, is because interest rates have risen significantly to the highest they've been in over three years in the closing quarter of 2018. It is also worth noting that Profitability, which was ranked as the second largest risk in the previous survey, has now dropped to ninth place. As the sector has reached the maturity stage of its life cycle, profitability has become less of a threat than it was during the growth stage since earnings of MFPs are now stable and growing. Instead, Credit Risk, which was previously at fourth place, now occupies second place as the biggest risk being faced by the sector.

The results also indicated that Talent, i.e. recruiting and retaining qualified staff, is now considered the third most severe risk in the sector. Previously ranked twenty-first on the biggest risks of 2015, it has made the highest jump compared to any other risk. This has led the risk from Macro-Economic Trends to drop down a position as the fourth biggest risk being faced by the sector since stakeholders still consider the threat emanating from wider economic challenges as one of the greatest challenges being faced by the industry.

Natural Disasters, which was previously ranked as the biggest risk faced by the sector, now stands at the fifth position. The threat is still considered as one of the most serious challenges faced by the sector because of the unpredictability and uncertainty associated with such events. In 2015 alone, approximately 1.6 million people were affected by a series of flash floods, heat waves and earthquakes which severely impacted the agricultural sector and portfolios of multiple MFPs which led to Natural Disasters being the biggest risk to the sector that year.

While globally, Technology Risk is considered as the biggest risk to the sector, it has escalated to being ranked as sixth this year, as compared to tenth in the previous study. While technology opens the way to huge growth in the provision of financial services, it contains risks of its own. The most serious of these is the risk that the players in the industry will fail to understand and exploit technology while placing themselves at risk. In the process of facilitating access to financial services, the less technologically literate clients could potentially be lured into irresponsible borrowing and debt difficulties.

The fastest trending risks this year according to the study are Talent, Macro-Economic Trends & Management in that order. Competition, which was the most trending risk in the previous study, has dropped down to fourth place, despite the double-digit growth in outreach and increasing geographical coverage by MFPs. Whereas, Talent, which was previously ranked at twenty third, has quickly escalated as the most trending risk in the sector right now. Macro-Economic Trends have also risen from the eighth spot to being perceived as the second fastest growing threat to the industry.

Table 3:
Top Ten Fastest Rising Risks

TOP 10 RISKS – FASTEST RISING		
CURRENT POSITION	RISK	PREVIOUS POSITION
1	Talent	23
2	Macro-Economic Trends	08
3	Management	13
4	Competition	01
5	Interest Rates	05
6	Strategy	06
7	Credit Risk	02
8	Technology Risk	03
9	Transparency	24
10	Natural Disasters	10

Credit Risk, which was perceived as the second fastest rising risk in 2015, is now ranked at seventh place. Despite a dip in its rankings, it is still considered to be one of the most prominent threats to the sector primarily because MFPs place emphasis on growth and compete to achieve scale. While it is perceived as a growing threat, most MFPs consider themselves equipped to cope with this risk.

Management and Competition are ranked third and fourth respectively on the list of fastest rising risks. The main reason for this being that the availability of human talent at all levels, management and lower staff is being poached due to increased competition leading to increased turnover. Moreover, rapid growth coupled with insufficient quality talent has become a problem.

Table 4:
Risks - Lowest Ability to Cope

TOP 10 RISKS - LOWEST ABILITY TO COPE		
CURRENT POSITION	RISK	PREVIOUS POSITION
1	Interest Rates	07
2	Natural Disasters	01
3	Political Risk	02
4	Macro-Economic Trends	05
5	Regulation	14
6	Religious Influence	03
7	Security	04
8	Liquidity	10
9	Technology Risk	20
10	Product Development	08

In terms of preparedness, the study indicated that the sector perceives itself to be least prepared to deal with exogenous/external risks. The top ten list of risks with the least ability to cope indicate that top 7 of the risks are all external factors, with Interest Rates, Natural Disasters and Political Risk occupying the top three spots respectively.

Table 5:
Regional & Global Comparison of Top Ten Risks

TOP 10 RISKS TO THE MICROFINANCE SECTOR		
PAKISTAN	SOUTH ASIA*	GLOBAL*
Interest Rates	Political Risk	Technology Risk
Credit Risk	Product Risk	Strategy
Talent	Technology Risk	Political Risk
Macro-Economic Trends	Strategy	Credit Risk
Natural Disasters	Credit Risk	Risk Management
Technology Risk	Talent	Product Risk
Political Risk	Risk Management	Corporate Governance
Regulation	Service Delivery	Talent
Profitability	Funding	Management
Competition	Management	Regulation

***CSFI Banana Skins 2018 Report**

A global comparison of the top ten risks indicates that the most serious risks facing the global microfinance landscape are those that are internal to players of the microfinance sector as opposed to exogeneous. Only two of the top ten are external i.e. Political Risk and Regulation. Technology Risk, Strategy and Political Risk are considered the most severe risks globally. Comparatively stakeholders in Pakistan are equally concerned about macro or environmental risks as they are about micro-risks that are institution specific.

According to the CSFI Banana Skins 2018 Report, respondents in South Asia emphasized Political Risks, including turbulent elections in Pakistan and unpredictable events such as demonetization in India. Product risk also ranked higher in this region than it did globally. Respondents were concerned about the "one size fits all approach" within the region and that products did not consider consumer insights. Moreover, results from South Asia framed the risks around modern technologies and digitization in terms of consumer protection and complaint redressal mechanisms.

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.

Table 6:
Practitioners Working in the Sector - Including Those Employed by MFPs

PRACTITIONERS IN THE INDUSTRY		
SEVERITY	FASTEST RISING	LOWEST ABILITY TO COPE
Interest Rates	Talent	Interest Rates
Credit Risk	Strategy	Regulation
Talent	Competition	Natural Disasters
Competition	Technology Risk	Macro-Economic Trends
Macro-Economic Trends	Management	Religious Influence
Technology Risk	Macro-Economic Trends	Security
Profitability	Credit Risk	Political Risk
Natural Disasters	Foreign Exchange Risk	Foreign Exchange Risk
Management	Transparency	Liquidity
Regulation	Interest Rates	Funding

Practitioners working in the sector perceived Interest Rates as the most severe risk in the sector. The reason for this is most likely the significant increase in interest rates by the end of 2018. The other most severe risk categorized is Credit Risk – ahead of factors such as competition, interest rates, economic conditions and over-indebtedness. Talent with respect to staff and skills is also considered to be a key risk facing the practitioners in the industry which is attributable to increasing competition and saturation of the sector. Risks that are perceived to be the fastest growing in the sector include Talent, Strategy and Competition. With the sector

growing by double-digits, competition between players has intensified and led to increased demand for appropriate talent and skills. However, practitioners are confident that they can cope with these growing risks and manage them effectively. Areas where practitioners do not feel as confident primarily include environmental factors, the highest ranked being: Interest Rates, Regulation and Natural Disasters.

Table 7:
Regulators & Policy Makers - People Who Make or Drive Policy In Microfinance

REGULATORS & POLICY MAKERS		
SEVERITY	FASTEST RISING	LOWEST ABILITY TO COPE
Talent	Talent	Macro-Economic Trends
Credit Risk	Competition	Political Risk
Funding	Transparency	Talent
Macro-Economic Trends	Interest Rates	Natural Disasters
Natural Disasters	Corporate Governance	Transparency
Operations	Funding	Mission Drift
Political Risk	Management	Funding
Product Development	Mission Drift	Operations
Transparency	Political Risk	Security
External Fraud	Technology Risk	Corporate Governance

All regulators and policy makers agreed on the top five risks to the sector - Talent, Credit Risk, Funding, Macro-Economic Trends and Natural Disasters as the most severe risks facing the industry. All respondents felt that practitioners are well-positioned to handle most of the severe risks but were not as confident about their ability to cope with the challenges of handling Talent or other macro or environmental factors. The primary concern voiced was regarding the sector's ability to attract and retain quality human resources (Talent) 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.

Table 8:
Donors - People Who Fund Mfps For Social Return Only

DONORS		
SEVERITY	FASTEST RISING	LOWEST ABILITY TO COPE
Credit Risk	Credit Risk	Macro-Economic Trends
Macro-Economic Trends	Macro-Economic Trends	Internal Fraud
Natural Disasters	Interest Rates	Political Risk
Funding	Liquidity	Product Development
Mission Drift	Competition	Corporate Governance
Political Risk	Funding	Religious Influence
Reputation	Natural Disasters	Competition
Technology Risk	Regulation	Natural Disasters
Transparency	Technology Risk	Technology Risk
Interest Rates	Transparency	Regulation

Respondents in this category of stakeholders rated risks in areas of Credit Risk, Macro-Economic Trends, Natural Disasters, Funding and Mission Drift as either high or very high. This is in stark contrast with MFPs, who do not see corporate governance or products as a risk to the sector. This ties in with the identification of Credit Risk, Macro-Economic Trends and Interest Rate Risks by all respondents as risks that are rising. Like other stakeholders, donors seem comfortable with the Regulation and do not foresee any threat to the sector from this front. The risks associated with Management or Talent are also not deemed too serious by this stakeholder group.

Table 9:
Investors - People Who Invest In Mfps

INVESTORS		
SEVERITY	FASTEST RISING	LOWEST ABILITY TO COPE
Natural Disasters	Interest Rates	Natural Disasters
Macro-Economic Trends	Natural Disasters	Regulation
Foreign Exchange Risk	Management	Interest Rates
Liquidity	Macro-Economic Trends	Competition
Political Risk	Talent	Mission Drift
Corporate Governance	Transparency	Technology Risk
Credit Risk	Corporate Governance	Liquidity
Funding	Mission Drift	Religious Influence
Internal Fraud	Political Risk	Reputation
Mission Drift	Strategy	Security

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 the sector's ability to handle the risks they face. However, they seem more worried that risk trends are rising rather than falling. This stakeholder group is more concerned about external factors. Natural Disasters, Macro-Economic Trends, Foreign Exchange Risk and Political Risk are four out of the five risks that all investors rated very high or high in terms of severity. It was also highlighted that three out of the top five rising risks were also environmental factors i.e. Interest Rates, Natural Disasters and Macro-Economic Trends. Investors also deemed Talent and Management as rising risks of this sector.

Table 10:
Analysts, Consultants & Researchers - People Who Work Closely With Other Stakeholders on A Range of Issues

ANALYSTS, CONSULTANTS & RESEARCHERS		
SEVERITY	FASTEST RISING	LOWEST ABILITY TO COPE
External Fraud	Credit Risk	Interest Rates
Mission Drift	Natural Disasters	Transparency
Natural Disasters	Regulation	External Fraud
Political Risk	Funding	Management
Regulation	Interest Rates	Product Development
Talent	Macro-Economic Trends	Profitability
Interest Rates	Mission Drift	Security
Credit Risk	Political Risk	Natural Disasters
Internal Fraud	Product Development	Political Risk
Macro-Economic Trends	Strategy	Competition

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 or regulators who happen to view the sector through their own lens, analysts, researchers and consultants have a broader and more independent view of the issues surrounding the sector. In terms of risk profiling, this group agrees with donors and investors, who consider risks arising from exogenous factors, such as Natural Disasters, Political Risk and Regulation as more severe. The most seriously perceived of all risks were External Fraud and Mission Drift. Like donors, this group also views Credit Risk as the fastest rising threat to the sector, mainly due to the lack of a fully functional Credit Information Bureau and over-indebtedness, while all other risks falling under this category were mostly external.

Details Of Risks And Possible Mitigation Strategies – A Deeper Look

Details of Risks & Possible Mitigation Strategies – A Deeper Look

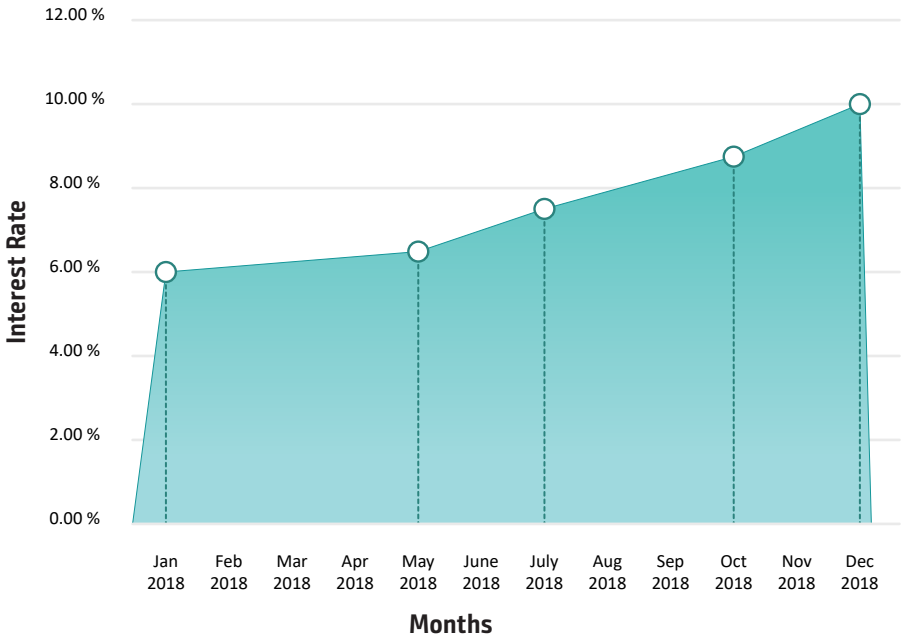
This section of the report examines closely the risks faced by the industry, addressing all the risks covered by the survey. Some risk mitigation strategies are also identified for the top risks.

1. Interest Rates

The risk that providers will suffer due to changes in the prevailing interest rate levels in the market.

73% of the respondents considered Interest Rates to be the biggest challenge being faced by the sector with the ability of MFPs to cope with this risk as the lowest. Given the economic challenges Pakistan is currently facing, rising interest rates coupled with growing inflation are perceived to be the biggest threat to the sector.

Figure 3: Trend in Interest Rates

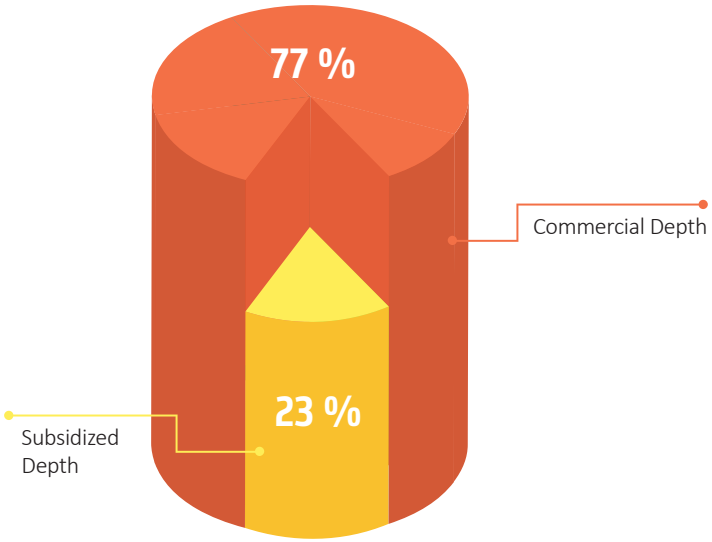


Interest rates are a tool used by the Central Bank to implement its monetary policy within the economy. With concerns on the economic front continuing to persist on the back of rising inflation and large twin deficits (both fiscal and external), it is likely to compromise the sustainability of economic growth. The increase in interest rates pose a significant challenge to the sector as the impact of this risk puts pressure on financial service providers as well as their customers. Figure 3: Interest Rate during 2018 indicates the prevailing trend of interest rates through the calendar year 2018. Moreover, increasing London Inter-bank Offered Rate (LIBOR) in an already

turbulent period has led to suspected return of overseas cash. This directly affects corporate credit markets globally (especially in Asia) where many local investors use leverage to enhance yield.

Rising inflation, currency risk and commodity price volatility has increased the cost of servicing debt. Considering that and the sizable proportion of commercial debt in the sector would severely impact the operations of service providers as debt financing costs would increase significantly. Figure 4 highlights the proportion of commercial and subsidized debt in the microfinance sector as of 2017.

Figure 4:
Proportion of Debt in the Sector as of 2017



The Pakistan Microfinance Investment Company (PMIC) adopting risk-based pricing makes matters more challenging for service providers that rely on their funding. Risk-based pricing would mean that the national wholesale apex lender would be offering different interest rates and loan terms to different MFPs based on their creditworthiness. This would only add to the mounting pressure on service providers as MFPs would now need to price their offerings appropriately while carefully reviewing periodic fluctuations in interest rates.

To mitigate interest rate risks, possible strategies for the service providers involve directing new client loans and/or deposits into the currency, rate fixation and maturity profiles aimed at reducing interest rate risk. The shifts in liquid asset reserves and the adjustments to/of short-term overdraft and money market borrowing instruments would also aid in off-setting on the maturities and repricing instruments. MFPs could also make use of futures contracts on long-dated government bonds and interest rate swap agreements to offset risk properties of underlying primary assets and liabilities.

In the long-run, MFPs need to develop flexible policy limits with adjustments only made based on very well-reasoned changes in the interest rates and if the potential losses associated with the risk cannot be brought back in line with the postulated limits.

2. Credit Risk

The risk that providers will suffer losses from lending to businesses and consumers who do not have the capacity or willingness to repay.

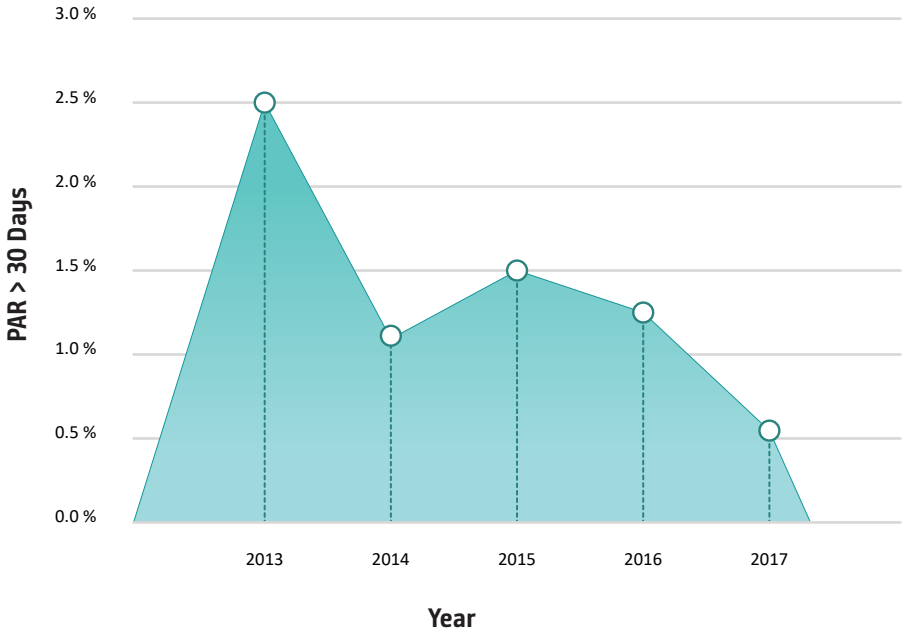
Credit risk, the most fundamental lending risk, jumped up from fourth to second this year with 71% of the respondents considering it a significantly severe threat to the sector. According to the CSFI Banana Skins 2018 report, Credit Risk was ranked fifth in the Asian Region and fourth globally in terms of severity. The primary reasons for Credit Risk gaining significance as a risk is due to digitization in the provision of credit in terms of credit scoring and electronic delivery channels, the lack of a fully functional Credit Information Bureau and the persistent issue of Over-Indebtedness.

Digitization particularly in loan automation can lead to irresponsible borrowing, particularly among individuals unfamiliar with financial services. Driven by the motivation of increasing market share, a large growth in the amount of credit offered can be observed by service providers. It has also been evident that most of these highly priced but easily accessible offerings, delivered through digital channels, are geared towards personal consumption rather than income generating activities or financial inclusion. The absence of a fully functional credit bureau that collects and researches individual credit information has further heightened the risks associated with Credit or lending decisions made by service providers. Weak creditor rights and virtual inability to enforce some contracts makes lending a risky business in certain regions of Pakistan, especially where most of the lending is unsecured. Establishment of an effectively regulated Credit Bureau(s) would allow borrowers to build reputational collateral and have more bargaining power for credit services. The ability of credit bureaus to significantly improve access to outreach of financial services also depends on the inclusion of information from the non-banking sector.

The lack of financial literacy coupled with the drive for increased market share by MFPs and increased access to credit has led to shallow standards of lending. Consequently, this had caused multiple borrowing by individuals due to classic client behavior which is more consumption based rather than income based. This “overborrowing” behavior is described as over-indebtedness. The issue is aggravated when there is already insufficient and unreliable information available on low-income individuals, but this is ignored due to increasing industry competition. Moreover, there has been significant increase in Concentration risk; i.e. the herd-mentality adopted by service providers to the point of saturation in a district, product line (agricultural, energy etc.) or market segment.

The aftermath of the Sindh Drought in the districts of Tharparkar, Thatta, Jamshoro, Badin, Umerkot and Sanghar. has further heightened the risk of default. A similar scenario on a much wider scale was observed during the 2015 floods in the districts of Southern Punjab. Hence, it is worth noting that such incidents associated with natural disasters lead to increased probability of default and exposure for service providers while causing fatalities.

Figure 5: Trend of Potential Delinquency (PAR > 30 days) Portfolio at Risk > 30 days



Service providers could mitigate the potential threats associated with Credit risk by utilizing effective credit scoring models and analytical tools which could appropriately analyze the creditworthiness of individuals. Additionally, it is also worth noting that increased saturation and competition in the market has led to a lack of quality human capital. Therefore, institutions need to take steps regarding the recruitment and training of qualified staff. Furthermore, the establishment of a Disaster Risk Fund at the highest level could help shield service providers from potential risks associated with natural calamities.

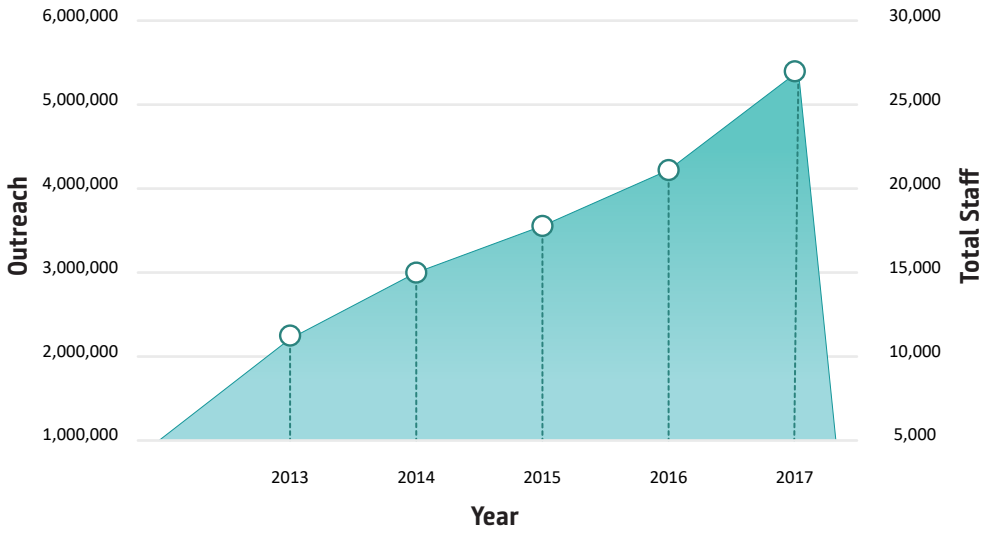
3. Talent

The risk that service providers will fail to attract and retain suitably qualified staff.

With 67% of the respondents considering this a high-risk area, Talent was ranked at third in our survey compared to twenty-third in the previous study conducted in 2015. In the regional context, Talent is ranked at sixth in Asia whereas globally, it is ranked at eighth, highlighting the importance of human capital in the industry globally. The jump in the rankings globally and nationally indicates the issues faced by service providers in skill deficiency in key areas of their businesses and poor staff retention measure in terms of staff turnover.

As the sector continues to grow and outreach increases by 30% on average annually, the demand for skilled human capital is increasing linearly as well. Figure 6 highlights the trend of growth in outreach of the sector along with relative increase in total staff being employed. Institutions have been unable to provide employees with compelling enough reasons to remain with a service provider in terms of remuneration, challenging work environment, or growth prospects within a specific institution. Additionally, with tightening regulations and increased competitiveness in the market, it remains unclear if the sector has the means to attract the appropriate skills in terms of remuneration or work culture.

Figure 6: Trend of Growth in Outreach and Staff



Other factors associated with poor talent management in the industry involve the recruitment of skilled staff by larger, more developed institutions which lead to high staff turnover in smaller institutions. For example, as the banking sector looks to target the lower segment of the financial bracket, the probability of recruitment from MFBs or more traditional NBMFCs increases, which is perceived to be a more lucrative opportunity for the staff in terms of compensation and culture.

The risks associated with talent could be managed by developing sound human resource policies and infrastructure within institutions. Having a strategic talent management department aids an institution in keeping their employees motivated which creates more reasons for them to stay with the company. It is also essential to train and develop staff for critical skills to plan and address highly specialized roles in the institutions. Appropriate performance measurement and grievance/complaint management policies could also mitigate the probability of high staff turnover. Additionally, the establishment of the Centre of Excellence by PMN for training and development of industry individuals and MFPs is likely to cater to the growing human capital needs of the sector.

4. Macro-Economic Trends

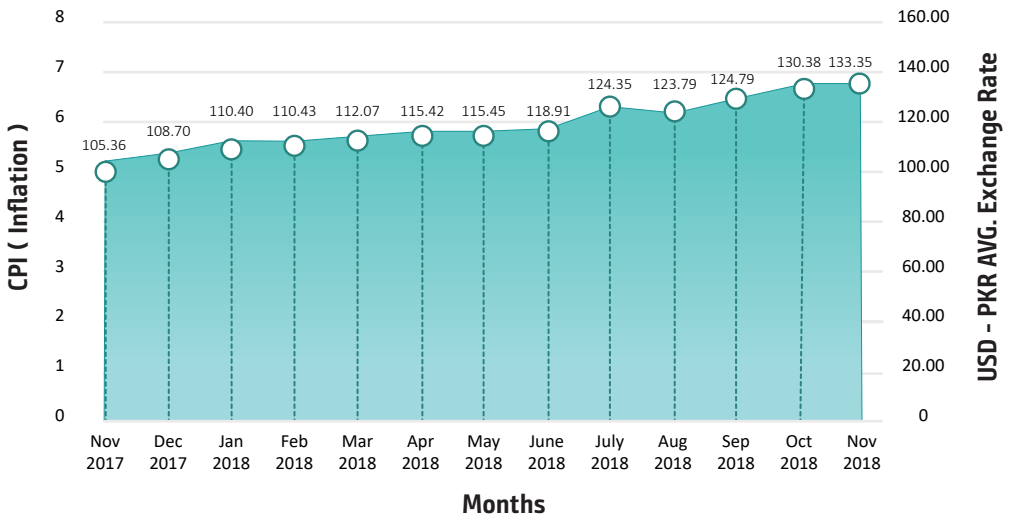
The risk that service providers and their clients will be damaged by trends in the wider economy such as inflation and recession.

Macro-Economic trends were previously ranked at third in 2015 but dropped to fourth this year. 66% of the respondents perceived this risk to be very high or high, whereas, the risk was not considered one of the top risks regionally in Asia or globally. Even though there is growth in the sector and institutions are strengthening their infrastructure, service providers still do not have the capacity to effectively manage shocks from macro-economic factors. This is a matter of concern as Macro-Economic conditions have a direct impact on service providers and their clients, particularly in the case of inflation, interest rates and devaluation of currency. Figure 7 highlights the trend in Inflation and the average exchange rate of USD – PKR over one year.

The fiscal year of 2019 began in July 2018. As the current account deficit narrowed with an increased flow of foreign remittances, it helped in

managing the sharp rise in the country's import bill. However, higher oil prices and the significant devaluation of the Rupee against the US Dollar, hitting multi-year lows, coupled with rising inflation due to higher import costs have further damaged the economy. With all signs pointing towards a slowdown, the country is grappling with economic imbalances, while both fiscal and monetary policy tightening take hold. Furthermore, the existing energy crisis and increasing unemployment are considerably impacting economic growth. Investors abroad continue to distance themselves from the Pakistani economy with Foreign Direct Investment dropping by more than half to $160 million in October 2018 compared to $354 million in the same month last year. With the country entering the IMF Program for a bail out from a severe crisis that threatens to cripple its economy, all indicators point towards a struggle in the economy that will significantly affect the sector as well.

Figure 7: Inflation and Exchange Rate (USD-PKR)
Macro - Economic Trends



Although there is little that service providers could do to prevent Macro-Economic trends from affecting them or their clients, institutions should consider building up significant equity as a defense mechanism to mitigate impact from such risks. The setting up of risk funds institutionally would also considerably shield MFPs from potential losses caused due to threats associated with this risk. Service providers could also look to diversify their client base (along segment or geography) to mitigate effects from such risks. Additionally, strengthening client relationships would further allow MFPs to consider appropriate rescheduling of credit facilities in times of economic turmoil.

5. Natural Disasters

The risk that service providers will suffer in case of loss of life, injury or destruction and damage from a disaster in a given period.

Risks arising from Natural Disasters remain one of the biggest concerns of the sector with 65% of the respondents ranking it as high in terms of severity. The risk ranked first in the study conducted in 2015 because of the extensive losses incurred due to devastating floods throughout the country, a heatwave in the region of Sindh and multiple

earthquakes. Therefore, it is no surprise that sector stakeholders consider this risk as one of the most severe and with one of the lowest abilities to cope by service providers. Since 2015, Pakistan has been experiencing several natural disasters each year. They include multiple floods in KPK and Punjab, earthquakes, heavy rains in the north west regions of the country, severe heatwaves in the southern province of Sindh and droughts due to lack of rainfall.

The absence of significant rainfall in the last few seasons has triggered a drought emergency in the southern part of the Sindh Province in Pakistan. As of 2018, the situation has become worse due to continuing lack of rainfall in the monsoon season, with the Sindh Government declaring six districts, Tharparkar, Umerkot, Sanghar, Thatta, Dadu and Shahdadkot, drought-stricken.

Natural Disasters are a major concern for the stakeholders of the sector considering that the underprivileged population is affected the worst. The wellbeing of the sector is directly linked with the wellbeing of the marginalized communities it serves. The number of individuals or households affected by natural disasters creates a ripple effect across segments, districts and the microfinance sector.

To tackle risks associated with Natural Disasters, institutions should diversify their client base geographically to minimize the effect of potential calamities in a specific region. Another viable way to mitigate this risk is by offering mandatory micro-insurance coverage to small scale clients in the case of agricultural financing since crop and livestock are most vulnerable to such potential calamities. On the sectoral level, PMN is in the process of establishing a Disaster Risk Fund (DRF) to shield its members and microfinance providers from losses incurred in the case of natural calamities by fulfilling the short-term liquidity needs of service providers.

6. Technology

The risk that service providers fail to capitalize on new developments in IT, cannot effectively manage data, or suffer losses from IT mismanagement.

With 57% of the respondents considering this to be a significant threat to the sector, Technology is now ranked sixth as compared to tenth previously. In the regional context, Technology is considered the third most severe risk in Asia while it is ranked as the biggest risk globally. This risk is also considered as one of the fastest rising risks in the sector with MFPs ability to cope low.

The most severe threat to institutions is to remain ignorant of technological advancements or failing to recognize its importance in the value chain. The increasing competition and the dynamic needs of clients only increase the importance of technology in providing successful solutions. Given the initial costs associated with developing an appropriate technological infrastructure, it is worth noting that the benefits associated with it create cost effective solutions that add value throughout the value chain, from origination to client delivery.

Looking at the sector, it becomes evident that only the top tier MFPs have been successful in leveraging technology to their advantage through loan automation, mobile payments, digital wallets, alternative delivery channels amongst others. Comparatively, smaller institutions lack the skills, resources or capacity to develop or improve their technological infrastructure due to the high setup costs of establishing such an infrastructure. Given the difference in the innovations in technology and the rate of adoption at which it is leveraged by service providers, traditional or smaller NBMFIs face the risk of being shut out of new markets. Moreover, there is also a risk that these smaller service providers might lose their existing client base if they fail to stay competitive in the market place.

Increased adoption or usage of IT systems or

technological infrastructure, creates the risk of mismanagement of technology or data. As institutions become more reliant on such systems, they become prone to certain associated inherent risks, such as higher losses and reputational damage that come with systems failures, leakage of information and cybercrime. These inherent risks have the potential to multiply exponentially as institutional outreach and dependence increase. Therefore, there is a need for appropriate regulations, such as data protection and privacy laws, to be in place.

Possible risks mitigation strategies regarding technology include the adoption of proper information systems and infrastructure followed by capacity buildings and trainings of staff. It is also vital to understand the legal obligations involved for conducting business using these systems. Additionally, institutions need to place suitable security systems to prevent information leakages or data breaches. At the macro level, regulators need to coordinate with the sector and develop fitting policies and regulations to shield the sector from potential threats that could cause damage to institutions or their reputations.

7. Political Risks

The risk that intervention by politicians will harm the sector and distort the market, for example through taxation, subsidy, rate capping, etc.

53% of the respondents perceived Political Risk to be high. Ranked at seventh, its position remains unchanged compared to the previous study. Whereas, regionally, the risk is ranked at first in Asia, perceived to be the most severe risk faced by the whole industry. Comparatively, the risk is placed third globally, which signifies its potential impact and ability to influence the sector. Stakeholders also consider it to be one of the top risks that service providers have the least ability to cope with.

The risk weighs in on the sector in the form of regulation and government introduced schemes. Subsidized schemes have the potential to crowd out conventional MFPs. It is obvious that these interventions would have a negative impact on the sector.

The significance of Political Risk seems to have increased considerably as the entire sector has now come under the regulatory umbrella. With 2018 as the transition year with elections taking place and new policies being implemented, the financial services industry remains one that is easily scrutinized by the government. Furthermore, the decision to increase interest rates with the tightening of the monetary policy adds pressure on the operations of service providers and their client base.

By developing improved relations at the policy level with regulators and the government, service providers could reduce the risk emanating from political interventions. Utilizing the established network of members, i.e. PMN, could help service providers to voice their opinions and address any issues arising from political interventions. Proactive advocacy is the most fitting means to address the work being done by service providers for low income individuals and showcase the positive impact being made by the sector.

8. Regulation

The risk that the sector will be hampered by a lack of appropriate supervision and regulatory coordination.

Regulation is perceived as one of those risks service providers are least prepared to cope with. This is mainly because stakeholders other than regulators are unable to completely understand the dynamics of the market. 53% of the respondents perceived this as a high-risk area, ranking it at eighth as compared to fourteenth in the previous study. The risk is ranked tenth globally in the CSFI Banana Skins 2018 report and eleventh in Asia.

Regulation is meant to create an enabling

environment where institutions operate effectively and in the public interest. There are instances when policies are not appropriately formulated because regulators are detached from market dynamics. Such instances of poor regulation could lead to inadequate quality of services provided by institutions or unrealistic expectations by the regulators. At the same time, over regulation is just as risky. The improvements or revision in regulation for service providers may not be easy to adhere to for more traditional or smaller service providers creating considerable costs of compliance.

With the inclusion of MFIs and RSPs under the regulatory ambit due to their increasing size, the costs associated with governance, licensing, disclosures and reporting have significantly risen for service providers. Moreover, given the challenges faced by the country on security and pressed by international bodies like the Financial Action Task Force (FATF), the SECP and SBP have issued strict Anti-Money Laundering (AML) and Know Your Customer (KYC) guidelines for the financial industry. This has added to the pressure being faced by service providers due to interventions by regulators. Additionally, the State Bank's initiative of the adoption of Europay Mastercard Visa (EMV) standard by all regulated banks (commercial and MFBs) has increased compliance costs even more. It is essential to consider that costs associated with the standard are high for the sector especially since the target clientele belongs to the lower income strata and issuing EMV compliant debit cards is an expensive option for MFBs.

While all these regulations are considered essential for effective governance of the sector while protecting the interest of clients, the impact of increasing costs of compliance are significant for institutions. With excessive costs already an issue for service providers, higher compliance costs will only make it more difficult to operate profitably within the sector. With the evolution of the sector, the regulators need to incorporate the complexities in the changing market dynamics.

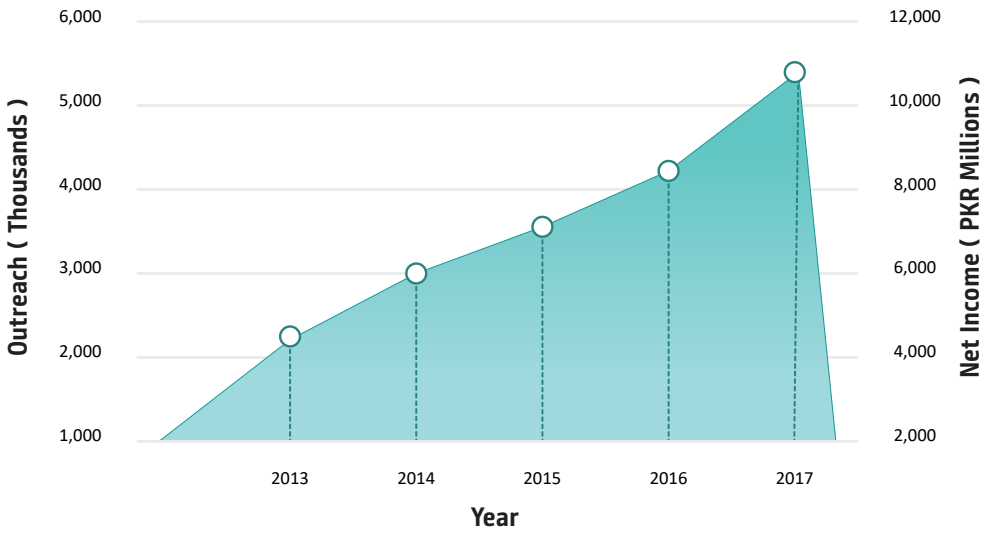
9. Profitability

The risk that the service provider will not be able to generate adequate returns from its operations.

This year, Profitability has been ranked at ninth place with 52% of the respondents considering it a considerable risk. The respondents that categorized this as a severe risk for the sector were mainly practitioners in the industry. Considering that 23% of the total proportion of debt in the industry is subsidized, this indicates that institutions must focus on sustainability which is dependent on their profitability. Figure 8 shows the trend in outreach over the years with respect to the profitability of the sector.

Stakeholders consider the risk of Profitability one of the biggest risks because of its ability to be affected by other risks (both external and internal). External risks such as fluctuations in the interest rate, foreign exchange risk, natural disasters, etc. have the potential to significantly impact profitability of service providers and the sector. Similarly, internal risks arising from operating inefficiencies, fraud, poor management, ineffective strategy, etc. can have just as much of an impact on profitability. This correlation between other risks and profitability makes it essential for institutes to mitigate this risk based on the ability of service providers to manage it.

Figure 8: Growth & Profitability of the Sector



Different stakeholder groups had differing perceptions about this risk. While Profitability is important to maintain the overall stability of the sector and to provide a cushion against negative trends, it could be argued that a profit driven motive would impact the main objective of the sector. In order to improve profitability, institutions tend to move towards products that can prove to be sustainable and deliver high profits. While this approach seems appropriate from the perspective of investors or practitioners, it might affect the client negatively by ignoring their true needs. A profit driven approach in the sector might lead to maximizing profits or market share in the short run, but it also could potentially lead to the risk of Mission Drift.

The positive trend in the profitability of the sector along with the fact that stakeholders do not consider this a rising threat indicates their ability to manage this risk. Large service providers have invested significantly in the strengthening of their institutions and infrastructure to ensure sustainable organizations. However, with the regulator imposing strict CAR requirements and shareholders demanding dividends from their institutes now, MFPs have been placing increasing emphasis on profitability.

To mitigate potential threats regarding this risk further, MFPs must devote resources to improve efficiency through innovation. Leveraging technology and streamlining their value chains to improve productivity would drive operational costs down. Diversification in the product range, market segment and geography would also mitigate the risk of potential losses that may arise due to excessive concentration.

10. Competition

The risk that excessive or insufficient competition will prevent healthy growth of the market.

With 51% of the respondents deeming it to be a high-risk area, risks emanating from Competition were ranked at tenth. The risk has declined in ranking and was previously ranked at the fifth spot, but it is still considered an increasing threat being ranked at fourth on the list of fastest rising risks. This is primarily because of the diverse types of institutions currently operating the market. With Banks, Telcos, FinTechs and traditional MFPs currently competing, the dynamics of the market

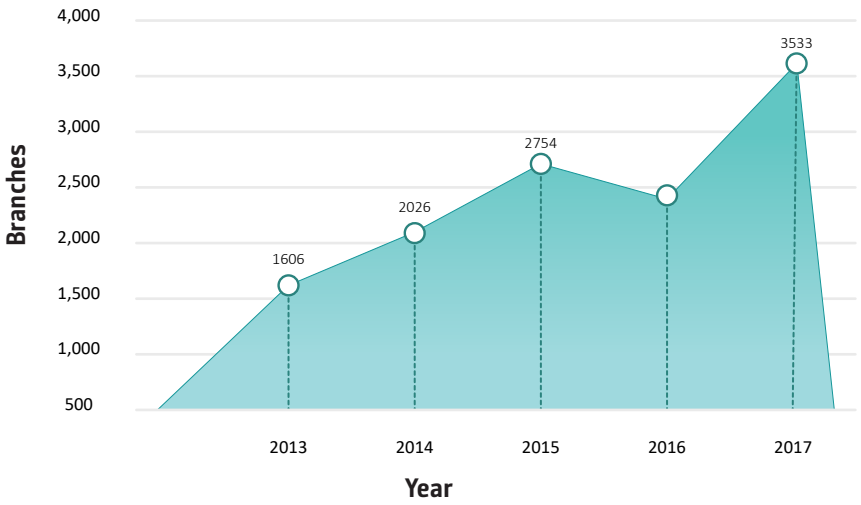
are sometimes considered by stakeholders to be unfair because of the expertise each type of player brings to the market. Figure 9 shows the increasing number of branches nation-wide over time.

With the "herd-mentality" of some of the MFPs, the market is saturated with products with similar features and value chains being offered under different brand names. Moreover, the increasing concentration of players in a certain district has increased competition geographically with MFPs placing little emphasis on diversifying to new markets or districts. Additionally, with this excessive competition, service providers are forced to compete on market share and their motives become more profit-driven which causes them to lose sight of their core mission. This leads to the un-ending issue of Over-Indebtedness. With service providers competing based on market share, their targets become the financially illiterate or the underprivileged segment that is least likely to be able to pay.

However, there is no denying that competition is the breeding ground for innovation and improved product offerings. The results indicated that Competition is not ranked highly in the list of MFPs lowest ability to cope list, which means that service providers consider this risk manageable. Seasoned industry leaders highlighted that the competitive dynamics of the market place forces institutions to come up with improved strategies, a more client-centric approach and increasing value added services.

According to the 49th Issue of Microwatch (Q3 – 2018), the penetration rate of the sector stood at 32.5%. This indicates that there is substantial room to grow for the sector and a large chunk of the market remains untapped. The growth in the sector can also be observed by observing the trend in the number of branches in the market.

Figure 9: Total Number of Branches of Mfps Nation-wide



Therefore, in order to reduce the threat from the risk of competition while pursuing healthy growth, institutions need to evolve and improve their strategies. The use of technological solutions and digitization are the way forward with Telco backed banks leading the way in such initiatives. Furthermore, the use of data analytics and client behavior have the potential for institutions to come up with tailored solutions for customers. It is also essential for the sector to maintain an important level of discipline while placing less emphasis on the aforementioned "herd-mentality". Unless service providers develop the behavior of responsible lending and devise a code of conduct, persistent issues such as over-indebtedness will not be tackled.

11. Management

The risk that poor management in service providers will damage the business.

50% of the respondents considered Management to be a significant risk, ranking it at eleventh in terms of severity as compared to twelfth in the previous edition of the study. The risk is considered to be growing considerably as stakeholders ranked it third on the fastest rising list. The risk of poor management is also considered amongst the most significant (top 10) risks when compared geographically as its ranked at tenth in Asia and ninth globally.

Capacity issues have always prevailed in the sector with demand for skilled middle managers increasing exponentially with growth. The risk of poor management is higher on the side of traditional small NBMFIs as compared to MFBs and larger providers. Additionally, despite multiple changes in the market, most MFPs still rely on founders or sponsors for leadership. The absence of an appropriate succession plan, trainings and business knowledge adds to the challenges faced by smaller service providers operating in underdeveloped regions.

To reduce potential threats rising from this risk, institutions need to invest in capacity building exercises and trainings for their human capital. Development of appropriate policies with respect to human capital should enable institutions to attract, develop and retain competent managers that can lead MFPs. Moreover, the establishment of the Centre of Excellence by PMN for the development of middle-line managers will help in developing and improving capacity of its member institutions.

12. Strategy

The risk that service providers will fail to stay relevant and competitive in a changing marketplace.

Ranked fourth in Asia and second globally, the risk associated with the Strategy of MFPs has been ranked at twelve based on the results compiled for this study. It is also one that seems to be holding steady in the category of fastest rising, and stakeholders do not foresee much change in terms of its ability to hurt the sector with the MFPs' ability to cope with it being perceived as relatively easy.

The reason for this bump in the risk associated with Strategy is because most MFPs have not developed an appropriate strategic plan to stay relevant within the changing landscape. A lack of understanding of the market dynamics coupled with reluctance to change have rendered MFPs complacent and emphasizing on survival in the short term. This has led to institutions now becoming more concerned about their sustainability than addressing client needs.

To mitigate potential threats associated with this risk, service providers need to develop a market based, client-centric strategy. Given that technology and digitization will shape financial services in the economy, institutions would have to align their strategies accordingly. Although it could be argued that digitization and the costs associated will be risky for MFPs trying to provide products and services to low-income segments and compromise what they do already well, it is essential to understand the benefits associated with adopting an appropriate digital strategy geared towards market gains.

13. Foreign Exchange Risk

The risk that the sector will face in the event of fluctuation in the value of the local currency.

Risks arising from Foreign Exchange fluctuation were previously considered as the least severe, being ranked at twenty-six. This year's edition of the study indicated that this risk had jumped to thirteenth. 48% of the respondents considered this risk to be severe, with Investors considering it the third most severe risk in the market.

Over the past few years, the exposure to foreign

currency has increased in the sector. Given the constraints on funds, the growth of MFPs requires financing from external sources. This has led to industry dynamics shifting towards commercial foreign currency exposure. Foreign equity stakes in MFBs (KBL, TMFB, NRSP-B, FINCA) and NBMFIs (ASA & BRAC-Pakistan) along with foreign debt placement in tier-2 MFPs creates unique challenges and risks for both borrowers and lenders. Moreover, increasing volatility due to devaluation of the Pakistani Rupee and uncertainties in the macro-environment are putting pressure on financial service providers regarding risks associated with Foreign Exchange. The impact of this risk can be felt throughout the sector in the form of Forex Translation, re-Translation, Transaction and organization reserves.

Institutions can mitigate these risks by using hedging instruments. Investing in currency-hedge funds such as futures and options could help lower Forex risks. However, hedging instruments may be limited or cost prohibitive.

14. Funding

The risk that service providers will fail to attract diversified sources of debt and equity.

Funding was previously seen as a minimal risk, ranked at twentieth, but the findings of this research indicated that this year it had moved up in ranking to fourteenth. Intuitively, funding seems to be a legitimate problem for MFPs in the South Asian region, where it was ranked ninth in the biggest risks faced by the sector. 47% of the respondents agreed that the lack of funds was a significant issue for the sector in terms of severity. These stakeholders were primarily donors, investors and regulators, while practitioners and researchers deemed it less significant. However, the threats associated with this risk were considered to be rising quickly and that the MFPs' ability to cope with it was weak.

There are several MFPs that are relatively well-placed to grow, but cannot, due to a lack of funding. Despite guarantee funds administered by the SBP earlier, PMIC's efforts to inject capital in the sector and the interest from international impact investors looking to place debt in the market, MFPs are still examining options to borrow from other possible sources. In this regard, MFBs primarily rely on deposits to meet their funding needs and their financial position indicates that these banks are going concerns. In the case of NBMFIs, their funding needs are dependent upon debt and are currently served preferentially in terms of funding. However, the weak capital structure of smaller entities makes it a challenge for them to borrow as they rely significantly on retained earnings to improve their financial position. This raises the main concern regarding their sustainability and growth despite being well-placed in the market. Under such circumstances, it is evident that they need to make their case as profitable businesses to secure a sufficient flow of funding.

15. Transparency

The risk that a service provider is operating in such a way that it is difficult for others to see what activities are performed.

Previously ranked at sixteenth, risks associated with Transparency witnessed a small rise to fifteenth this year. While its severity was only considered significant by donors, the results also indicated that all stakeholder groups considered a lack of transparency as one of the growing concerns in the sector, placing it at ninth on the fastest rising list. It is also worth noting that both researchers and regulators considered lack of transparency as an issue the sector is least prepared to cope with.

The regulators have played a pivotal role in ensuring transparency within the sector. Given the nature of their business, MFBs are more strictly regulated by the SBP, and the more recently introduced prudential regulations by the

SECP for NBMFIs is also aimed at increasing transparency for the sector. While it could be said that the primary objectives of MFBs are profit driven and motivated by market share, the non-profit nature of NBMFIs focuses on social impact which has led to higher expectations regarding reporting both, financial and social information. However, with the regulations by SECP just introduced and given the capacity issues of these NBMFIs, it would take them a little while before improvements in their reporting are observed.

16. Internal Fraud

The risk that service providers will face fraud that is committed by an employee against an organization.

The threats associated with Internal Fraud jumped up from nineteen to sixteenth place this year. Of all stakeholder groups, only researchers and investors perceived the risk as considerably severe. Despite this, there was a consensus amongst the stakeholder groups as almost all of them deemed it as manageable.

The jump in the ranking of this risk is primarily because of the increase in the size of the industry over time. As outreach continues to increase by 30% annually, total staff of the industry has also been witnessing a complementary growth of 25% each year. Consequently, this growth has also increased the likelihood of fraudulent activities internally within organizations and the sector.

Given the nature of this risk, organizations can only tackle this challenge by strengthening the institution internally. As institutions become seasoned, they have learned to deal with this risk. An array of controls at each level of the institution has become the norm. While larger players have as much as three lines of defense (from business line management, independent corporate operational risk function and a dedicated Internal Audit department), smaller players too have established effective internal controls. Other possible strategies to mitigate this risk could be the development of appropriate human resource policies such as compensation and disciplinary action, which are aimed at incentivizing human capital and managing employees in case fraudulent behavior has been observed. Furthermore, investing in a fidelity bond or insurance policy can also prove to be valuable for institutions to shield itself from disloyal employees.

17. Liquidity

The risk that service providers will be unable to meet short term financial demands without a loss of capital and/or income in the process.

The threat from Liquidity was previously considered high and ranked at eighth. While the risk has decreased significantly in the global and regional setting, the only stakeholder group to consider it a significant threat were the investors while donors perceived it to be the one of the fastest rising risks in the sector. However, there was a consensus amongst stakeholders regarding the ability to address this risk, ranking it at eighth in the list of lowest ability to cope.

With increased focus by MFBs on deposit mobilization, the threats emanating from this risk have reduced considerably. Increased market experience has also led to improved financial performance by institutions with balance sheets of most reflecting an appropriate liquid asset cushion. Evidence of financing for microfinance operations from blended sources also plays a vital role in improving the liquidity of players. Furthermore, improved governance and operations have further helped in strengthening the financial position of the sector.

To further mitigate this risk, there is a need for players to work with the regulators, SECP in the case of NBMFIs, to improve investor confidence. For medium and smaller sized institutions, a focus on strengthening the financial position is required to improve individual financial performance and asset utilization.

18. Product Development

The risk that service providers will fail to offer appropriate products to clients, for example because they fail to understand their needs.

The risk from Product Development, ranked eighteenth, was ranked at twenty-second in the previous study. Described as the second biggest risk in Asia and ranked sixth globally, it is evident that the threat from this risk is not considered significant in Pakistan. While most stakeholders did not consider this to be a severe risk, it was widely agreed that it was gradually rising to become a significant threat in the future.

As the sector has become seasoned and competition has increased, most of the bigger players have become aware of the need for product development. A client-centric approach in the market has led to solutions beyond credit and savings. Branchless banking, more tailored product offerings and innovations in agricultural financing are some of the categories where practitioners have shifted their focus. Moreover, improvements in product delivery mechanisms have also been evident with digitization playing a pivotal role in the sector.

However, the level of competition in the market has led to a "herd-mentality" with all significant players working towards providing the same products under different brand names with little to differentiate their product offerings. The existing need for market driven development in products makes it evident that there is still some progress to be made regarding this risk. While digital uptake by existing and potential clients has increased substantially, product and service awareness remain an issue. While market research by medium and small sized institutions is required, they struggle with developing an appropriate strategy given the constraints on their resources.

19. Corporate Governance

The risk that the boards of service providers will fail to provide necessary oversight and strategic direction.

Although ranked at seventh place globally, the threats associated with Corporate Governance were ranked at nineteen in terms of severity as compared to fourteen previously by stakeholders in Pakistan. With varying views amongst different stakeholder groups in Pakistan, only investors considered this a severe enough risk to impact the sector, while regulators and investors both perceived it to be fast-rising threat. Practitioners were relatively optimistic about threats related to Corporate Governance as they perceived the sector to have matured and developed seasoned as well as competent leaders over the previous decade, especially in the case of MFBs.

During the research, it was also highlighted that there was a growing need for a proactive approach regarding risk mitigation strategies that could be undertaken by practitioners regarding Corporate Governance. This is true, especially in the case of smaller NBMFIs, which lack qualified directors on the board level and the ability to effectively lead their institutions. This challenge can be overcome by smaller service providers by adopting international best practices for effective governance. The introduction of qualified, independent board members, conducting need-based trainings, the establishment of different committees at board level and developing appropriate terms of reference are a few strategies that institutions should undertake in order to reduce the threat from this risk for NBMFIs with constrained resources.

20. External Fraud

The risk that the service providers will suffer unexpected financial, material or reputational loss as the result of fraudulent action of persons external to the firm.

Previously ranked eighteenth, the risk of External Fraud has dropped to twentieth in this edition of the study in terms of severity. Less than 40% perceive this risk to be severe enough to impact the sector whereas it was ranked lowest in terms of rising threats. The relationship-based style adopted by MFPs and the presence of the Microfinance - Credit Information Bureau (MF-CIB) have been the primary factors for the categorization of this risk in the low-tier category. While most stakeholders associated this risk with clients, they failed to consider other potential avenues of this threat arising such as through the increasing use of technology in the sector as the rate at which it is adopted has created vulnerabilities in the systems of service providers. These vulnerabilities could be exploited by cyber-attacks and digital fraud and could cause considerable damage to smaller and more unprepared service providers. As the number of experts and technology are increasing in the market, this risk is becoming more manageable.

21. Mission Drift

The risk that service providers have deviated from the organization's mission or mission statement.

The risk of Mission Drift in Microfinance arises from the feeling that the industry is losing its focus on the quality of service it provides to low income people as it reaches for scale. Previously ranked at twenty-forth, this risk has climbed up a few positions. Less than 40% of the respondents deemed this risk serious enough to substantially impact the sector or a growing threat.

While not considered as serious as it was in the nascent phase of the sector, it could be argued that with increasing competition the inflated cost of operations and considerable default rates affect the sustainability of the service provider. This could consequently shift their focus from a social mission to a sustainable one which may alter the character of the MFPs into one that is more profit-driven. The challenges that arise from such a behavior are: inappropriate products being laden on clients of MFPs and the neglect of clients at the base of the pyramid in favor of easier targets.

However, through the adoption of more socially responsible initiatives, service providers and other stakeholders are emphasizing the importance of social objectives over financial ones. A client-centric approach has helped the sector as a whole to stay true to its purpose while enjoying healthy returns and keeping the threat from this risk under the lower categories of severity and growth.

22. Reputation

The risk that the industry will suffer a poor reputation or lack of public trust.

The risks associated with Reputation have declined significantly this year. Ranked at eleventh in the previous edition of the study in terms of severity, it now stands at twenty-second. Globally, the risk was ranked at sixteen. The threat of Reputation risk rises with lack of transparency by MFPs and when service providers fail to deliver according to social expectations. However, with the evolution of the sector, service providers have devised strategies to minimize the threat emanating from this risk.

With the entire sector now under the regulatory ambit of the SECP and the SBP, Reputation risk in the sector has declined significantly. The prerequisites of being associated with a regulatory body and the professional recognition that follows, adds to the credibility of institutes. Additionally, socially responsible initiatives, such as the SMART Certifications and Social Audits by institutions, has led to a more relationship-based approach between service providers, clients, employees and other important stakeholders. The adoption of the Annual Percentage Rate (APR) and pricing transparency have increased the level of trust placed in the sector by donors and

investors. Moreover, the setting up of appropriate Grievance Redressal Mechanisms by MFPs, with the facilitation by regulators, have proven to be vital in addressing their clients. Lastly, the availability of appropriate and seasoned human capital has led to entities recruiting persons knowledgeable of local markets.

23. Unrealistic Expectations

The risk that service providers overestimate the results that are to be achieved by their activities.

The risk of Unrealistic Expectations dropped further with respect to severity with no expectation of becoming significant in the foreseeable future. With increasing experience and clarity of stakeholders regarding the sector, the expectations have become more rational. Increasing awareness about the way business is to be conducted has led to more straightforward objectives of the service providers.

While the severity of this risk remains low, practitioners need to emphasize on maintaining expectations of different stakeholder groups, especially the public, to avoid any potential threats to the reputation of the MFPs or the sector.

24. Religious Influence

The risk that religious beliefs will hinder the model of delivery of products and services in the market.

The influence of Religion is not considered a significant threat by MFPs operating in non-sensitive areas. However, this risk continues to be a challenge in certain underdeveloped regions, especially the western border of the country, particularly relating to the issues of interest rates. Most MFPs operating in such regions have found it challenging to function and grow using just their conventional microfinance products and services.

Based on the responses of different stakeholder groups regarding this risk, it has become evident that most of them do not consider this a significant threat to the sector with its impact reduced substantially over time. Another reason for this is that an increasing number of MFPs have engaged in Islamic finance and come up with customized and interest free products for the religiously sensitive clientele of the sector. Increasing awareness regarding these customers and Shariah compliant products has decreased the significance of this risk.

25. Security

The risk that the law and order situation in the country will affect the operation of service providers and the sector.

An important change in sentiment identified by this survey is that pertaining to security risk (unique to the Pakistani context). Practitioners working inside Pakistan, as well as, donors and consultants perceive the risk arising from the law and order situation in Pakistan to have reduced substantially. Ranked as the ninth most severe threat in the previous survey, stakeholders are now more optimistic about future security conditions.

The improvements in the Security risk are attributable to the fact that the security situation improved further in the last two years. In 2017 alone, there was a 16 percent decrease in the number of terrorist attacks in Pakistan, compared to the previous year. Furthermore, the development of the multi-layered National Security Policy, which focused on safety, security and the wellbeing of Pakistani citizens, and the reformulation of the National Internal Security Policy further addressed the internal challenges as well as border security issues being faced by the nation.

Nevertheless, security remains an unpredictable and major issue for the sector. Although the use of alternative delivery channels (branchless

banking, etc.) has mitigated this challenge of the distribution of financial services to remote and sensitive regions, outreach of MFPs in these areas of the country continues to remain low and there is growing need for MFPs to possess sound knowledge of local community affairs. The development of an exclusive risk fund at the sector level, which can be accessed during heightened sensitivity in security-related incidents would help protect small scale MFPs from potential threats related to this risk.

26. Operations

The risk of losses incurred by service providers resulting from inadequate or failed internal processes, people and systems or from external events.

Managing operational risks involves the responsibility of ensuring that business operations are efficient in terms of using as few resources as needed, and effective in terms of delivering output. This can be especially challenging in an environment where institutions are growing faster than their operational capacities, which leads to problems like fraud and credit risk.

The results from the survey indicated that risks arising from operations was the least severe for stakeholders as compared to its mid-level ranking in the previous study. The low ranking can be attributed to the fact that the Microfinance sector has reached a more mature stage of growth where people, processes and systems have become more developed. Capacity building of smaller MFPs and stronger controls have ensured adequate operations. Moreover, the development in human capital in the sector and improved technological integrations have further augmented improved operational risk management. To further mitigate threats from operational risk, institutions could opt for fidelity insurance to act as a buffer, so no significant losses are incurred due to employee dishonesty.

Pakistan Microfinance Network

PAKISTAN MICROFINANCE NETWORK

Third Floor, Plot No. 12-3/2, Mandir Square, G-8/1 Markaz, Islamabad
Tel, +92512266214-17, Fax: +92512266218
www.pmn.org.pk