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RISKS TO MICROFINANCE IN PAKISTAN 2020

FINDINGS FROM A RISK ASSESSMENT SURVEY

Pakistan Microfinance Network
Achieving Together

ACKNOWLEDGEMENT

This report would not have been possible without the contributions of PMN's members, supporters and strategic partners. 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.

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

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ACRONYMS AND ABBREVIATIONS

CAGR	Cumulative Average Growth Rate
CGAP	Consultative Group to Assist the Poor
CSFI	Centre for Study of Financial Innovation
FCDO	Foreign, Commonwealth and Development Office
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

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PREFACE

Risks to Microfinance in Pakistan is the fifth 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; the 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, which 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 now 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 for the microfinance industry. 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 key stakeholders of the industry. 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: Rising, Stagnant or Falling;

MFPs' Ability to cope with risk: Excellent, Good, Average or Poor.

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 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.

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

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 Institutes (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.

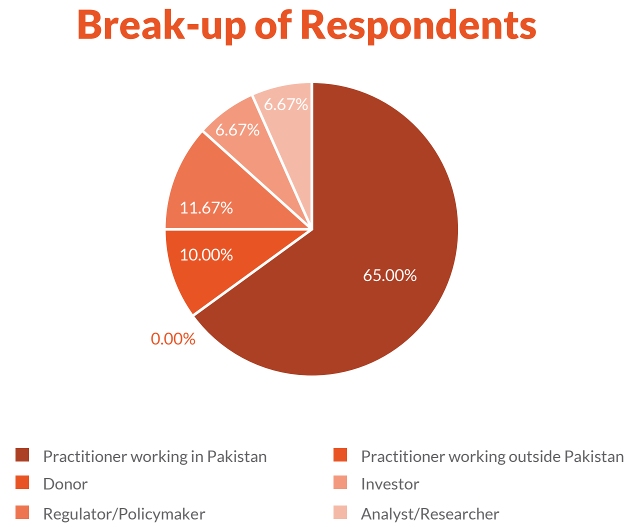

Figure 1: Break-up of Respondents

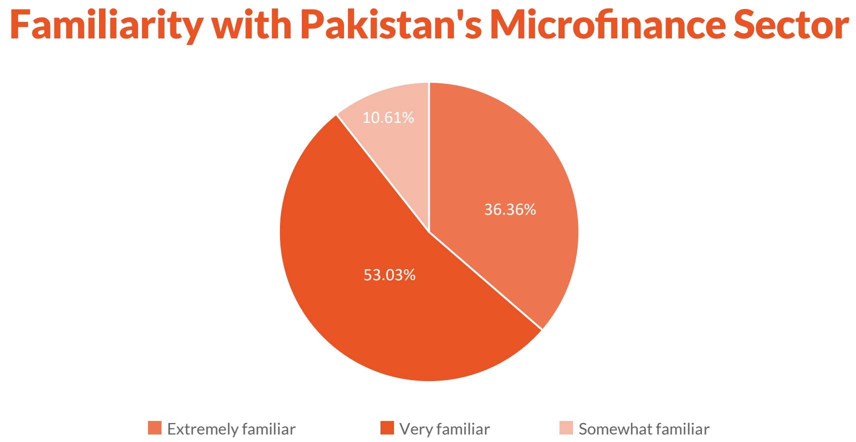

Figure 2: Familiarity of Respondents with Pakistan's Microfinance Sector

HEADLINE FINDINGS

ANALYSIS OF DATA

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, 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 is the ability of microfinance practitioners to deal with the different risks. 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 results of the survey were dominated by the risks aggravated by the Global Health Crisis that have affected the industry, directly and indirectly. The findings indicate that the threat arising from Credit Risk (previously second) and Natural Disasters (previously fifth) are the two biggest risks this year. Strategy and Profitability jumped to third (previously twelve) and fourth place (previously ninth) respectively, while external threats, such as Liquidity, Macro-Economic Trends, Interest Rates, Technology and Competition Risks, remained major challenges for the stakeholders of the industry.

Table 1: Snapshot of the Sector's Risk Assessment (% of Respondents)

Severity		Fastest Rising		Lowest Ability to Cope	
Credit Risk	78% (71%)	Credit Risk	67% (40%)	Strategy	39% (8%)
Natural Disasters	76% (65%)	Macro-Economic Trends	56% (47%)	Talent	22% (27%)
Strategy	74% (48%)	Profitability	54% (25%)	Natural Disasters	17% (44%)
Profitability	72% (52%)	Strategy	52% (45%)	Liquidity	13% (31%)
Liquidity	67% (42%)	External Fraud	50% (35%)	Macro-Economic Trends	11% (43%)
Macro-Economic Trends	63% (66%)	Competition	48% (41%)	Technology Risk	11% (29%)
Internal Fraud	61% (44%)	Liquidity	43% (30%)	External Fraud	11% (15%)
Interest Rates	60% (73%)	Natural Disasters	41% (40%)	Foreign Exchange Risk	9% (28%)
Technology Risk	57% (57%)	Internal Fraud	41% (18%)	Product Development	9% (29%)
Competition	53% (51%)	Technology Risk	39% (11%)	Profitability	9% (19%)
Operations	52% (30%)	Transparency	39% (34%)	Internal Fraud	9% (17%)
Reputation	50% (34%)	Foreign Exchange Risk	30% (40%)	Political Risk	9% (43%)
Regulation	48% (53%)	Regulation	30% (44%)	Corporate Governance	9% (24%)
Management	46% (50%)	Interest Rates	27% (31%)	Reputation	9% (27%)
Foreign Exchange Risk	46% (48%)	Reputation	24% (46%)	Religious Influence	9% (40%)
Transparency	43% (44%)	Talent	24% (15%)	Unrealistic Expectations	9% (16%)
Corporate Governance	43% (37%)	Funding	22% (27%)	Transparency	7% (15%)
Funding	43% (47%)	Management	22% (26%)	Operations	7% (13%)
Product Development	41% (38%)	Corporate Governance	22% (29%)	Credit Risk	4% (20%)
External Fraud	37% (37%)	Mission Drift	20% (11%)	Management	4% (11%)
Mission Drift	37% (36%)	Product Development	20% (20%)	Interest Rates	2% (47%)
Political Risk	37% (53%)	Operations	15% (30%)	Competition	0% (27%)
Talent	33% (67%)	Political Risk	13% (13%)	Regulation	0% (41%)
Security	33% (30%)	Unrealistic Expectations	13% (15%)	Funding	0% (29%)
Religious Influence	20% (33%)	Security	11% (52%)	Mission Drift	0% (22%)
Unrealistic Expectations	17% (34%)	Religious Influence	11% (25%)	Security	0% (37%)

Figures in the brackets represent the responses from the previous survey conducted in 2018

Table 2: Top Ten Biggest Risks/Severity

1	Credit Risk	2
2	Natural Disasters	5
3	Strategy	12
4	Profitability	9
5	Liquidity	17
6	Macro-Economic Trends	4
7	Internal Fraud	16
8	Interest Rates	1
9	Technology Risk	6
10	Competition	10

Credit Risk has been characterized as the highest this year jumping from second place previously and significantly outranking Interest Rates. Credit Risk has risen significantly due to the COVID-19 Pandemic which has hindered lending activities of MFPs. The deferment and rescheduling of the existing portfolio of institutions at the discretion of the regulators further escalated this risk. The decision of the regulators came amidst the financial constraints and liquidity challenges faced by borrowers which affected their ability to pay. The global health crisis also contributed to the escalation in the risk from Natural Disasters rose to second place compared to its prior fifth place.

Risks associated with Interest Rates, ranked as the largest risk in the previous survey, has now dropped to eighth place. Just like the pandemic has propelled Credit Risk to the top, risk associated with Interest Rates has fallen because of relaxations provided by the State Bank of Pakistan (SBP). SBP responded to the crisis by cutting the policy rate during the year, introducing temporary regulatory measures to maintain financial system soundness and sustain economic activity. This might also be why risks associated with Macro-Economic Trends did not rise as high as expected due to the pandemic this year; Macro-Economic Trends was ranked at sixth compared to fourth previously due to a number of relief measures taken by the SBP as well as the government.

Risks associated with Strategy jumped to third place from twelfth previously. Strategy presented itself as a major risk this time around due to the unprecedented situation globally and the lack of an appropriate strategic plan to deal with the challenges posed by the prevailing health crisis.

Profitability soared to fourth place from ninth previously as respondents attributed this increase to the uncertainty caused due to the pandemic and associated lockdowns nationwide. The findings highlight that MFPs continue to face challenges with repayments and increasing provision expenses which are expected to significantly impact their bottom-lines.

Liquidity was another substantial challenge faced by the industry during the year amidst the health crisis, which rose from seventeenth to fifth position. Since cash and other current assets help to ensure survival of financial services providers in a liquidity crisis and as loan repayments and deposit inflows became "frozen" for a while, a liquidity crunch was observed by the sector, which is why respondents classified this as one of the severe risks currently faced by the sector.

Several respondents flagged Internal Fraud as a growing risk as it jumped from its previous sixteenth position to seventh, bringing it among the top ten biggest risks faced by the sector. The primary reason highlighted by respondents were ineffective controls, increasing digitization; which increased associated risks, and dearth of client literacy.

Technology Risk declined from sixth previously to ninth position. Despite the impact Technology has had on financial inclusion, the risks associated have remained amongst the top 10 in all the past surveys. Its ability to facilitate growth remains unquestioned but has also encouraged excessive risk-taking. The most serious of these risks highlighted include high investment and the inability of smaller players in the industry to understand or exploit technology.

The 2020 Global Health Crisis has highlighted underlying issues in the Operations of MFPs. While this risk was ranked as least severe at twenty-six, it has ascended to eleventh place due to the MFPs vulnerability to exogenous factors. Respondents emphasized the importance of MFPs ability to adapt to the rapidly changing environment in order to remain sustainable.

According to the study, the fastest trending risks this year are Credit Risk, Macro-Economic Trends and Profitability in that order. Talent has declined to sixteenth place and been replaced by Credit Risk as the fastest rising risk. Macro-Economic Trends are still perceived as the second fastest growing threat to the industry, while Profitability has been propelled from eighteenth to third place.

Table 3: Top Ten Fastest Rising Risks

1	Credit Risk	7
2	Macro-Economic Trends	2
3	Profitability	18
4	Strategy	6
5	External Fraud	26
6	Competition	4
7	Liquidity	14
8	Natural Disasters	10
9	Internal Fraud	21
10	Technology Risk	8

Credit Risk, which was ranked seventh, is apparent as the fastest rising risk in 2020. It is one of the most prominent threats to the sector primarily because of the Global Health Crisis and its impact on MFPs credit operations. While it is perceived as a growing threat, larger MFPs consider themselves well equipped to cope with this risk.

Management and Competition which were previously ranked third and fourth on the list of fastest rising risks, have now declined to eighteenth and sixth positions respectively and have been replaced by Profitability and Strategy respectively. The primary reason for the increase in these risks is due to the fact that in this very challenging environment, respondents felt that many service providers are not developing a strategic plan to stay relevant with enough urgency, if at all to ensure sustainability of operations, let alone improved profitability.

External Fraud rose to fifth from twenty-sixth. Correspondingly, Internal Fraud also jumped from twenty-first place to ninth place this year. While these risks are an inherent issue due to the nature of Microfinance operations, they have increased with the developments in digital financial services. Respondents also highlighted ineffective internal controls and limited regulatory support available to NBMFCs as another reason for the surge in these risks.

Liquidity rose to eighth place from fourteenth previously as the findings highlighted a lack of availability of funds to MFPs during the year because of the pandemic. Responses indicated that this was a significant hinderance for NBMFCs; since they are unable to mobilize deposits to fund their operations.

Amidst decreasing repayments and increasing defaults, institutions looked forward to relief measures by the regulators to contain the threats arising from this risk.

Table 4: Top Ten Risks with Lowest Ability to Cope

1	Strategy	26
2	Talent	15
3	Natural Disasters	2
4	Liquidity	8
5	Macro-Economic Trends	4
6	Technology Risk	9
7	External Fraud	22
8	Foreign Exchange Risk	12
9	Product Development	11
10	Profitablitiy	19

In terms of preparedness, the findings of the survey indicated that the respondents still perceive that the sector is least prepared to deal with exogenous/external risks. Five of the top ten in the list of risks with the least ability to cope are associated with external factors, of which **Talent, Natural Disasters and MacroEconomic Trends** ranked in the top 5 risks alone.

Strategy moved from the twentysixth position to the first position this time around. A similar jump was exhibited by **External Fraud**, which moved from twenty-second position to the seventh position, and **Profitability**, which moved from nineteenth position to tenth position. MFPs ability to cope with these risks was challenged this year due to the pandemic. The jump in the ability to cope with the risk with **Profitability** is also reflected in the ability to cope with **Liquidity**, which was also severely impacted by the pandemic as it rose from eight position to the fourth position.

Macro-Economic Trends and **Natural Disasters** fell marginally from fourth to fifth position and from second to third position respectively. This is because the sector was able to cope better than expected from the effects of the pandemic, in part due to the policies adopted by the government.

The pandemic also challenged the ability to cope of MFPs with regards to **Talent**, **Technology Risk** and **Product Development**. **Talent** rose from the fifteenth position to the second position; Technology Risk rose from ninth position to sixth position and Product Development rose from eleventh to ninth position. Talent rose as the pandemic required dedication from the loan officers as they were acting as essential service providers. Adoption of **Technology** rose because pandemic required the sector to adapt quickly to ensure an unfettered loan disbursement process and continuation of operations. Similarly, **Product Development** rose as the sector did not have products in place that could be customized to address the needs given the pandemic.

Table 5: Regional & Global Comparison of Top Ten Risks

Top 10 Risks to the Microfinance Sector – 2020					
	Pakistan		South Asia		*Global*
1	Credit Risk	1	Political Risk	1	Technology Risk
2	Natural Disasters	2	Product Risk	2	Strategy
3	Strategy	3	Technology Risk	3	Risk
4	Profitability	4	Strategy	4	Credit Risk
5	Liquidity	5	Credit Risk	5	Risk Management
6	Macro-Economic Trends	6	Talent	6	Product Risk
7	Internal Fraud	7	Risk Management	7	Corporate Governance
8	Interest Rates	8	Service Delivery	8	Talent
9	Technology Risk	9	Funding	9	Management
10	Competition	10	Management	10	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. 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

Table 6: Practitioners Working in the Sector - including those employed by MFPs

Practitioners in the Industry					
	Severity		Fastest Rising		Lowest Ability to Cope
1	Profitability	1	Credit Risk	1	Strategy
2	Natural Disasters	2	Competition	2	Natural Disasters
3	Credit Risk	3	Macro-Economic Trends	3	Macro-Economic Trends
4	Liquidity	4	Natural Disasters	4	Talent
5	Macro-Exonomic Trends	5	Profitability	5	Foreign Exchange Risk
6	Interest Rates	6	Liquidity	6	Credit Risk
7	Internal Fraud	7	Technology Risk	7	Liquidity
8	Competition	8	Internal Fraud	8	Interest Rates
9	Strategy	9	Foreign Exchange Risk	9	Profitability
10	Technology Risk	10	Strategy	10	Funcding

*CSFI Banana Skins 2018 Report

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 the microfinance space.

Practitioners working in the sector perceived Profitability as the most severe risk in the sector because of rising non-performing loans and higher provision expenses during the year. Other severe risks identified were Natural Disasters and Credit Risk– both of whose severity had intensified this year as a result of the uncertainty caused by the COVID-19 pandemic. Fastest growing risks in the sector were Credit Risk, Competition and Macro-Economic Trends. With the sector growing at a rapid pace, Competition between players has intensified and consequently led to increased demand for appropriate talent and skills in the market. 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 Strategy, Natural Disasters and MacroEconomic Trends in the stated order. Strategy particularly tested severely this past year due to the pandemic which exposed the lack of preparedness of the sector due to the unprecedented situation globally.

Table 7: Regulators & Policy Makers - people who make or drive Policy in Microfinance

Regulators					
	Severity		Fastest Rising		Lowest Ability to Cope
1	Strategy	1	Competition	1	Talent
2	Competition	2	Credit Risk	2	Foreign Exchange Risk
3	Credit Risk	3	Macro-Economic Trends	3	Strategy
4	Macro-Exonomic Trends	4	Talent	4	Transparency
5	Transparency	5	Strategy	5	Regulation
6	Operations	6	Transparency	6	Operations
7	External Fraud	7	Interest Rates	7	Competition
8	Interest Rates	8	Internal Fraud	8	Credit Risk
9	Technology Risk	9	Technology Risk	9	Interest Rates
10	Security	10	Natural Disasters	10	Macro-Economic Trends

All regulators and policy makers agreed on the top five risks to the sector: Strategy, Competition, Credit Risk, Macro-Economic Trends and Transparency were considered the most severe risks facing the industry. All respondents felt that practitioners are well-positioned to handle these risks but were not as confident about their ability to cope with the challenges of handling Talent and other macro or environmental factors. The primary concern was regarding the sector's ability to attract and retain quality human resources (Talent) at an affordable cost. Interestingly, policymakers also expressed concerns about the lack of an appropriate Strategy moving forward to ensure the sector's long-term growth in the wake of the pandemic.

Table 8: Donors - people who fund MFPs for social return only

Donors					
	Severity		Fastest Rising		Lowest Ability to Cope
1	Liquidity	1	Strategy	1	Strategy
2	Macro-Economic Trends	2	Transparency	2	Transparency
3	Regulation	3	Profitability	3	Profitability
4	Competition	4	Regulations	4	Regulations
5	Interest Rates	5	Competition	5	Competition
6	Internal Fraud	6	Corporate Governance	6	Corporate Governance
7	Mission Drift	7	Credit Risk	7	Credit Risk
8	Management	8	Internal Fraud	8	Internal Fraud
9	Natural Disasters	9	Liquidity	9	Liquidity
10	Technology Risk	10	Macro-Economic Trends	10	Macro-Economic Trends

Donors rated risks in areas of Liquidity, Macro-Economic Trends, Regulation, Competition and Interest Rates as either high or very high. Their responses are aligned with those of practitioners, who consider exogenous factors as the primary concern affecting their operations and aggravating associated risks during the year. Donors also identified Strategy, Transparency and Profitability as risks that are rising and likely to pose a challenge to the sector. Interestingly, the risks associated with Management's ability to cope were deemed serious by this stakeholder group only. However, Management risk could be correlated with the donors' perception about the risk associated with Strategy which was identified as a severe risk by practitioners, regulators and policymakers.

Table 9: Investors - people who invest in MFPs

Investors					
	Severity		Fastest Rising		Lowest Ability to Cope
1	Credit Risk	1	Competition	1	Corporate Governance
2	Internal Fraud	2	Liquidity	2	Internal Fraud
3	Interest Rates	3	Corporate Governance	3	Liquidity
4	Liquidity	4	Credit Risk	4	Macro-Economic Trends
5	Macro-Economic Trends	5	Internal Fraud	5	Political Risk
6	Profitability	6	Reputation	6	Profitability
7	Natural Disasters	7	Profitability	7	Product Development
8	Political Risk	8	Religious Influence	8	Religious Influence
9	Reputation	9	Macro-Economic Trends	9	Foreign Exchange Risk
10	Operations	10	Management	10	Natural Disasters

Risk perceptions of investors matter greatly for institutions looking for funding, especially via commercial sources. Although the sample size of investors is small, it does offer some insights into what this group is concerned about. 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. Credit Risk, Internal Fraud, Interest Rates and Liquidity are four out of the five risks that all investors rated very high or high in terms of severity. It was also highlighted that four of the top five rising risks were internal to the institutions i.e. Liquidity, Corporate Governance, Credit Risk and Internal Fraud. Investors also deemed Corporate Governance, Internal Fraud and Liquidity as risks that the sector was least equipped to deal with.

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
1	Technology Risk	1	Management	1	Internal Fraud
2	Reputation	2	Technology Risk	2	Talent
3	Regulation	3	Profitability	3	Technology Risk
4	Corporate Governance	4	Credit Risk	4	Product Development
5	Internal Fraud	5	Interest Rates	5	Corporate Governance
6	Management	6	Internal Fraud	6	Credit Risk
7	Natural Disasters	7	Liquidity	7	Management
8	Operations	8	Mission Drift	8	Competition
9	Credit Risk	9	Natural Disasters	9	Foreign Exchange Risk
10	Interest Rates	10	Operations	10	Interest Rates

Given the breadth of stakeholders this group tends to work with, their insights on risks in microfinance in Pakistan adds 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 highlighted Technology, Reputation, Regulation and Corporate Governance as either very high or high in terms of severity. The perceived fastest rising risks were Management, Technology and Profitability. Like donors and investors, this group also views Internal Fraud as the threat with the lowest ability to cope, while Talent was also considered as another serious threat by regulators. Risk associated with Technology was an area of concern as digital services were deployed by many countries to ensure speedy continuous delivery of services and loan disbursement during the pandemic, an area where the sector has a long way to go before it can catch up with international best practices.

A DEEPER LOOK

DETAILS OF RISKS AND POSSIBLE MITIGATION STRATEGIES

CREDIT RISKS

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 inherent risk in lending operations, jumped up from second place to first this year with 78% of the respondents considering it a significantly severe threat to the sector. With 67% of the responses classifying it as quickly rising, the risk is also ranked highest in terms of the fastest rising risks. According to the CSFI Banana Skins 2018 report, Credit Risk was ranked fifth in the Asian Region and fourth globally in terms of severity. While all stakeholders considered this risk significant and quickly escalating, only donors considered this medium on the severity spectrum.

From the perspective of Microfinance providers and financial institutions, the measures taken to contain the spread of the virus; such as lockdowns, stopped the economy from functioning and hindered repayments. The closure of businesses and other measures such as social distancing and working remotely, created uncertainty for lenders and borrowers alike to meet their loan obligations. This compounded the previously observed credit concerns of institutions exponentially, such as over-indebtedness, lack of data availability from Credit Information Bureaus (CIBs) and irresponsible lending due to digitization.

Over-indebtedness is still considered one of the most significant components leading to enhanced credit risk. While bad debts do not necessarily result from over-indebtedness, the perceptions of respondents, which, fashioned by experiences and ground realities, can differ from the numbers reported. The respondents are also of the view that during the pandemic, loans provided for productive or income generating activities were being used for consumption or to repay existing debts instead. This was also highlighted as one of the reasons for increased over-indebtedness in the industry.

With the issuance of licenses by the Central Bank to the two private CIBs, the data should allow MFPs to make evidence-based decisions. The findings of the survey indicated that some respondents believed data of CIBs to be insufficient to make quality decisions. However, the establishment of CIBs is likely to improve the portfolio quality and to reduce the associated credit risk as data is collected over time. The better quality of client data can allow MFPs to increase the scale and depth of outreach by identifying the untapped or the "riskier" segments of the potential microfinance market which could also assist in tackling over-indebtedness.

Although Digitization has proven essential in increasing the outreach of the sector, respondents also revealed that it contributed to irresponsible lending behavior by providers. The desire to increase market share by leveraging digital technologies and delivery mechanisms is being compromised by feeble credit appraisal methodologies.

While the long-term impact of the pandemic on the industry is not yet fully understood, it is important for lenders to be proactive in order to be equipped to handle the downstream affects. MFPs could achieve this by developing sound processes for managing outreach of clients. It's also essential for players to detect and track existing and emerging credit risks and their trends for improved decision making. While the regulators (SBP & SECP) took preemptive steps by offering payment reliefs and granting a moratorium to financial institutions, players nevertheless need to be able to better identify and manage their short-term liquidity financing to remain resilient. The continuous development of their credit scoring models and algorithms could further aid in minimizing credit risks arising due to lending to poor segments.

NATURAL DISASTERS

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

The risk arising from Natural Disasters was another concern of the sector with 76% of the respondents ranking it as high in terms of severity. In 2018, the risk had dropped to fifth place in terms of severity, while this year it rose to second place due to the Global Health Crisis caused by the COVID-19 Pandemic. The sector stakeholders consider this risk as one of the most severe and with one of the lowest abilities to cope by service providers.

Since 2005, 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 and by 2020, a health crisis due to the COVID-19 pandemic. These crises directly affect the clientele of the Microfinance sector considering that marginalized and underprivileged population is affected the most, which creates a domino effect throughout the financial sector.

Respondents also highlighted the impact of Climate Change on microfinance activities. The resultant adversity faced within the agriculture sector due to water shortage and low yields poses a threat to the industry as half of the outreach and portfolio is directly related to this sector.

At the macro-level, the government, through the National Disaster Management Act of 2010, has made permanent allocation of resources, both at the federal and provincial levels, towards disaster risk management. However, it is mostly a reactive response to emergencies rather than developing an ex-ante prevention and mitigation strategy. Keeping this in view, another possible solution is to the creation of a microfinance sector level Disaster Risk Fund. Such a fund can be created in a form chosen from a variety of structural options and can provide an array of selected functionalities. The industry can also play an instrumental role in providing the lower-income sector with insurance products. There is a need to expand insurance services to cover the wider set of risks that vulnerable clients face, particularly in the agricultural sector, where due to climate change, the vulnerabilities of poor farmers are exacerbated manifold. This can be done my MFPs increasing the range and volume of insurance products offered and by raising awareness around the benefits of existing insurance products. Institutions should also consider diversifying their portfolios geographically to ensure diversification in risk as well.

STRATEGY

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

Strategy was previously ranked at twelfth place with 48% of the respondents classifying it as medium on the severity spectrum. This year the risk propelled to third place with 74% of the respondents believing it to have become a severe challenge for service providers. The risk also ranked at fourth, compared to sixth previously, on the list of fastest rising risks and as the risk with lowest ability to cope for practitioners.

The reason for this jump in rankings was largely due to a lack of an appropriate strategic plan in place by MFPs to deal with the challenges posed by the prevailing health crisis. Limited understanding of the market during the pandemic along with the reluctance to change and limited digitization efforts have some MFPs struggling for existence. The added liquidity crunch faced by these providers during the first wave of the crisis has also added to this risk. As a result, the sustainability of institutions has come under question.

The effects of the pandemic on the sector has made evident that there is a need for MFPs to develop a robust strategic framework to achieve their long-term objectives in a changing landscape. Moreover, leveraging technology in these times to offer innovations in products and their delivery should be adopted rapidly to stay relevant and mitigate risks.

PROFITABILITY

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

Profitability rose from ninth to fourth this year as 72% of the respondents classified this as high on the severity spectrum. The risk was classified as the most severe particularly by practitioners. It also ranked third on the list of fastest rising and tenth on MFPs' ability to cope. The respondents believed that the bottom line of the providers would be affected due to the increase in costs and poor repayments as a result of the pandemic.

The resultant surge in provisioning expense due to higher non-performing loans and delinquencies has led to lower margins. In addition to declining profitability, rising leverage and increased pressure on capital adequacy, in the case of banks, further intensified this risk. While this threat is not so significant for larger players due to their strong balance sheets, relatively smaller entities with low profitability and high non-performing loans could face a significant deterioration in their capital positions, and some of them may experience capital shortfalls. Moreover, the vulnerability of MFPs to other external shocks; such as variations in the interest rate and foreign exchange rates, also hampers their profitability. Respondents of the survey also criticized the internal inefficiencies and a lack of digital footprint of providers which also adversely impacts profitability.

It is essential to understand that the primary focus of MFPs is to serve the underprivileged and marginalized as clients would be negatively impacted if MFPs were to prioritize profitability. A profit-driven approach could lead to maximizing profits or increasing their market share, however there would lead to the risk of Mission Drift.

For practitioners to mitigate Profitability risk, they need to invest in eliminating inefficiencies. This could be done by leveraging technology to optimize business processes and digitizing supply chains, which would bring down operational costs. The development of a robust credit scoring mechanism could also aid in identifying the most lucrative target segments and hence result in decreased provisioning and loan loss expenses. Losses arising due to increased concentration could also be curtailed if institutions aim to diversify their portfolios geographically and introduce product innovations. Lastly, institutions should consider building reserves that provide them with the cushion to address the challenges emanating from crises, such as the pandemic and other natural disasters. This would ensure there is limited or no capital shortfall as a result of such events.

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.

Liquidity escalated from seventeenth to fifth place as 67% of the respondents classified it as a high risk in terms of severity. The risk also fell in the top 10 risks that are quickly growing and against which practitioner are least equipped to cope. It is no surprise that this risk jumped this year amidst the pandemic. The business activity in the global economy and Pakistan slowed down during 2020 as containment measures and smart lockdowns continued to be implemented to contain the spread of the virus.

The clientele of practitioners are micro and small entrepreneurs, who are particularly susceptible to economic shocks due to their modest capital base, limited clientele, and vulnerable work force. Due to the pandemic and associated lockdowns, the incomes of these clients has been significantly affected or somewhat decreased which reduces the clients' capability to repay their loans as their main concern was to secure food and liquidity in case lockdown was maintained for an extended period of time. A reduction in clients' repayment capacity has in turn caused liquidity challenges for MFPs especially the non-deposit taking institutions. This also led to the regulators announcing debt relief measures for individuals and businesses which provided some respite to practitioners. The national apex, PMIC, followed suite by deferring repayments due from borrowers for up to one year which enabled international investors and local commercial institutes to follow in their lead.

In terms of peer groups, MFBs, as deposit-taking entities, did not have to face severe liquidity challenges. Their deposits remained relatively stable and diversified. However, MFBs do not have access to discount windows, which can be critical in these challenging times. Expanding access to the window would require SBP supervisory review. The NBMFCs, in the absence of a lender of last resort and for not taking deposits, are generally more vulnerable to sharp declines in revenues and liquidity challenges. In addition, NBMFCs also faced uncertainty about their own credit lines from domestic banks due to an increase in perceived risk associated with the microfinance sector.

Practitioners should conduct stress tests on a regular basis for short-term as well as protracted institution-specific and market-wide stress scenarios and use stress test outcomes to adjust its liquidity risk management strategies, policies and position and develop effective contingency plans. The monitoring for potential liquidity stress events can be conducted using early warning indicators and event triggers. Moreover, practitioners need to have in place formal contingency funding plans that clearly set out the strategies for addressing liquidity shortfalls in emergency situations. This contingency plan should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. It's also essential to maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios.

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.

The risk stemming from wider economic challenges has remained the greatest fear among stakeholders in the preceding surveys and this year was no different. However, the vulnerability to this risk has been continuously abating over the successive years which demonstrates growing optimism about the overall economic outlook and the sector's ability to deal with this risk. Among the respondents, 63 percent rated the severity of this risk as high, compared to 66 percent in 2018, whereas, 56 percent regarded the risk to be rising compared to 47 percent in previously.

Given the pandemic, the risk of macro-economic trend should have impacted the country and the sector adversely, however, the macro-economic risks were not as severe as were expected. GDP registered only a minor drop in the year 2020 with GNI rising compared to the previous fiscal year. Furthermore, prompt and effective policies were implemented by the government to mitigate the macroeconomic impact the pandemic was likely to have on the economy thus, further alleviating the risk associated with macro-economic trends. Pandemic was not the only macro-economic shock felt by the country in the year as the country also experienced high levels of rain, floods, and locust attack thus, macroeconomic challenge remains a major concern for the sector. Beyond the unexpected shocks, inflationary pressures on business-related goods and services have severely hampered the repayment capacity of the clients, an issue which gets compounded by the credit limits imposed on the sector by the regulators.

Like any sector, the overall economic situation of a country has a profound impact on microfinance providers either through business conditions or through clients thus, macroeconomic trends have a dual effect on microfinance providers. To further mitigate macroeconomic risk, regulators should keep some of the concessions given to the sector due to the pandemic for at least the duration of the pandemic. Furthermore, regulators should also keep abreast of and implement international best practices and recommendations pertaining to the sector as a buttress against the adverse impact of the pandemic.

While the industry itself is too small to impact the economy, provisions can be put in place that reduce the impact of macroeconomic externalities. These provisions can include building up equity, setting up a risk fund to absorb shocks during economic and health crises and developing a crisis management strategy.

INTERNAL FRAUD

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

The risk associated with Internal Fraud jumped drastically from sixteenth to sixth position this year. Of all stakeholder groups, all except regulators considered this risk to be severe, with researchers and investors classifying it among the top five most severe risks faced by the sector. While the sector is concerned about the severity of Internal Fraud risk, stakeholders remain optimistic about the sector's ability in dealing with the risk.

The jump in the ranking of this risk is primarily because of the pandemic in conjunction with the increasing outreach of the industry. Despite the pandemic, the size of the industry did not shrink by as much as expected given the pandemic. The growth of the industry combined with the economic and financial stress faced by the sector has increased the chances of internal fraudulent activities.

The nature of the risk requires organizational strengthening coupled with hiring of a better talent pool. Given the aggressive approach of the sector in expanding the outreach, staff integrity issues resulting in rising risk of Internal Fraud is likely to remain a concern unless steps are taken to attract, employ and retain better quality staff and to provide them with incentives that act as automatic barriers to this risk. Another effective strategy could be to invest in a fidelity bond or insurance policy as a hedge against disloyal employees.

INTEREST RATES

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

While the risk associated with Interest Rate was the biggest concern for the industry stakeholders in previous years, this risk fell to the eight position with 60% of the respondents considering it a severe risk (as compared to 73% previously). Out of all the respondents, donors and investors still consider Interest Rates to be a risk of high concern whereas researchers, practitioners and regulators also considered Interest Rates risk to be a cause of concern. However, most of the respondents, apart from donors, were optimistic about the sectors ability to cope with the risk.

While the pandemic and the resultant business slump would have posed a significant challenge to the sector, the regulators took preemptive steps to ease the burden likely to be caused by the pandemic on the sector by reducing the policy rate. These steps had a tremendous impact on easing the burden on the MFPs as it also alleviating some of the economic pressure on the clients. The resulting drop in the severity of Interest Rates as a risk demonstrates the MFPs were already overextended in dealing with this risk and that steps need to be taken to manage the risk associated with interest rate fluctuations.

The sector's overall health during the pandemic is a strong indicator that there is a need for policy intervention in this sector. The drop in the policy rate was a prudent step that, if allowed to persist for a longer period e.g. the length of the pandemic, would provide MFPs the time to create sustainable growth strategies in achieving sales and recovery targets while increasing profitability. Furthermore, MFPs need to develop hedging strategies which will allow them to better cope with Interest Rate risks which is needed as MFPs avail funding at a higher fixed rate.

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 dropped to ninth as compared to sixth previously. This risk is also considered as one of the fastest rising risks in the sector with MFPs ability to cope relatively low. In the regional context, Technology is considered the third most severe risk in Asia while it is ranked as the biggest risk globally.

The respondents emphasized the importance of technology and the foreseeable convergence of digitization with microfinance. For clients, it offers convenient access to a wide range of products and services even in remote areas through mobile phones or agents, quickly and safely. For MFPs, it enables them to achieve efficiency and lower costs while improving customer experience.

An overview of the industry depicts that only larger players and telco led banks have been truly successful in leveraging technology which has enabled them to offer a plethora of services and innovate in their delivery. Although the benefits are undeniable, this also creates challenges in terms of data management, privacy, and security. Increased dependencies on such systems can potentially cause considerable damage. In contrast, resource constraints and challenges in capacity hamper the adoption of technology when it comes to smaller and mid-sized entities. The excessive infrastructure costs coupled with a lack of appropriate human capital could potentially threaten the market share of these entities if they no longer remain competitive. Another challenge faced by the industry is the availability of smartphones and the deficiency of digital literacy amongst the clientele, which further affects uptake of products.

It is critical for MFPs to recognize that products offered must respond to customer needs. Therefore, in order to ease the risks associated with Technology, providers must design customer-centric products, aim to improve customer engagement and educate clients while complying with client and data protection policies. The availability of appropriate infrastructure and skilled professionals is also crucial when considering the effective adoption and development of technology within an institution. Providers also need to place suitable security systems to prevent information leakages or data breaches to safeguard themselves from cybercrime and reputational risk. This could be achieved by partnering with the Network's digital services platform, Munsalik, to ensure end-to-end digitization from origination to delivery.

COMPETITION

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

While the ranking of Competition as a risk remained unchanged, 53% of the respondents perceived this risk to be high in terms of severity compared to 51% previously. It was also classified as one of the fastest rising threats to the microfinance sector.

The primary driver of competition risk has been growth in the microfinance sector. With increase in outreach and the number of outlets of MFPs in the country, competition amongst service providers has intensified. Although this has assisted in making progress in the sector in the form of infrastructure, funding, product innovations and new players, it is also argued that deepening competition is a significant factor for 'over-indebtedness' in the sector. The desire of MFPs to increase market share has resulted in poor risk reduction practices. It was also highlighted that the dynamics of the market are sometimes considered to be unfair by stakeholders because of the different type of institutions (Banks, Telcos, Fintechs, Traditional MFPs). Respondents also highlighted lack of transparency in product pricing, the inability to diversify geographically, and make improvements in data reported by Credit Information Bureaus as other factors that heighten this risk.

In order to ease this risk from Competition, MFPs need to increase their geographic footprint by exploring other districts or areas where penetration is low. By Q3 2020, penetration hovered around 33% with an outreach of 6.8 million , which shows that the need for microfinance services is still substantial and hence present opportunities for all service providers. Institutions also need to invest significantly in product research and innovation in order to improve outreach further. While digitization remains crucial, leveraging technology continues to be a challenge for most entities. Improving human capital is also imperative to ensure continuous product innovation. Lastly, the improvement in reporting of Credit Information Bureaus would further aid in identifying target market segments.

OPERATIONS

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

The findings of the survey indicated that risks emanating from Operations propelled to eleventh place from twenty-sixth previously. 52% of the respondents classified this as high in terms of severity as opposed to just 30% in the previous study. The implications of the Global Health Crisis during the year 2020 has highlighted underlying issues in the Operations of MFPs. The reason for this escalation highlighted by respondents was due to the MFPs vulnerability to exogenous factors. Participants of the survey stressed the importance of MFPs' ability to adapt to the rapidly changing environment in order to remain sustainable.

Financial constraints and a liquidity crunch due to the pandemic hindered the operations of MFPs. This is especially true for small and medium sized entities that are more vulnerable to operational risk. Such organizations have scarce resources and limited capacity to ensure strong controls and efficient back office operations when exposed to exogenous events such as the pandemic. Furthermore, the lack of skilled human capital and technological advancements further aggravate poor operational risk management.

Service providers need to further develop systems and processes in order to contain this risk. Capacity building of skilled staff would also prove vital when addressing these risks, especially in the context of smaller entities. Institutions could also opt for fidelity insurance to act as a buffer, so no significant losses are incurred due to employee dishonesty. Moreover, with the developments in the financial sector with regards to AML/CFT, institutions need to incorporate steps in their processes which ensure compliance with these standards. Lastly, the setting up of disaster risk fund for the sector would significantly shield organizations from future crises.

REPUTATION

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

The risk of reputation escalated to twelfth place compared to twenty second this year. The findings of the survey indicated that 50% of the respondents believe this risk to have become significant in recent times. Analysts/Researchers/Consultants and Investors considered this a severe risk, with both peers ranking them in their top 10 severe risks.

The key concern raised by respondents with regards to Reputation is that the risk has increased significantly due to the inability to service new customers due to COVID-19 Health Crisis and liquidity constraints of smaller and mid-sized entities. Other factors that were highlighted by respondents which contributed to the increase reputational risk were over-charging clients, a lack of transparency or when service providers fail to deliver according to social expectations.

Reputation risk can be mitigated by adopting a client-centric relationship-based approach towards all key stakeholders. Institutions could also minimize this risk by adhering to the regulatory guidelines and principles as laid down in their respective regulatory frameworks. Focusing on socially responsible initiatives is another way service providers can improve their credibility. Moreover, appropriate disclosures with respect to Annual Percentage Rates (APRs) and efficient Grievance Redressal Mechanisms would further benefit MFPs when dealing with their stakeholders. Lastly, organizations should attract and retain seasoned professionals that have the knowledge to operate in the local markets in order to be sensitive to market dynamics.

REGULATION

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

Regulation decline on the list of most severe risks this year as only 48% of the respondents considered this a serious risk. Of the stakeholder groups, Analysts/ Researcher/Consultants and Donors considered this a significant risk as these peers ranked this risk as third in terms of severity.

With the sector now falling completely in the regulatory ambit, the threat from regulatory risks has declined. As the sector has matured, service providers now understand the regulatory requirements comprehensively. The periodic amendments in the regulatory frameworks in order to align existing regulations with changing market dynamics have further facilitated in MFPs ability to cope with this risk. Furthermore, development of appropriate controls due to the introduction of AML/ CFT regulations have ensured improved regulatory compliance but at increased costs.

The primary concern for service providers remains the increasing costs of compliance which are significant for institutions and likely to grow. In order to mitigate the threats associated with this risk, institutions need to establish dedicated compliance and internal audit departments that ensure effective regulatory compliance. Moreover, the training and development of skilled professionals would also prove beneficial for service providers.

MANAGEMENT

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

Only 46% of the respondents considered Management to be a significant risk, which further declined its ranking from eleventh to fourteenth. The risk also declined considerably in the fastest rising and ability to cope list. In the geographic context, the risk of poor management is considered amongst the most significant (top 10) risks as its ranked at tenth in Asia and ninth globally. The significance of the risk continues to decline with MFPs placing more importance on development of middle management employees as outreach improves. This risk continues to be significant when considering smaller entities operating in remote areas as compared to larger, more formalized ones.

In order to mitigate the threats emanating from this risk, MFPs should develop appropriate succession plans for future management. Additionally, trainings and capacity building exercises for management personnel could help improve business acumen of MFPs. Furthermore, effective human capital policies that attract and retain management personnel should prove essential in acquiring skilled managers.

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 ranked at thirteenth and have declined to fifteenth this year. 46% of the respondents considered this risk to be severe, with most stakeholders agreeing that MFPs would be poorly equipped to tackle this risk in terms of ability to cope.

The decline in the ranking is attributed to the fact that only a handful of MFPs have exposure to foreign currency with foreign debt on their balance sheets. International borrowing despite being expensive compared to local sources remain popular with NBMFCs due to the ease of access of availing such loans with the absence of tangible collaterals. However, 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.

Service providers can mitigate these risks by creating dedicated reserves or using hedging instruments. While currency hedge funds and options could prove useful in lowering this risk, their high cost remains a constraint.

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.

The risks associated with Transparency declined from fifteenth to sixteenth in terms of severity. Interestingly, only donors and regulators considered this a significant threat in terms of severity, quickly rising and in terms of preparedness.

Transparency in the sector remains a challenge especially when it comes to smaller, underdeveloped NBMFCs. These NBMFCs were traditionally NGOs with a mission of poverty alleviation and traditionally relied on grants or subsidized sources of funding for expansion, funds which were initially provided from international donors and investors. This led to increased scrutiny from regulators and enforcement agencies locally. As the entire sector came under the regulatory ambit, the risk of transparency declined as regulation mandated appropriate disclosures. This had led to improved reporting by MFPs in terms of both financial and social information.

FUNDING

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

The global report indicates that 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. However, in the local context, Funding Risk decreased from fourteenth previously to eighteenth this year as only 43% of the respondents considered the lack of funds a significant issue for the sector in terms of severity. The findings of the survey indicated that this concern has eased as commercial financial institutions continue to warm up to the microfinance sector, while PMIC is another major source of funding.

Additional funding to mid-sized and smaller entities would prove vital for their growth while also improving outreach. Moreover, the availability of a Credit Guarantee Facilities can smoothen the flow of funds from commercial banks to these NBMFCs. This would also prove beneficial as these entities can help commercial banks achieve their agricultural credit targets, extend coverage to geographic areas where they do not have a footprint or tap into women clients. Likewise, the successful issuance of Tier 2 capital to a few MFBs with help from PMIC would further funding avenues for MFBs. It is likely that other MFBs could also follow in their footsteps to meet their capital adequacy requirements. Backed by sturdy balance sheets and sponsors, the MFBs are also well positioned to successfully tap into the capital markets.

CORPORATE GOVERNANCE

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

The risks associated with Corporate Governance ranked seventeenth in terms of severity as compared to nineteenth previously. Of the stakeholder groups, only Analysts, Researchers and Consultants considered this a severe enough risk. In contrast, Practitioners ranked this risk low as they considered the sector to have matured and developed seasoned as well as competent leaders.

The findings of the survey indicated that the boards of the MFPs have become capable enough over the last decade to effectively manage microfinance business. This is further reinforced by the 'fit and proper' criteria defined by the regulators as well which mandate compliance with their corporate governance frameworks. Other stakeholders such as the PMIC, have played a vital role in improving the capacity of the board of NBMFCs with scarce resources. Primarily, risk mitigation strategies pertaining to Corporate Governance largely rest with the practitioners themselves, which can be addressed by adopting international best practices in board composition.

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, previously ranked twenty second, rose to nineteenth position in this edition of the 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 but is rising globally.

The results indicated that the increase arises as a result of increasing competition amongst MFPs. It was also highlighted that most competing products being offered have little features to differentiate them which is why a need for market-driven developments in products. Moreover, awareness for the uptake of products with digital features remains a challenge. It is also noteworthy that most small and medium institutions realize the importance of market research and development, but limited resources make it challenging for them to develop appropriate products.

With greater competition and maturity of the sector, service providers need to realize the importance of appropriate product development with respect to their clientele. MFPs need to offer tailored blended finance products alongside the traditional ones. While service providers have been forced to embrace digitization and accepted innovation in product delivery mechanisms, it is essential to understand that awareness regarding uptake of these products is just as essential for clients with low digital and financial literacy. Hence, appropriate market development would significantly mitigate this risk.

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.

The risk of External Fraud remains unchanged in this edition of the study in terms of severity as less than 40% perceive this risk to be severe enough to impact the sector. The threat remains low due to the presence of private fully functional Credit Information Bureaus. However, respondents believe that this to be a quickly growing threat as the risk ranked fifth and seventh in terms of rising threats and the poorest ability to cope with respectively.

The risk of external fraud is considerable when considering digitization in the industry. The use of alternative delivery channel for the provision of financial services has created vulnerabilities within the systems of service providers. Additionally, the use of branchless banking agents further aggravates the risk of fraudulent behavior when considering clients with limited financial and digital literacy.

In order to manage this risk, the capacity building and development of staff is deemed essential. Additionally, as more service providers adopt technological solutions for their services, the availability of skilled experts and staff would contain the threats emanating from this risk. Furthermore, client awareness campaigns and literacy drives would help customers understand the risks involved and aid in mitigating associated risks.

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. The ranking of this risk in terms of severity remains unchanged as less than 40% of the respondents deemed this risk as a growing threat serious enough to substantially impact the sector.

While not considered as a serious risk anymore, it could be argued that the adverse economic conditions due to increasing scrutiny by regulatory and security agencies has increased compliance and associated costs. These developments have presented the sector, particularly NBMFCs, with growing financial challenges and prompted NBMFCs to consider transforming into for-profit entities. While this could be considered an essential indication of the sector maturing, it is argued whether it is possible to effectively align non-profit ideals with for-profit business practices. 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 threat from this risk could be mitigated if MFPs adopt socially responsible initiatives. Moreover, encouraged by the funding of donors and international impact investors, the positive relationship between MFPs and clients has helped the industry to deliver on their social mission while maintaining financial stability, which has kept this risk under the lower categories of severity and growth.

POLITICAL RISK

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

37% of the respondents perceived Political Risk to be a considerable risk to the industry. Previously ranked at seventh, its position dropped considerably to twenty second compared to the previous study. Whereas, regionally, the risk is ranked at first in Asia in the Banana Skins report published in 2018, 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 in the same report.

The significance of Political Risk declined considerably as the entire sector has now come under the regulatory umbrella. However, this is also another reason why this unpredictable risk is susceptible to exogenous factors that could considerably influence the sector; especially as the financial services industry remains one that is easily scrutinized by the government. However the presiding government, as per the NFIS, prioritizes to bring 60% population in the formal financial fold, specifically with niche segments like agriculture for marginalized & small farmers and SME finance for micro and very small enterprises; and they recognize the role of the Microfinance sector to achieve these objectives. 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.

In order to mitigate the challenges emanating from Political Risks, it is essential to comprehend the value in developing good relations at the policy level with regulators and the government. This would considerably reduce the risk to service providers from political interventions. Utilizing PMN as the recognized national network for MFPs, could help service providers to voice their opinions and address challenges arising at the top level. 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.

TALENT

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

Previously ranked third in the 2018 edition of the report, the risk from Talent declined significantly as only 33% of the respondents considered this a significant threat. However, the risk still ranks high in terms of service providers ability to cope with this. 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 drop in the rankings nationally indicates that the industry has managed to identify and address the deficiency of skills in key areas of their businesses and accept, if not improve, the staff turnover. The growth in the sector continues to affect the growth in the demand for skilled human capital. As the sector has become more formalized over the course of the past few years, service providers recognize the value of skilled staff at the management and technical level. Moreover, increased regulatory scrutiny and competition in the market, have made it essential for MFPs to retain quality staff.

While most MFPs have sound policies regarding the hiring and development of human capital, the risk associated with fraudulent behavior by employees is the only factor that is considered significant by these service providers, which has been classified separately. The establishment of a Staff Reference Bureau could help mitigate this risk by identifying employees previously involved in such activities. Moreover, the PMN's Centre of Excellence has proven to be vital in the training and development of industry individuals and MFPs in order to cater to the growing human capital needs of the sector.

SECURITY

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

The addition of security risk in the survey are unique to the Pakistani context. While this risk may not be ranked high in terms of severity, almost all stakeholder groups identified this risk as moderately significant in terms of the service providers ability to cope with this risk.

Over the past few years, the security situation of the country has continued to improve. Non-state armed group attacks decreased by 13% across the country during 2019, marking it the fourth consecutive year of declining attacks. Furthermore, the multi-layered National Security Policy and the improved interagency cooperation between institutions further addressed the internal challenges as well as border security issues being faced by the nation. The risk has further subsided due to the use of alternative delivery channels i.e. digital, which aids in delivery of financial services to remote and sensitive regions where outreach is low. Establishing an exclusive risk fund at the sector level, which can be accessed during heightened sensitivity in security-related incidents would improve institutional capacity of MFPs to tackle this risk.

RELIGIOUS INFLUENCE

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

Risks arising due to religious influence declined further and are not considered a significant threat by MFPs operating in non-sensitive areas. However, the risk persists in underdeveloped areas and communities; such as at the western border of the country. The emanating challenges particularly relate to the interest rates and availability of Islamic microfinance products in the market. The availability of interest free loans has further decreased the risks emanating from Religious Influence.

While the impact of this risk has reduced substantially over time, Religious Influence remains a challenge that many MFPs are not adequately equipped to tackle, as evident by the results. The MFPs can tackle resulting issues effectively by developing customized Islamic and Shariah compliant products for the religiously sensitive clientele of the sector. Moreover, the availability of interest free loans can also assist in tackling this risk. Additionally, improved awareness sessions arranged by MFPs could further decrease the significance of this risk.

UNREALISTIC EXPECTATIONS

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

The risk of Unrealistic Expectations declined further in terms of ranking with respect to severity. The results of the survey indicated that stakeholders do not expect this risk to be a significant concern in the foreseeable future. With increasing experience of stakeholders regarding the sector, the expectations have become more rational as business acumen of service providers has improved and the objectives of the service providers have become clear.

Despite a low severity, the management of stakeholder expectations is essential, in order to contain reputational risk to the industry. This is especially true since microfinance is now recognized as an essential pillar of the financial sector of the economy.

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