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MicroNOTE

FUNDING INDUSTRY GROWTH: GOING BEYOND NUMBERS

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BACKGROUND

In April 2011, at the MFCG meeting, it was agreed that funding and risk (natural disaster) management fund are two important areas that need to be focused on by the industry. As such, two sub committees were formed to determine the funding requirement of the industry as well as development of a concept/proposal for risk management from natural disasters.

As per PMN's MicroWATCH, the microfinance market is estimated to be comprised of 27 million potential clients. At present, market penetration stands at 9 percent and offers a huge potential in terms of not only microcredit but also micro-insurance, micro-savings and remittances. Initial finding of the demand side projections presented to MFCG in January 2012 clearly indicated data issues from the MFI segment. At the MFCG, PMN was asked to conduct an exercise to determine the funding needs of the MFIs segment. Over eight organizations, based on their size, growth potential and capacity to expand, were part of this study. This analysis has been dovetailed with the MFB data already available with SBP and consolidated in this paper to give a holistic picture of the funding (especially debt) gap prevailing in the microfinance industry for the year 2012-16. The paper has also attempted to go beyond the numbers by disaggregating the overall gap into three main segments, Debt, Deposit and Equity. The paper has attempted to find funding gap over the next 4 years by adjusting for the availability of resources from existing sources and tried to come up with solutions at the Macro (policy and regulation), Meso (apex and network) and Micro (MFI and MFB) level. PMN management has consulted with SBP, PPAF, commercial banks and MFPs to uncover the prevailing challenges and solutions to address this gap.

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GROWTH PROJECTIONS

In order to determine the funding requirements, SBP and PMN requested MFBs and MFIs for their growth projections up till 2016, against a set template developed jointly by the two organizations. These projections were consolidated and rationalized for the entire microfinance industry in the country. The projections are based on the business plans of the institutions and have been aggregated to reach the consolidated figure for the industry. It should also be noted that these growth figures are not linked with availability of financing but rather are based on the estimates developed keeping in view the market size and demand. The organization from whom the projections were obtained currently account for 88 percent of the outreach.

The total GLP for the sector will increase from PKR 36 billion to PKR 94 billion from 2012 to 2016 as shown in the EXHIBIT 1. This requirement will be met by a combination of debt and deposits. The following findings reveal the future trends to growth and funding:

- 1. Growth in active borrowers will remain modest (CAGR); however, increase in GLP will be driven by i) largely MFBs and ii) entry into micro entrepreneur segment resulting in increasing average loan sizes.
- 2. Majority share of the microfinance market to be with MFB in terms of loan portfolio; however MFIs will continue to have a higher market share in terms of active borrowers, contrary to popular belief prevalent in the market.
- 3. MFB will take a deposit-led approach to funding
- 4. MFI to take a debt-led approach to funding
- 5. MFB to have a lower utilization ratio¹ as compared to MFI due to regulatory and statutory requirements

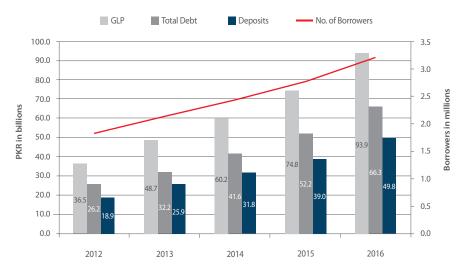
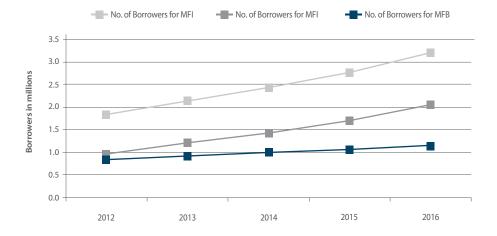


EXHIBIT 1: PROJECTED FUNDING REQUIREMENTS OF THE INDUSTRY 2012-2016

This incremental increase in deposit and debt will lead to an additional 1.4 million active borrowers (1.8 million in 2011 to 3.2 million in 2016 as shown in EXHIBIT 2) and an additional Rs. 58 billion in portfolio growth. The resulting GLP growth in MFBs is likely to be a factor of increasing loan size, as the average loan balance increases from PKR 28,014 in 2012 to PKR 43,377 in 2016. The average loan balance for MFIs in the same period will be PKR 12,753 to PKR 21,299.

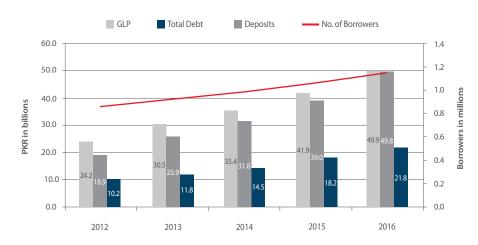
 $^{^{1}}$ Asset utilization ratio measures the effectiveness of the organization by stating the percentage of advances in the asset base of an organization.

EXHIBIT 2: GROWTH IN ACTIVE BORROWERS 2012-16



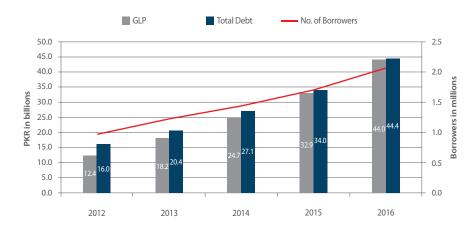
MFBs will follow a deposit-led approach to funding asset growth with the deposits increasing from PKR 18 billion to PKR 49 billion from 2012 to 2016 (see EXHIBIT 3). Despite having deposits as a primary source of funding, debt requirement for MFBs will increase from PKR 10 billion to PKR 21 billion to fund GLP growth from PKR 24 billion to PKR 49 billion. Part of this requirement will be for liquidity management needs, primarily newer MFBs entering the market will require debt to fund the initial forays into the microcredit market.

EXHIBIT 3: PROJECTED FUNDING REQUIREMENT FOR MFBS 2012-16



As Non-Bank MFPs are unable to mobilize deposits, they would be relying on debt as the main source of funds. It is estimated that the funding needs of the MFIs will increase from PKR 16 billion in 2012 to PKR 44 billion by 2016 as shown in EXHIBIT 4.

EXHIBIT 4: PROJECTED FUNDING REQUIREMENTS FOR MFIS 2012-16



A crucial role will be for the capital adequacy of the MFPs. While MFBs, due to regulatory requirements and increasing minimum capital requirement (MCR) in the last few years, are adequately capitalized, however, the same cannot be said about the MFIs. Total equity base for MFIs are projected to increase from PKR 4.4 billion to PKR 9.3 billion in 2016 and will be of critical importance in order to raise debt. This will be a challenging area keeping in view their non-profit status, which prohibits disbursement of dividends and are, therefore, unable to tap funds from commercial investors.

CURRENT SOURCES OF FUNDING

Currently, the MFPs are being funded by combination of commercial debt, subsidized debt, deposits (in case of MFBs) and debt obtained under the guarantee facilities. In addition, MFPs have been able to mobilize debt from commercial sources by securing it against liquid securities. PPAF remains the primary provider of debt for the sector especially in the context of mid-tier and small MFPs. Its instruments include both subsidized loans, commercial loans and guarantee facilities². In addition, funds from commercial banks are also available under MCGF administered by SBP. Only MFBs are allowed to mobilize deposits among the MFPs. The success witnessed by MFBs in intermediating deposits has provided them with a relatively inexpensive source of funds and it is likely that deposits will remain the primary source of funds.

Kashf Foundation had issued TFCs and successfully redeemed them at completion of tenor. Similarly, , TMFB has also successfully floated their commercial papers to meet their short term funding requirements. These can be considered pioneering transactions for the sector and more MFPs depending upon their funding requirements may access capital and money markets for funding options.

Debt

SBP's Microfinance Credit Guarantee Fund (MCGF)

Microfinance Credit Guarantee Fund (MCGF) was established in 2008 with an aim of providing partial risks against loans to microfinance providers (MFPs) by commercial banks. The facility is worth GBP 10 million. Since its launch, fourteen guarantees with total exposure of Rs. 957 Million have been issued for mobilizing PKR 3,275 million. PKR 787 million is currently available for further partial risk coverage of loans from commercial banks.

PPAF

PPAF is the national apex which is providing a vast array of funding products to the microfinance sector. The products include plain vanilla financing lines, credit guarantee facilities and equity placement funds. In addition it has been administrating grants to the sector for institutional strengthening and capacity building. Mid-tier and small MFIs are totally dependent on financing from PPAF.

Based on our discussions with PPAF management, we expect funding for on-lending will be exhausted by the end of 2012. This will seriously impair further growth and expansion in the sector especially for mid-tier and small sized MFPs who are totally dependent upon PPAF for their financing needs.

Access to Commercial Finance

Debt from Commercial Banks

Strong efforts have been made by various stockholders, most importantly SBP, PPAF, PMN and DFID to tap commercial loans from banks which have achieved partial success. Bigger and national level players have been successful in availing loans from

² Subsidized loans are extended at below market interest rates by PPAF and International Donors, Commercial loans are extended at market rate by PPAF, other financial institutions and money & capital markets and borrowings by MFP secured by special guarantee funds set up to promote commercial lending in the microfinance industry.

commercial sources through guarantee mechanisms; however Tier II players have had partial success due to a number of factors – both on the supply and demand side.

Capital and Money Market

In addition, a couple of organizations have been successful in tapping capital and money markets; Kashf Foundation (KF) has been successful in issuing Term Finance Certificates (TFCs) while Tameer Microfinance Bank (TMFB) has issued commercial papers.

Interestingly these additional facilities have had a marginal impact on increasing the total number of active borrowers which has almost remained flat and oscillates between 1.9 to 2.1 M active borrowers in the last 4 to 5 years.

Deposits

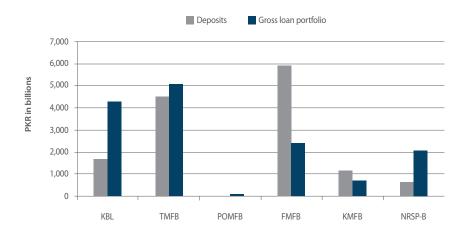
The total number of MFBs has grown from 5 to almost 9 in the last few years. Most of these MFBs are in the process of transition and will have deep pocket investors by 2012 ends. MFBs have clearly indicated that their future growth strategy will be a factor of deposit mobilization.

The MFBs despite being at an early stage of their life cycle curve has been able to cross PKR 15 billion mark in terms of deposits as shown in EXHIBIT 5. This is largely through institutional sources but when we carry out an analysis the number of retail and low end clients are around 80% and growing. These trends conform with the international studies that indicate that viability and volume of deposit is a factor of cross selling between institutional and retail and high net worth individuals with micro and SME clients.

16 14 12 10 8 6 4 2 2 0 2007 2008 2009 2010 2011

EXHIBIT 5: GROWTH IN DEPOSITS 2007-11

Despite the impressive growth in deposit mobilization the MFBs have only met their partial financing requirements through deposits with the exception of KMFB and FMFB as shown in the EXHIBIT 6 below. Banks will have to aggressively continue with deposit mobilization in order to meet their future growth requirement through deposit.



Equity

Among the players, MFI are inadequately capitalized and many of the players are in need of equity injection. Equity placement by PPAF under PRISM-Equity Fund is a step in this direction and will lead to strengthening of the mid-tier MFIs. This will not only strengthen their financial position but also enable them to access commercial finance.

MFB are adequately capitalized due to increasing Minimum Capital Requirement (MCR) over the last few years by SBP and are on a strong footing. With recent acquisition by deep pocket investors (commercial banks, International MF investment funds, mobile network operators and high net worth individuals), MFBs are better positioned to raise private equity going forward.

FUNDING FUTURE GROWTH

As we see it, the funding needs would have to be met by combination of funds from PPAF, guarantee facilities of SBP and PPAF, loans from commercial banks, funds from international investors and eventually capital and money markets.

Future Funding Strategy

The microfinance industry is moving into its growth stage after a consolidation phase from 2008 to 2012. Due to the growth in the industry, the MCGF funds are expected to be fully utilized in the medium term while the PPAF funds are already drying up. At a time where the sector is witnessing product diversification and establishment of an industry infrastructure for risk management like launch of MF-CIB, consumer protection codes and monitoring mechanisms along with financial literacy initiative, additional financing through a combination of sources is vital for the long term growth and sustainability of the sector. While MFBs will be following deposit-led approach, the initial requirement for debt will remain high; MFIs will be dependent upon subsidized debt as the primary source of funds. These financing requirements can either be met through tapping existing source of funding i.e. PPAF and MCGF. This can be achieved by increasing their funding amount or guarantees as well as exploring new sources like agriculture financing by commercial banks to be channelized through MFPs or a spun off PPAF being able to access commercial, most importantly impact investment for the industry. In addition, there is a need to engage with commercial banks and capital market players so that financing from them can be secured for the sector.

The future requirements to fund balance sheet growth will require a blended approach.

This includes debt, equity and saving. It will also require tapping of different supply side players and instruments in addition to existing facilities and where ever possible a favorable policy or regulatory environment. In certain cases it could require synergies like ones being developed between BB operators and MFIs, which can lead to a 360 degree credit line loop for MFIs.

To meet the future funding requirements of the sector, existing sources of funds need to be increased to meet the additional demands. This includes additional funds for PPAF and enhancing MCGF. Funding from commercial sources will be an important part of the funding combination of the sector. In order to promote commercial funding in the sector, concerns of the fund providers should be addressed and they should be educated about the dynamics of the sector. Despite the delinquency crisis in 2008 and adverse external factors, no MFP has defaulted on their commitment which is a major plus and an important selling point for the industry. Lastly, the financial positions of a number of MFPs need to be strengthened to allow them to access commercial finance.

However, it is felt that, recently, where there has been heavy government borrowing from the private sector and a 'crowding out effect' taking place, borrowing from commercial banks will become easier to tap with declining inflation, easing monetary policy that will make banks flushed with additional liquidity. Also, the same holds true for the capital and money markets. Let us now delve into the projected gaps and challenges faced under each element of future growth strategy at macro, meso and micro level.

Deposits

As indicated below the overall deposit gap between 2012-16 is Rs. 30 billion which MFBs will have to raise in order to finance their financial requirements as seen in the EXHIBIT 7.

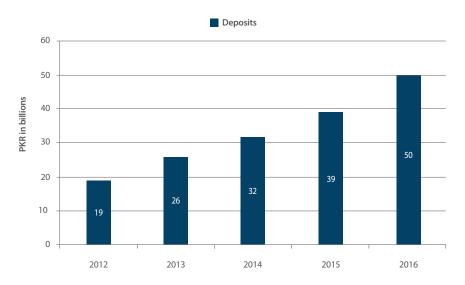


EXHIBIT 7: PROJECTED DEPOSITS FOR MFB FROM 2012-16

According to most of practitioners, deposit mobilization by MFBs faces constraints at all levels. This includes at the macro and meso level; i)MFBs being not members of clearing house with the exception of TMFB, ii)MFBs inability to offer full set of services like call centers & ATM given their small branch network and inability to provide consumer loans like credit cards and personal loans³ which most retail clients anticipate and iii) given that MFBs are not scheduled banks, the tax break advantage

³ In our conversation with MFBs we felt that depositors expect that their bank would provide them all banking services which not only saving products but also includes credit cards, overdraft and mortgages which MFBs are unable to provide to non-microfinance client.

to not-for-profit sector by placing funds in scheduled banks is not available and hence impedes their ability to get not-for-profit sector surplus funds right now parked in commercial banks.

At the micro level, in mobilizing deposits, MFBs will need to segment their market in terms of mobilizing deposits from micro and SME ends versus mobilizing deposits from institutions and high net worth individuals. In case we follow the latter model there will be a direct competition we will face with the commercial banks as they have strong and visible presence in the market. Keeping this in mind MFBs will have to target virgin markets, develop a brand identity that differentiates them with commercial banks and will require innovation. MFBs need to undertake research to segment and identify their market niche and develop savings products accordingly. MFBs lack internal infrastructure and systems to cover their liability side and are therefore finding it hard to enter this segment effectively. Moreover their staff needs training and reorientation and savings mobilization needs to become an integral part of their operational activities and not treated as an additional burden. One example of such innovation is branchless banking and MFIs/ NGOs and MFBs willing to create synergies given an enabling policy and regulatory framework. New products can be developed leading to additional depositors and deposits coming to MFBs from MFIs and MFIs either entering into a revenue sharing model or on lending model with MFBs to finance their books.

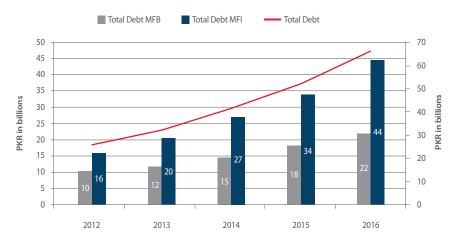
Debt

EXHIBIT 8: DEBT REQUIREMENTS FOR THE INDUSTRY 2012-16

Debt (PKR)	2012	2013	2014	2015	2016
Total Debt	26,155,128,632	32,182,917,956	41,577,532,823	52,235,997,765	66,256,618,321
Total Debt MFB	10,194,148,892	11,812,046,295	14,500,925,754	18,197,843,098	21,810,005,147
Total Debt MFI	15,960,979,740	20,370,871,660	27,076,607,069	34,038,154,667	44,446,613,174

The overall additional debt requirement for the industry is PKR 40 billion; with higher requirements in the initial year which segregates into MFB requiring PKR 12 billion and MFI PKR 28 billion (see EXHIBIT 8).

EXHIBIT 9: PROJECTED DEBT REQUIREMENT FROM 2012-16



In order to meet the debt requirements of the industry, a number of efforts shall be required at macro, meso and micro level and will require efforts by all stakeholders including regulators, donors, national apex and the players themselves. Some of the challenges identified at macro, meso and micro level are summarized in the EXHIBIT 10.

EXHIBIT 10: STEPS NEEDED TO BOOST LENDING TO MFP

Macro-level	SBP/FIP	 Topping up MCGF Extending SME Guarantee Fund to MFP Increasing access to global debt from microfinance investment vehicles by allowing long-term hedging for International Investors in MFP Agriculture credit by commercial banks could also be channelized through MFPs
	SECP	 Regulatory & Legal Cover for Non-Banking MFP leading to standardization of financial statement, reserve requirement and disclosure requirements. Legal Recourse for Non-Bank MFP
Meso-Level	PPAF	 Spinoff and specialization of financial services Diversification of funding sources, this includes accessing funds in addition to multi lateral from MIVs, Impact investors and foundations Structuring of financing facilities, allowing longer term loans with amortization schedules that promotes growth. Topping up of existing debt facilities and guarantee funds
	PMN	 More interaction between PMN commercial banks and the non banking financial industry locally and with MIVs at the global level Investor's roundtables and road shows targeted towards different lenders including commercial banks, international funds and capital market investors. Clarifying concerns around narrative of microfinance, as charity focused or commercially viable model. In fact clarifying that this is double bottom line industry and both objectives are mutually inclusive. A clear discussion around current credit default and the fact that till to date and despite credit wave of 2008-2009 there has been no default on debt obligations and call against guarantees issued. Clarity needs to build around our credit models and what works and what does not work in group models, why there is a shift towards individual lending and what are the different ways we secure our loans. Research publication through brokerage houses Publications and promotion of transparency Investment readiness training
Micro-Level	MFP	 MFIs will require improved governance and depth in their senior management team, especially in terms of interaction with banking industry MFBs will need to aggressively market their business models Standardization of financial statement presentation and most importantly the disclosures around asset impairment and provisioning of loan book. Clearly MFPs will need to show profitability along with strength of their balance sheet

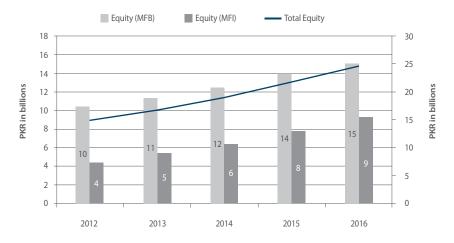
Equity

EXHIBIT 11: PROJECTED EQUITY REQUIREMENTS FOR THE INDUSTRY

Equity (PKR)	2012	2013	2014	2015	2016
Total Equity	14,890,473,968	16,795,364,613	18,880,777,598	21,844,306,363	24,655,182,507
Equity (MFB)	10,456,826,398	11,356,745,803	12,462,990,026	14,059,807,258	15,322,188,065
Equity (MFI)	4,433,647,570	5,438,618,810	6,417,787,572	7,784,499,105	9,332,994,443

The overall equity gap given the different capital requirements for MFBs and MFIs amounts to PKR 14 billion for the industry as a whole and segregated into two broader segments for MFI it will amount to PKR 5 billion and for MFB it will be at PKR 9 billion as show in EXHIBIT 11.

EXHIBIT 12: PROJECTED EQUITY REQUIREMENTS FROM 2012-16



As the portfolio of MFIs expands, leverage will begin to push against available equity and focus will be on raising paid-up capital. Moreover, MFIs are categorized as manufacturing concerns by banks rather as financial institutions due to which debt to an MFI cannot increase four times the equity of an MFI. The equity capital constraint is much higher for MFIs as they are not-for-profit institutions and cannot raise equity through commercial investors. As a result, Non-Bank MFPs will have to increase their equity capital by increasing retained earnings only and will continue to be dependent on their profitability.

This means for MFIs, either SBP will need to allow higher leverage by categorizing MFIs differently from manufacturing concerns and/or MFI segment will need to be regulated as non MFB MFIs under SECP where they are allowed to take equity financing and their leverage ratios are linked with what is available to financial institutions or MFBs.

At organizational level, MFBs are already attracting deep pocket investors both from the domestic and international markets. This is leading to change or dilution of ownership, as we see it this trend will continue and deepen. Focus will thus shift from hubris and founding syndrome to rationally engaging with deep pocket investors.

For MFIs the option will be to remain small within the existing fragmented registration requirement versus being regulated as Non-MFB financial institution entities. This will again help them in attracting equity investors. However they will need to be provided with the level playing field in terms of tax exemptions and links with platforms like one link etc.

For NGOs that remain outside the non bank MFI framework; option will only be their dependence on raising Grant equity and building retained earnings, thus remaining small and niche players. This obviously is an option for innovation, working at grass root levels and providing necessary linkage for the larger players.

CONCLUSION

Over the next few years growth in the microfinance industry in Pakistan will be a combination of increasing outreach and increasing loan sizes. The GLP for the industry is projected to reach nearly PKR 94 billion with over 3.2 million borrowers. Microfinance Banks are not only going to have a higher loan size but also a greater market share in terms of GLP.

Funding this growth would require a combination of debt, deposit and equity instruments. Future funding needs will vary among the peer group with MFBs taking a deposit-led approach to funding whereas MFIs will be dependent upon debt as primary source of funds. The existing sources of funds including the national apex

PPAF and SBP's MCGF are nearly exhausted and will be unable to meet future funding requirements. This would require the industry to diversify access to funds, mainly through commercial banks and international funds. Moreover, MFPs particularly MFIs will need to be adequately capitalized in order to raise additional financing.

This would require efforts at macro, meso and micro level in order for MFPs to meet their funding needs either through debt or deposits. SBP will need to enhance MCGF, provide long-term hedging instruments, divert some proportion of agriculture financing to microfinance sector for rural financing and extend SME guarantee fund to the MFBs. In addition, non-bank MFPs need to be brought under regulatory cover and provided legal recourse in case of willful defaults. The national apex PPAF will need to spin-off its microfinance business into a specialized microfinance investment vehicles so that it is able to diversify its funding sources and is able to tap the huge MIV and private funding market in addition to public funds from donors. It will also need to segment market and provide longer term loans to mature institutions and may also consider providing guarantees to them, whereas for the emerging players plain vanilla facilities with a shorter repayment period will continue. PMN as an association would have to play an important role in addressing the communication gap between the investors and the industry by holding roundtables, conferences and printing and disseminating various publications. Lastly, most important role will have to be played by the practitioners themselves. They would need to improve their governance standards, add depth to their management teams, improve financial disclosures and show institutional maturity leading to profitability and long term sustainability.

ACRONYMS & ABBREVIATIONS

MFCG Microfinance Consultative Group

SBP State Bank of Pakistan

PPAF Pakistan Poverty Alleviation Fund

MFP Microfinance Providers

MFB Microfinance Banks

MFI Microfinance Institutes

CAGR Compounded Annual Growth Rate

TMFB Tameer Microfinance Bank

KF Kashf Foundation

FMFB First Microfinance Bank

KMFB Kashf Microfinance Bank

MF-CIB Microfinance – Credit Information Bureau





MicroNOTE: Funding Industry Growth - Going Beyond Numbers

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