The liquidity challenge for Pakistan's Microfinance Banks

early September 2020: M-CRIL Advisory Note on the liquidity of MFBs in Pakistan

Preamble: Covid-19 has caused mayhem in the microfinance sector in Asia resulting in low recovery rates of loans and liquidity challenges for inclusive financial service providers. Both private communications and published statements about Microfinance Banks in Pakistan, however, suggest that the sector has a sanguine approach to the Covid challenge. The analysis in this note indicates that short term comfort provided by the stability of deposits may be misleading and that a deeper analysis is needed for MFBs to manage their liquidity over the next 12-18 months.

Lockdown period: Late March (various dates in different regions/provinces) to a gradual easing beginning early May
Lockdown rigour: Strictly enforced in the early weeks but gradually eased after that.[1]

Most likely scenario – assumptions

• Client collections (January-December 2020)	avge 65-70%
• Redemption of deposits, net	5%
• Disbursements, % of normal annual disbursements	75%
• Borrowings repaid, net	20%
• Cash buffer, % of total funds	~5%

Analysis sample — 10 out of 11 MFBs*

Liquidity shortfall

- **MFBs#** – 5 of 10 have cash short-falls in excess of 5% of funds — **Total: ~$124-180 million** or PKR 19-28 billion
  10 MFBs, active loan accounts = 2.8 million, portfolio, $1.2 bn/PKR 186 billion — $52-72 million (PKR 6-8 bn) shortfall for the largest MFBs

* Microfinance Banks licensed as deposit taking financial institutions; there are 11 MFBs excluding two recently licensed; Telenor MFB not included here due to its unique pre-Covid challenges.
\# MFBs do not have scheduled bank status and are not, therefore, able to access the State Bank of Pakistan's liquidity window.

[1] CGAP/PMN, June 2020. "Pakistan: Policy, Regulatory & Supervisory Covid-19 Responses for Microfinance" CGAP Background Document.

This analysis is based on the understanding that

a) Covid lockdowns have posed ***severe*** challenges for **collections of repayment from clients** during April-June 2020 and still significant ones during July-September and beyond; the restructuring of about 30% of loans has added to potential liquidity issues for the microfinance sector as a whole, including MFBs.
b) Because of lockdown conditions, it has been difficult for MFIs to manage their business normally; this has put a **brake on disbursements** resulting, for now, in below normal flows of fresh loans to microfinance clients. While MFBs are able to recover most of the loan instalments due (after restructuring), their confidence both in extending repeat loans to existing clients and in issuing fresh loans to new clients has been undermined.
c) The reduced inflow of collections has resulted in a decline in disbursement levels with MFBs juggling their cash flows to determine the optimal level. While low disbursements conserve cash, the higher the reduction in disbursement level the greater will be the compression of the microfinance business in the medium term.
d) There has not been, and is unlikely in the future, to be an extra-ordinary **withdrawal of deposits** from MFBs. Even during the severe lockdown period, none of the MFIs experienced a significant withdrawal of deposits.
e) Though the lockdown has been greatly eased, the Covid-19 crisis is not over. The businesses of microfinance borrowers will take months to recover fully from the economic disruption of the varying levels of lockdowns and other restrictions in different parts of the country.

In undertaking this analysis we have taken into account the **maturity profile of assets and liabilities** over a **one year timeframe**.

This note parallels the analysis in the other recent Advisory Notes by M-CRIL – the details of the calculation method and other assumptions about loans without collateral and no default by trade debtors are set out in the **Annex**.

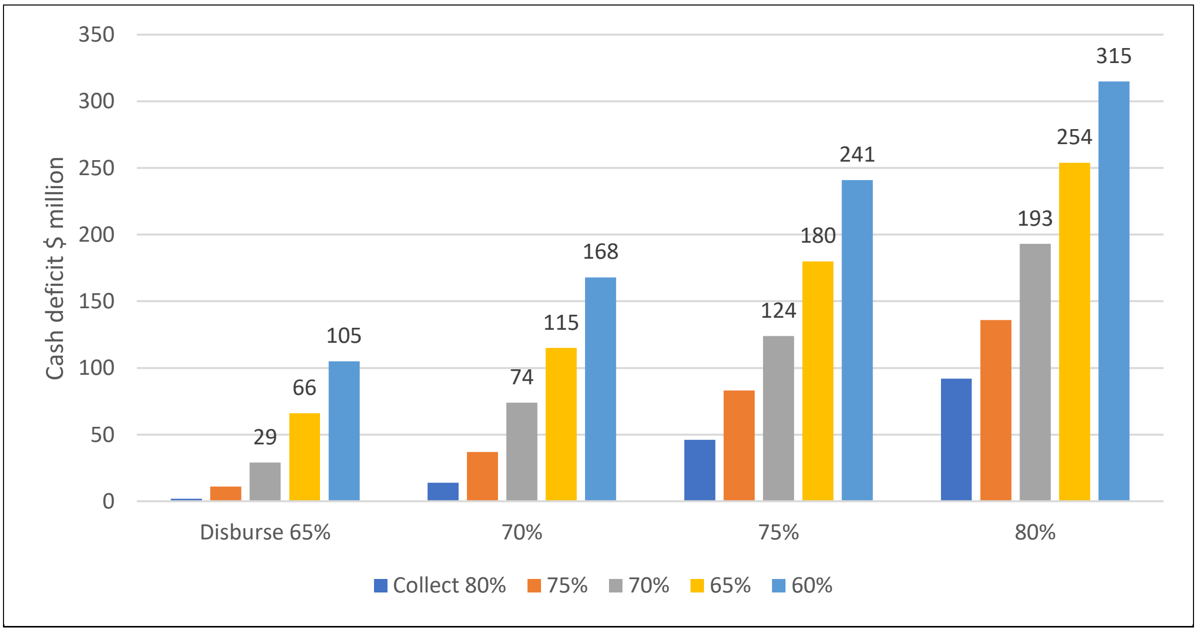
Table 1 and **Figure 1** show significant liquidity issues arising for MFIs in the following conditions

- **Most likely**: With 65-70% of amounts due collected during the one year analysis period, and 75% of expected disbursements paid out, 5 of the 10 MFBs in our sample have significant liquidity shortfalls (>5% of total funds) resulting in the need for a liquidity fund amounting to **$124-180 million** (PKR 19-28 billion) for all the MFBs in the sample to tide over the crisis.

Table 1: # MFBs in sample of 10 (of the 11 MFBs) facing >5% liquidity shortfalls

	Disburse 65%	70%	75%	80%
Collect 80%	0	2	2	4
75%	2	2	4	5
70%	2	4	5	5
65%	3	5	5	7
60%	5	5	8	8

Figure 1: Amount of liquidity support necessary to ensure survival of the 10 MFBs covered by this analysis (extrapolated, US$ million)



- **Maintaining disbursements at the 75%** level seems optimal since higher disbursements result in a sharp increase in the liquidity shortfall up to $190-250 million (PKR 29-39 billion); a lower level of disbursement (even 65%) substantially reduces the liquidity shortfall but would lead to a compression in operations over the next 12-18 months with drastic implications for profitability. A 75% disbursement level also impacts profit-ability but not as drastically.

The covid liquidity paradox…

Based on the above analysis, **the key pre-existing factors that enable institutions to manage Covid conditions** are as follows

- While commercial logic dictates that a high proportion of assets should be in portfolio since that is what generates income for MFIs (and has higher interest yields than any bank deposits are likely to provide), at a time like this, **a lower proportion of assets in loan portfolio** is beneficial for managing liquidity. Pakistan MFBs have 40-68% of their assets invested in loan portfolios so are less challenged than India's SFBs (69-80%) and Nepal's large MFIs (85-95%) but there is, nevertheless, a liquidity shortfall particularly for those with >65% of assets in loan portfolio.

- **A high maturity period of portfolio is also helpful** at a time like this since that reduces the need for loan rescheduling. MFBs with >40% of portfolio in <180 day maturities have greater potential for a liquidity crisis than those with lower proportions in short maturity loans. This is contrary to received microfinance wisdom of short maturity loans being more profitable than those with longer maturities.

- Deposit withdrawals have not been a major consequence of the pandemic. As a result, **with deposit funding at the 70-98% level** and borrowings less than 10% of liabilities, **Pakistan's MFBs are less challenged** than the higher leveraged

- large MFIs of Nepal (30-60% borrowings),
- India's large MFIs (70-90% borrowings) and
- also somewhat better off than India's Small Finance Banks (50-75% deposit funding).

The numbers in this analysis indicate the **additional** funds from investors and local or international lenders (SBP, Pakistani commercial banks or foreign lenders) that some of the MFBs will need to access **in order to grow** beyond survival.

The purpose of this exercise is to facilitate decision making in relation to the Pakistan micro-lending value chain; it is also to enable understanding of the finances of MFBs in Pakistan and the potential role of domestic as well as external investors & lenders in supporting the microfinance eco-system of the country.

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Annex – methodology & assumptions not stated in the text above

As mentioned in the main text, this Pakistan microfinance bank liquidity assessment is for a one year period (calendar year 2020) and beyond into 2021 on the assumption that the liquidity challenge is immediate and it is during this period that additional liquidity support may be necessary. Specifically, we have used the following (estimated for the analysis period based on MFB financial statements for 2019 and applying a growth factor of 20% per annum)

Inflows over one year =
+ **opening balances** (cash + cash equivalents)
+ **portfolio** (repayment) **collections**
+ **interest income on loan portfolio** collected during the period
+ **deposits collected** (as discussed above)
+ **other income** (total for the year)

Outflows over one year =
+ **interest paid on borrowings** over one year
+ **deposits matured** during the period (95% renewed)
+ **interest paid on deposits** (total for the year)
+ **operating expenses** (annual staff salaries, establishment expenses, travel).

Since calendar year 2020 is ongoing we have used published 2019 data for this analysis. The **assumptions** are

- The contours of the 2019 balance sheets/financial statements remain largely unchanged in 2020; we recognise this may not always be true but the objective here is to indicate the dimensions of the liquidity problem rather than to provide accurate information. In order to make a realistic estimate of orders of magnitude a 20% average growth rate for 2020 has been assumed (based on aggregate growth numbers available for the past two years).
- Nearly 100% of these MFB portfolios are with micro-borrowers with no collateral.
- Due to the scare created by Covid, collections were already down to 81% in February 2020. This decline was expectedly exacerbated by lockdown regulations in March and April resulting in collections of the order of 33%.[2] When operations picked up from May collections of amounts due improved rapidly but short term inflows were constrained by the restructuring (or loan deferment) of 30% of loans.[3] This is expected to depress collections for most of the rest of the year yielding an average of just 68% of normal collections for all of 2020.
- There will be no default on MFB **receivables** from debtors on non-operational transactions
- **Other income** (commissions & miscellaneous) do not decline significantly.

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See disclaimer and briefs about the authors' organisations on the following page

[2] CGAP/PMN, June 2020, *op cit*. and http://www.technologyreview.pk/microfinance-registers-90-plunge-in-pakistan-during-covid-19-lockdown/

[3] https://www.finca.pk/news-press/pakistani-microfinance-recovers-after-coronavirus-brought-sector-to-grinding-halt/

A disclaimer for readers…

These findings provide a guide for the managements of micro-lending institutions, for wholesale lenders to them and for investors in such institutions to understand the liquidity challenges of the lockdown. As indicated by the qualifying statement earlier in this note, the analysis here is based largely on the 2019 balance sheets of the MFBs in the sample. This document does not purport to set out rules of operation for MFBs in normal times, it is meant mainly as an indicator for all stakeholders of the microfinance industry in Pakistan of the challenges involved and the orders of magnitude of funds of additional investment or lending to be considered. ***However, actions taken by stakeholders are at their own risk and M-CRIL will not be responsible for decisions based on the contents of this note***.

M-CRIL is a responsible development research and analytics firm with a concern for **inclusive microeconomics**. Along with its parent firm, EDA Rural Systems, M-CRIL has over 40 years of experience of international issues in microenterprise promotion and financial inclusion through a substantial record of analytics in this field including microfinance ratings, programme evaluations and focused management training and capacity building support for MFIs. Its work in support of smallholder farmers and with agricultural value chains in South and Southeast Asia also emphasises its commitment to supporting the lives and livelihoods of low income families.