LUMS | Chaudhry Nazar Muhammad Department of Economics

Making Microfinance Institutions Resilient in the Face of Crises: Lessons from COVID-19

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Microfinance sector plays a crucial role in economically empowering customers that can not access commercial banking services. Despite being considered a mature microfinance sector in Pakistan, the experience during COVID-19 revealed certain vulnerabilities that require policy shifts to ensure resilience and agility in responding to such shocks in the future. This policy brief recommends regulatory convergence between different microfinance institutions, better and quick communication to borrowers regarding their instalments payments, and a shift to low-powered incentives to microfinance loan officers in the event of a shock to protect the interest of microfinance borrowers and the institutions themselves.

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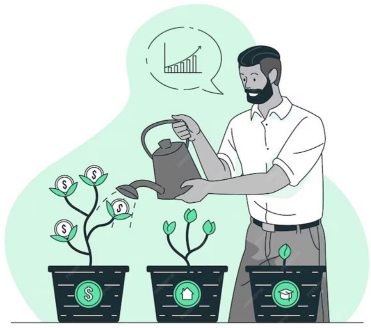
Introduction

Microfinance institutions (MFIs) offer loans and saving services to low-income customers who lack easy access to traditional commercial banks, helping them maintain liquidity, invest in microenterprises, and save. In Pakistan, microfinance borrowers are poor[1], but not poor enough to be eligible for poverty reduction.

Microfinance Sector in Pakistan

The microfinance sector in Pakistan is quite mature **(Table 1)**. There are different categories of microfinance institutions viz-a-viz their sources of funding and business model, ranging from relying primarily on Zakat to those relying heavily on investments with a commercial focus.



Notably, Microfinance Banks and Non-banking Finance Companies differ in key aspects as shown in **Table 2**.

Table 1: Microfinance Sector Statistics (September 2023)

Outreach	Number of Branches	4037
	Penetration Rate (%)	23.1 %
	Female (Active Borrowers)	45 %
	Rural Outreach	42 %
Assets	Gross Loan Portfolio (PKR Billion)	510
	Active Borrowers (Million)	9.25
	Average Loan Size (Rs.)	55,081
Deposits	Value of Deposits (PKR Billion)	488
	Number of Deposit Accounts (Million)	98
	Average Deposit Size (PKR)	4,969

Source: PARCRA Report (2023), PMN Watch (Issue 67)
Note: Stats are for 3MCY 2023

Table 2. Differences Between Types of MFIs

Microfinance Banks (MFB)	**Non-banking Finance Companies (NBFCs)**
Accept deposit	Don't accept deposit
Regulated by the State Bank of Pakistan (SBP)	Regulated by the Securities and Exchange Commission of Pakistan (SECP)
Stricter regulation regime	Less strict regulation regime
Relatively better off customers	Relatively poor customers
Public sector funding	Debts provided by Microfinance Investment Company

[1] Poverty scores 35 - 60 typically, exceptions exist.

Learnings from COVID-19: Vulnerabilities of the Microfinance Sector

While COVID-19 is not the first crisis faced by Pakistani MFIs, industry experts emphasized how it was qualitatively different and hence, exposed deeper vulnerabilities of the sector. Previous crises like earthquakes, floods, and conflicts were addressed by providing direct relief. Restrictions on face-to-face contact distinguished COVID-19 as a unique challenge for MFIs, both directly (through the ability to collect repayments) and indirectly (through the impact of the lockdown on economic activity). Shocks like COVID-19 hit informal sector workers the most because of little to no job protection. SBP and SECP announced regulatory relief for all microfinance institutions in March 2020 in response to COVID-19.

Empirical evidence[2] **(Table 3)** shows how microfinance clients were affected in the aftermath of COVID-19 lockdowns.

Table 3: Impact of COVID-19 Lockdown on Borrowers

	Sample 1	Sample 2
Impact on Microenterprise Sales	Fell by 91 % on average. (From \$33 to \$3)	Fell by 93 % on average. (From \$52 to \$4)
Impact on Household Income	Fell by 88 % on average. (From \$43 to \$5)	Fell by 91 % on average. (From \$58 to \$6)
Impact on Loan Repayment	Fell from 98% in February 2020, 34% in March, 34% in April	

Following takeaways lay the foundation of our policy recommendations:

1. While conventional wisdom suggests that oversight is needed for deposit-taking institutions only but not others, the crisis has shown that this regulatory distinction provides an unreliable guide. Even microfinance institutions that do not take deposits need regulatory oversight, particularly with consumer protection in mind.

2. With high-powered incentives still in place, the empirical analysis suggested that some loan officers were still demanding repayments from customers, even when senior staff had established policies creating repayment moratoriums. Crises circumstances may call for low power incentives as best practices in normal times can be bad practices during a crisis.

The strength of the microfinance sector is derived from:

1. Length of shock i.e. crisis
2. Available financial cushion for financial institutions
3. The willingness of their creditors to be patient and forgiving
4. Steps taken by regulators and donors
5. Ability and willingness of customers to eventually make good on their obligations.

[2] All findings are based on data collected from rapid response phone surveys of about 1,000 microenterprise owners (two sub-samples of current customers and graduated borrowers), a survey of about 200 microfinance loan officers, and interviews with regulators and senior representatives of microfinance institutions.

3. Microfinance relies on face-to-face personal interaction by its very design, despite the digital revolution. Critical challenges that impede digitization include the overall low literacy levels of the target population and the very business model of MFIs.

4. The major founding block of the microfinance sector is trust, which is highly susceptible to how institutions treat their customers during times of crisis. Institutions need to preserve their social and organizational capital on a priority basis in times of crisis.

5. Certain nuances were highlighted regarding managing the interest burden of MFI borrowers:

> **a.** Relief to MFI borrowers by deferring principal payments but collecting interest rate payments is not administratively or economically feasible for MFIs because of small amounts of monthly loan interest payments.
>
> **b.** Because declining balance and hence fixed payment structure is generally followed by more MFIs, the policy of collecting only interest payments is not feasible as the interest proportion varies every month. Especially given that interest payments are collected by agents who are used to collecting the same payment every month.
>
> **c.** For agricultural loans involving huge bullet payments, accrual of a large amount of interest throughout deferral, and the ability of clients to pay off their deferred principal and accrued interest in a year need a better solution.

The COVID-19 crisis made the trade-offs between levels of regulation and access to support from regulators much more explicit: NBFCs are not connected to the State Bank of Pakistan which is the lender of last resort, yet they are the organizations serving the most vulnerable populations, and are plausibly most in need of support.

Policy Recommendations

A collapse of the microfinance sector risks pushing vulnerable communities backward. The following policy prescriptions are based on insights into the implication of a shock at a systematic and regulatory level.

01. Clear and Quick Communication

The ambiguity of MFI policy has serious implications for client behavior as well as the future credibility of MFIs. *There is a need for quick and crisp communication, both to borrowers and loan officers about repayment flexibility to prevent rumors in the event of a shock.*

02. Regulatory Convergence

Different regulatory regimes applying to MFBs (deposit-taking banks) and NBFCs (not-deposit-taking) were reported to be a cause of concern. The policy recommendation is to ensure regulatory convergence between MFIs and NBFCs, especially in the event of an imminent liquidity crisis. Specifically, the NBFCs desire access to facilities available to MFBs by SBP, while the MFBs seem to object to 'light touch' regulations by SECP for the NBFCs.

03. Develop a Staff Information Bureau

Suggestions for a staff information bureau that keeps records of staff who are offering financial products to microfinance clients, and records if there are any instances of misconduct. The risk of negative loan officer behavior because of information asymmetry in the market is especially heightened at the time of such crisis and a staff information bureau can protect borrower's interests effectively.

04. From High Powered to Low Powered Incentives

The microfinance loan officers faced the following challenges (a) pressure from local authorities to close down their offices (b) client relationships being restrained (c) lack of public transport, especially creating challenges for female officers. *Policy recommendation involves decoupling payment incentives of loan officers from their ability to recover loan payments from the borrowers and emphasizing more on their jobs as facilitators, supporting the poor.*

05. Liquidity Management

SBP's liquidity window should be made accessible to both MFBs and NBFCs as it is available to commercial banks. Like commercial banks, MFIs specifically NBFCs risk laying off workers amidst a liquidity crunch. This may further lead to the erosion of principal assets i.e. loans.

06. Consolidation in Credit Information Bureaus

Data suggests high compliance with the CIB rules by both MFBs and NBFCs. However, rules stipulate that smaller loans are not subject to reporting, which makes it difficult to know exactly how indebted borrowers are and from how many institutions they are taking smaller loans. *It was thus, suggested to consolidate the credit bureaus to address concerns regarding the existence of two separate credit bureaus.*

07. Food and cash donation

An event like COVID-19 that disrupts the daily operations of microenterprises immediately puts them in a highly vulnerable position with food shortage. *Immediate relief in the form of cash donations, food donations, and rescheduling or waiving off of contractual obligations should be considered.*

08. Credit Guarantee Schemes (CGS)

There exists a huge demand for financing instruments with greater risk-sharing properties to improve the resilience of MFIs in the face of shocks like climate related crises, and agricultural shocks. e.g. credit guarantee schemes for the NBFCs. Such a scheme would offer risk sharing to lenders by taking a portion of the lenders' losses in the event of loan defaults. A CGS can provide risk mitigation either by sharing losses on a pari passu basis between the CGS and the lender, and/or with the CGS covering a fixed percentage of the first loss.

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