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An overview of Microfinance Institutions and Related Developments in Pakistan

Asif Javed¹, Faeyza Khan²

¹Sustainable Development Policy Institute, Islamabad, Pakistan

²Financial Inclusion and Innovation, Tangent Advisory Services, Pakistan

Correspondence:

Asif Javed: asifjaved04@gmail.com

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*Asif Javed and Faeyza Khan**

ABSTRACT

This research work is an attempt to assess the current state of microfinance in Pakistan with a view to collaboratively finding strategic and bespoke solutions to increasing the financial inclusion footprint in the country. Key Informant Interviews (KIIs) have been held with stakeholders across a wide spectrum comprising investors, development agencies, practitioners, apex bodies, credit bureau and regulators so that a candid and consensual approach may emerge with solutions that are practical and implementable. It was pointed out by stakeholders that Pakistan's financial institutions are well established, and the legislative framework and regulatory structure have nimbly evolved to create sufficient infrastructure for growth across the board. However, there is lack of partnerships among Microfinance Banks and Non-Banks Microfinance Companies. Going forward, financial institutions should focus on digital financial services to expand their network.

Keywords: Microfinance, Financial Inclusion, Digital Financial Services, Financial Institutes.

* Mr Asif Javed is a Senior Research Associate at the Sustainable Development Policy Institute (SDPI), Islamabad, Pakistan. Ms Faeyza Khan is Co-Founder and Head, Financial Inclusion and Innovation, Tangent Advisory Services.

1. INTRODUCTION

Expanding the financial inclusion footprint has long been established as the engine for fueling economic growth and alleviation of poverty while empowering people with the means to lead their lives with dignity (Williams et al., 2017). Pakistan took an early lead relative to its peers in terms of regulations and creating an enabling environment for the healthy off-take of microfinance in the country. These were supposed to play a catalytic role in expanding the financial inclusion footprint. However, according to the Global Findex Database (2021), Pakistan is lagging behind its peers with 21% of its adult population having access to an account at a formal institution, while India is at 78% and Bangladesh is at 53% (Demirguc-Kunt et al., 2022).

There are currently 11 microfinance banks; 20 active microfinance companies; engaged regulators like the State Bank of Pakistan (SBP) and the Securities & Exchange Commission of Pakistan (SECP); and supportive apex bodies - Pakistan Microfinance Network (PMN) and Pakistan Microfinance Investment Company (PMIC). Moreover, there is a fast-growing digital finance services enabling environment which global experience demonstrates, can plug very swiftly into the microfinance ecosystem for meaningful partnerships to catapult the delivery of targeted, bespoke products with low-cost delivery models to the client niche that needs it the most.

Microfinance banks have now experienced nearly two decades of operations and have built up healthy portfolios and ample deposits to ensure sustainability. There may be some mergers and acquisitions in the works as two commercial banks have received a greenlight to conduct the due diligence of two microfinance banks. Similarly, among the universe of non-bank microfinance institutions, most have converted to companies as a first step towards corporatisation. They have recently been given regulatory allowance to transform into companies which may invite foreign investment and will have the capacity to distribute dividends. A few of the microfinance companies are looking for interested investors to cement such a relationship. While banks are comfortably funded by deposits, microfinance companies will have to consistently work hard to develop robust operations and brand values to ensure continued funding lines from commercial banks or the wholesale financier in Pakistan - the PMIC.

The central bank significantly increased the ceiling for microfinance banks recently, opening a portal of opportunity for microfinance banks and companies to clearly delineate their spheres (SBP 2020). Currently, in some geographies, some of the banks and microfinance companies are seen to be competing for similar loan sizes. However, before this can happen, banks will have to up their game and develop the prerequisite risk systems, products, marketing approaches and, more importantly, their cadre of loan officers to be able to serve the upper strata. Observers believe this will enhance the standards of the microfinance industry. The sector will need to ensure that the behavioural

An overview of microfinance institutions and related developments in Pakistan

changes noted in customer repayment trends seen recently after the leniency shown by regulators during the COVID-19 period does not become an Achilles heel for the sector at large. Microfinance companies are expected to fare better because of their closeness to clients though banks have more professional assessment and monitoring tools.

The study aims to investigate the growth process of the financial industry of Pakistan and reviews what are the key developments in the microfinance industry. Besides, the objective is to scrutinise the key differences between Microfinance Banks (MFBs) and Non-Banking Micro Finance Companies (NBMFCs) in terms of their scale and outreach, lending and funding structure, target market and regulatory requirements. The contribution of the study is to focus on those aspects of the financial industry of Pakistan which are not highlighted in the existing literature such as the discussion on MFBs and NBMFCs. The next section of the study outlines the methodology while Section Three is based on Pakistan's financial sector dynamics. Section Four highlights the landscape of the microfinance industry, and Section Five presents the Strengths, Weaknesses, Opportunities and Threat (SWOT) analysis of the financial sector whereas Section Six highlights the differences among MFBs and NBMFCs. Section 7 offers an overview of the microfinance industry's size and penetration; Section 8 provides recommendations, with the final section presenting the conclusion.

2. RESEARCH APPROACH AND METHODOLOGY

The study uses descriptive analysis to present an overview of the recent developments in the financial sector of Pakistan. This includes the state of financial inclusion, Findex performance and overview of the microfinance industry. The study also consulted key stakeholders (Annex B) in the industry and based on their inputs, a SWOT analysis of the financial industry was conducted. In the first step, the study explored recent literature and policy documents from published sources to determine the key aspects related to the microfinance industry in Pakistan. Policy documents such as the 'National Financial Inclusion Strategy' and financial reports of various financial sector institutions were also reviewed. Recent data on financial indicators including percentage of population with banking, financial institution and mobile money accounts was extracted from published sources. Besides, data of key indicators of the financial industry including active borrowers, total assets and deposits was also incorporated in the study to examine the progress of the industry. The study also presents disaggregated analysis of financial institutions by MFBs and NBMFCs by reviewing their scale and outreach, lending rates and funding structure, target markets and their regulatory requirements. Potential market size of the microfinance industry is presented based on the latest reports of the Pakistan Microfinance Network. The study also highlights key players in the financial industry by examining the financial data and annual reports of relevant institutions.

3. PAKISTAN'S FINANCIAL SECTOR DYNAMICS AND FINANCIAL INCLUSION SPECTRUM

The financial sector is overall competitive and well regulated under an engaged central bank, the SBP. The banking sector is led by 15 local private banks, 5 public sector banks, 4 specialised banks, 5 Islamic banks, 4 foreign banks and 11 microfinance banks which reach the lower end of the pyramid and fulfil a development agenda (Annex A). In addition, there are 8 licensed development finance institutions, 2 credit bureaus and 3 payment system operators.

SBP provides regulatory oversight through adaptive approaches such as a sandbox environment for digital banks. The SECP is the apex regulator for more than 100 NBFCs, including 30 licensed non-bank microfinance companies of which around 25 are active.

According to the Pakistan Bureau of Statistics (PBS), the country's financial system plays a relatively minor role in its overall economic output. In the fiscal year 2019-20, the finance and insurance sector accounted for just 2.5% of the Gross Domestic Product (GDP). Additionally, the sector's contribution to overall employment is limited, standing at 0.5% in 2018-19, a figure that has remained largely unchanged since 2014-15.

3.1 The Case for Financial Inclusion

Sarma (2012) defined 'financial inclusion' based on various factors including accessibility, availability, and usage of formal financial systems by all members in an economy. In the world of development finance, limited financial inclusion has long been presented as the conundrum which some countries have addressed better than others, some are struggling on the margins while some of the inclusion (a portmanteau for financial inclusion) stars have catapulted relatively quickly. Undoubtedly, higher financial inclusion figures lead to a more conducive eco-system for denizens to unlock their socioeconomic potential to contribute to the economy and society at large (Ozili et al., 2022). Due to this significance, the United Nations (UN) member countries included financial inclusion as a formal target and a key measure in their development agendas (Sahay et al., 2015).

Literature points to a correlation and a causal relationship between lack of financial inclusion and poverty. Choudhury and Bagchi (2016) indicated that the persistent state of poverty and financial hardship in developing countries is partly due to financial exclusion and to eradicate poverty from the world, financial inclusion has been put forward as one of the panaceas (Bateman et al., 2019). A key element to ending social exclusion is financial inclusion, which presents an opportunity for people to benefit from financial services and as such contribute to the processes of economic and social advancement of the beneficiaries (Mubiru 2012). Lal (2018) emphasised that financial inclusion plays a

An overview of microfinance institutions and related developments in Pakistan

significant role in reducing poverty. Omar and Inaba (2020) pointed out that financial inclusion is a significant factor in reducing poverty in developing countries like Pakistan. Mahmood et al. (2023) examined that financial inclusion improves growth and helps in reducing poverty in Pakistan.

An inclusive economy is imperative for the world's vulnerable people involved in the informal sector since it facilitates daily payments (ITU 2016). It also enables the poor but active population to easily acquire loans which can be invested in any business to generate income. People who are included in the financial sector would be able to overcome risks through investments they have made because of their savings (Ibid.). Having access to financial services also empowers poor people to save and to borrow, helping them to acquire assets, invest in education and set up businesses that would enable them to improve their standards of living (Baidoo et al., 2020; Sakyi et al., 2021). Thus, financial inclusion is beneficial to less privileged people in rural areas of society, young people, and women.

3.2 Pakistan's Findex Performance

According to the latest Findex report from 2021, approximately 1.4 billion adults globally remain unbanked, lacking access to an account at a financial institution or a mobile money provider. Since account ownership is nearly ubiquitous in high-income economies, the vast majority of the unbanked population resides in developing countries. Notably, China and India have a significant number of unbanked individuals despite relatively high levels of account ownership, largely due to their massive populations. India has the world's largest unbanked population, with 229 million adults without an account, followed by China with 130 million, Pakistan with 113 million, and Indonesia with 97 million. These four countries, along with Nigeria, Mexico, and Bangladesh, collectively account for nearly half of the global unbanked population.

Financial inclusion in Pakistan is estimated at 21%, marking an increase of 7 percentage points since the previous survey in 2017. Although this increase represents the largest growth since the FII survey began in 2013, Pakistan's level of financial inclusion remains considerably low compared to countries with similar socioeconomic profiles. For instance, India's financial inclusion rate stands at 79.9%, and Bangladesh's at 50% (Karandaaz 2020).

Since the past few years, despite policy measures taken to improve the proportion of financially included population and expand the uptake of formal financial services, the latest data demonstrates the need to cover more ground, especially in case of women. According to the global Findex Database (2021) cited by Demirguc-Kunt et al. (2022), in Pakistan, the percentage of females having a bank account (13%) is lower as compared to males (28%). Over the past five-year period, the gender gap has widened to a staggering

30%. The 2021 Global Gender Gap Report by the World Economic Forum (WEF) (2021) ranked Pakistan 153rd out of 156 countries, which is 2 places lower than its 2020 ranking. Within the sub-indices, Pakistan has the lowest gender parity (0.33) for ‘Economic Participation and Opportunity.’ These factors require thorough analysis to develop effective solutions aimed at increasing the proportion of the population that is financially included.

Table 1: Pakistan’s Financial Performance

Description	2014 %	2017 %	2021 %
Account (% Age 15+)	13	21	21
Financial Institution Account (% Age 15+)	16	25	43
Mobile Money Account (% Age 15+)	6	7	9

Source: Global Findex Database 2021.

The data in Table 1 illustrates a notable shift in account ownership between 2014 and 2021. Specifically, the percentage of individuals with accounts increased from 13% in 2014 to 21% in 2021. Moreover, the percentage of adults holding financial institution accounts experienced a significant rise from 16% in 2014 to 43% in 2021. Furthermore, mobile money account ownership also saw an increase, rising from 6% in 2014 to 9% in 2021. These findings collectively highlight that a substantial segment of Pakistan’s population remains excluded from the financial system.

4. PAKISTAN’S MICROFINANCE INDUSTRY

Significant expansion in the MFBs sector in Pakistan can be attributed to their unique approach in extending financial services to remote and underserved areas. This lending model has demonstrated a trend towards maturation, marked by substantial growth in rural lending, an enlarged customer base, and improved profitability, as indicated in the study by Naz et al. (2019). Additionally, a report published by KPMG in 2022 revealed that in 2021, the total assets of all banks operating in Pakistan witnessed a substantial 20% increase.

An overview of microfinance institutions and related developments in Pakistan

Table 2: Key Indicators and Trends

Description	2017	2018	2019	2020	2021
Active Borrowers (Million)	5.5	6.7	7.4	7.0	8.0
Gross Loan Portfolio (Million)	196	256	302	319	372
Active Women Borrowers (Billion)	2.7	3.5	3.8	3.4	3.5
Branches	36,053	42,048	46,163	44,570	41,384
Total Assets (PKR Billion)	330	427	493	617	704
Total Deposits (PKR Billion)	186	239	266	373	401

Source: Pakistan Microfinance Network 2020.

Active borrowers increased considerably from 5 million in 2017 to 8 million in 2021 (Table 2). While Mobilink Micro Finance Bank (Telco-led) leads in terms of active borrowers with its plethora of digital accounts at more than 2 million, in terms of Gross Loan Portfolio (GLP), it is Khushhali Microfinance Bank (KMFB) in the lead with a GLP of 72.5 billion/ USD 414.4 million and a market share of 18.5%, followed by HBL MFB (former First Microfinance Bank), U Bank and NRSP Bank. In terms of active borrowers, KMFB has the largest share among traditional microfinance providers while Akhuwat leads among MFIs with NRSP and Kashf close behind.

4.1 Determinants of the Slow Pace of Growth

Pakistan made financial inclusion a top national priority ahead of numerous other countries. The country's commitment to the microfinance sector dates back to the 1990s. In 2001, the government initiated the establishment of microfinance banks, and by 2008, Pakistan emerged as one of the pioneering nations to embrace branchless banking regulations, facilitating the development of digital financial services.

Pakistan was also early to digitalise government payments. In 2010, its Benazir Income Support Program (BISP) began to digitalise safety net support to millions of poor women, and many other government programmes have become digital since then. In 2015, the government adopted the National Financial Inclusion Strategy (NFIS). NFIS (SBP 2015) aimed to create nationwide awareness and initiate education programmes, including the role and importance of financial services such as digital payments, credit facilities, insurance, Islamic finance, and credit guarantee schemes.

However, the country lags behind in financial inclusion as compared to peer economies (Zulfiqar et al., 2016). Experts have pointed out that public mistrust in banks and other

formal institutions is a major factor behind the slow progress. The Gallup World Poll 2017 offers some support for this idea, showing that more than a third of Pakistani adults do not trust financial institutions. This theory will have to be re-tested as in the years since, Pakistan has seen a rise in payment platform and e-wallets, especially during the COVID-19 Pandemic. While building trust is a long-term challenge, improving financial services providers' capacity and ambition to reach large scale, especially with mobile wallet account ownership, can be addressed in the shorter term.

Other determinants have been identified as macro pressures and instability in economic cycles, crowding out of private credit due to public borrowing from the overall financial system (Zaheer et al., 2017), high cost of micro credit (Waheed and Hamid 2001), growing informality in the economy and gender barriers in the use of smart phones (GSMA 2021) and limited collateral registry to unlock credit avenues. Besides, there is a limited presence of commercial banks in rural areas and the products they offer are ill suited to smallholder clientele (MDF 2020). Hussein and Khan (2009) pointed out that due to low outreach of formal financial institutions, rural populations depend largely on informal lending.

5. SWOT ANALYSIS OF BANKING AND NBMFCS

A Strengths, Weaknesses, Opportunities, and Threats (SWOT) analysis was conducted to draw upon in-depth informant interviews with industry stakeholders possessing extensive knowledge of Pakistan's financial sector. Their insights have allowed for an assessment of the industry's strengths and areas requiring improvement. Moreover, this approach has identified potential opportunities and threats facing the financial industry. This comprehensive evaluation serves as a foundation for gauging the current industry landscape, enabling informed future policy decisions:

Strengths

- Pakistan's financial institutions are well established, and the legislative framework and regulatory structure have nimbly evolved to create sufficient infrastructure for growth across the board.
- NBMFCs were donor dependent in the early years but are now considered a credit worthy asset class and have healthy funding lines from banks and apex bodies.
- The Government of Pakistan (GoP) was swift in recognising pressures on the economy in the COVID-19 scenario and put in place a system of loan repayment deferment mechanisms to avoid shocks to the economic cycle.
- Banks have achieved sustainability and self-sufficiency in funding through the establishment of strong, reputable brands built over the years.

An overview of microfinance institutions and related developments in Pakistan

- Credit bureaus are expanding their involvement to include Microfinance Institutions (MFIs) as well, serving as a mitigation measure against over-indebtedness.

Weaknesses

- Banks prefer low risk government lending (treasury instruments) rather than private credit uptake because of healthy spreads.
- MFBs face similar types of risks as commercial banks, yet their risk management structures remain basic. For instance, the microfinance industry was affected by the sugar crisis, but there were no established concentration limits in place to mitigate these risks.
- Operational costs are too high to allow innovation and product diversification- mezzanine level funds are needed by banks to innovate without risk of wiping out equities.
- MFBs are often perceived as relatively small in scale by larger financial institutions, and as such, they require the involvement of influential board members who can facilitate collaboration with other institutions.
- While management structures are strong at the top, middle management needs to be developed and empowered.
- There is a lack of aggregated data, e.g., on Micro Small and Medium Enterprises segmentation.
- Availability of affordable data chunks is limited. This is needed for the development of credit scoring models.
- The debt repayment moratoriums implemented during the COVID-19 period have introduced a fresh challenge for the sector: a noticeable shift in client behaviour. Clients have experienced regulatory leniency and have grown accustomed to willingly delaying their repayments.
- While the SBP has introduced higher revised limits, MFBs do not have ready products.

Opportunities

- Establish robust risk mechanisms, even in cases where regulatory mandates may not necessitate them.
- Explore opportunities and partnerships that allow sandboxing and experimentation at little or no cost (e.g., the AFIN platform).

- Leveraging the specialised expertise of board members can be instrumental in mentoring middle management for capacity building. Additionally, this expertise can also be utilised to foster partnerships and strengthen the institution’s positioning in a more robust manner.
- Exploring local opportunities for capacity building, such as partnerships with incubation centres like the National Incubation Center and accelerators, can enhance capacity, potentially create new pipelines, and facilitate connections with cost-effective technology providers.
- Investigate insurance and risk-sharing mechanisms provided by various entities, including but not limited to IFC and USAID-DCA, to potentially mitigate risk exposure and enhance financial stability.
- Strengthen ties with academia by introducing pertinent courses, collaborating with incubation centres, and establishing connections with Chambers of Commerce. This can foster knowledge exchange, skills development, and industry engagement.
- Consider exploring microfinance leveraging through partnerships with Digital Financial Services (DFS) models to reduce costs and expand outreach. Additionally, study avenues such as value chain financing, customised products targeting gender-specific needs, and the development of credit scoring models to enhance the overall microfinance offering.
- With the government’s focus on affordable housing, NBMFCs can consider developing housing loan products or collaborating with the Pakistan Mortgage Refinance Company to support this initiative.
- Secondary players can expand their partnerships to include organisations like NIFT, NIC, and other accelerators. Additionally, they can engage with university-affiliated incubators, NAVTTC, and Chambers of Commerce to establish connections, particularly with women entrepreneurs.

Threats

- Over-indebtedness indicators remain a concern as the credit bureau system is not yet comprehensive, with not all MFIs reporting. Currently, credit bureaus report to the SBP, and reporting by NBMFCs is voluntary.
- Limited credit limits can represent a missed opportunity for MFIs to cater to the needs of the ‘missing middle’ segment of the population.
- The lack of transparency within the sector, particularly in the delayed revelation of Non-Performing Loans (NPLs), poses a significant issue. Swift and transparent sharing of experiences is crucial to avoid missing valuable lessons. This challenge

An overview of microfinance institutions and related developments in Pakistan

was further exacerbated during the COVID-19 period when regulatory leniency led to changes in customer behaviour, including a greater willingness to delay or even default on repayments.

- Lack of deep funding sources (apart from Equity and Bank lines) for NBMFCs.
- The economy is still heavily affected by trends in the agricultural sector, which is mostly rain-fed and heavily influenced by monsoons. Poor weather could fuel food price inflation and undermine the incomes of much of the population that depend on agriculture for an income.
- Banks and other financial institutions must put in place robust Anti Money Laundering and Know Your Customer measures to mitigate the high risk of money laundering and terrorism financing which negatively impacts the financial sector.
- The recent increase in regulatory limits for MFBs brings the potential threat of increased bad loans, as they do not have the necessary risk management structures in place. Additionally, they have not yet developed specialised products tailored for the higher ticket segment, which could compound this risk.

6. MFBS AND NBMFCs: DISTINCT DOMAINS AND SHARED TRAITS

The key distinction between MFBs and NBMFCs lies in the capacity of MFBs to accumulate deposits. They may undertake almost all activities in line with commercial banking with the exception of foreign currency operations. NBMFCs cannot raise deposits and hence, must rely on wholesale funds, equity, or lines of credit.

The universe of microfinance banks falls under the regulatory purview of the SBP while the NBMFCs fall under the SECP. The Microfinance Ordinance of 2001 paved the way for MFIs to operate as licensed banks with virtually all operations possible compared to a full commercial bank apart from foreign currency operations. Generally, the NBMFCs have a lower interest threshold as they are not subject to the high operational cost that MFBs face. The key services offered by Microfinance Providers (MFPs) include savings, insurance, and remittance services. Besides, Life and Health insurance, enterprise development training, health and education services are also extended to the microfinance clientele. It is the NBMFCs and Rural Support Programmes (RSPs) which are providing more of these services. NBMFCs generally have better portfolio quality as they have a nimbler and intimate customer service model. Their women portfolio is much bigger than banks for the same reason - there is an informal and 'close to client' structure which is conducive to female clients.

The government is also running an interest free programme called '*Kamyaab Pakistan Program.*' However, its geographical outreach is different from microfinance providers as

the former is spread all over the country whereas the footprint of MFBs and NBMFCs extend to targeted areas according to their own risk appetite and specialisation.

Table 3: Scale and Outreach

Indicators	Description	2016	2017	2018	2019	2020	2021
Total Asset Base (PKR Billion)	MFBs	57	83	100	119	122	148
	NBMFCs	168	247	327	374	495	501
Gross Loan Portfolio (PKR Billion)	MFBs	89	136	48	215	234	278
	NBMFCs	43	60	76	87	85	95
Active Borrowers	MFBs	42%	46%	48%	50%	53%	57%
	NBMFCs	58%	54%	52%	50%	47%	43%

Source: Pakistan Microfinance Network 2020.

By the end of 2021, the GLP of the industry stood at PKR 373 billion compared to PKR 319 billion in the prior year (Table 3). This surge in GLP was driven by MFBs as the peer group managed to amass an additional PKR 19 billion, led by FMFB, MMFB, Ubank and KMFB as they accumulated an additional PKR 38 billion. However, the decline in portfolio of TMFB and AMFB of approximately PKR 20 billion offset the consolidated efforts of the peer groups. The GLP of NBMFCs declined from PKR 87 billion in the prior year to PKR 85 billion by the end of the year under review. While a majority of the NBMFCs experienced declines in their loan portfolio, only Akhuwat managed to record a substantial growth of PKR 3.8 billion during the year.

NRSP is among the oldest players and the largest both in terms of active borrowers and GLP, followed by Kashf, Akhuwat and ASA-P. In terms of gender financing, Kashf, ASA-P, DSP, JWS-P, FFO and Agahe have their entire portfolios dedicated to female borrowers. Many of these are operating in rural areas whereas in comparison, the MFBs are struggling to improve their female portfolios which is around 20%. There is a real case for developing nuanced gender products along the lines of SANASA in Sri Lanka, BLC Bank in Lebanon, Garanti Bank in Romania, and Garanti Bank in Türkiye. These actors developed gender products with advisory from IFC's Banking on Women (BoW) team. In Pakistan, HBL set up Nisa Banking (dedicated women's products).

6.1 Lending Rates and Funding

While the interest rates imposed by MFPs may indeed be notably higher, the primary rationale behind this stems from cost considerations and the pursuit of profitability to ensure the sector's sustainability and growth. These lending rates are influenced by various market factors, encompassing funding expenses incurred by MFPs, operational

An overview of microfinance institutions and related developments in Pakistan

overheads, and the inherent credit risk exposure. Hence, once operational costs are brought down, the benefit can be passed on to clients, making microfinance loans more affordable and scalable.

Variations also exist in funding requirements based on MFP peer groups. MFBs dependence is on deposits whereas NBMFCs depend upon debt as a major source of their finances. MFBs' rates are considered to be high (up to 40%) given that they generate funds from marginalised individuals like widows, pensioners, and other low-income groups. MFBs are able to leverage deposits as a source of finance because of a low interest rate regime which enables them to offer returns above the market rate and this also ensures their profitability. It is to be noted that in raising deposits, MFBs have to offer premium deposit rates over commercial banks because of the brand value of the latter and affiliated gamut of superior banking services/infrastructure which the latter offers.

PMIC serves as the primary lending body for NBMFCs whereas some of the commercial bank also offer financial services to meet their indicative agriculture targets set by the SBP for providing lending facilities to small and marginalised farmers. Recently, the SBP allowed commercial banks to claim a portion of the agri-portfolios of the borrowing MFB or NBMFC, thus facilitating commercial banks in meeting their targets (prescribed by the SBP as a development agenda to support priority sectors). The average borrowing rate acquired by these NBMFCs is KIBOR plus an additional 4%.

Overall, MFBs cannot compete with NBMFCs in terms of operational costs because of the nimble and informal structures of the latter while the MFB universe has to adhere to rigorous regulatory oversight, being deposit-taking institutions. Global examples have pointed to success in achieving cost efficiencies by leveraging technology and ramping up achieving economies of scale.

Table 4: Funding Structure

Funding	Description	2019 %	2020 %	2021 %
Equity	MFBs	14	11	10
	NBMFCs	28	28	30
Debt	MFBs	8	8	14
	NBMFCs	72	72	70
Deposits	MFBs	78	81	76
	NBMFCs	-	-	-

Source: Pakistan Microfinance Network 2020.

Table 4 indicates that the funding structure of both MFBs and NBMFCs did not change significantly during 2019-21. MFBs and NBMFCs are regarded as viable asset class by bankers. While the MFBs depend on deposits, the NBMFCs depend on wholesale financing from PMIC (PMIC provides 30% of all financing to this segment) and commercial banks, especially the ones with a focus on the development agenda such as National Bank of Pakistan and Bank of Punjab. This helps them meet their agri-finance targets too.

6.2 Profitability and Sustainability

The study by Javed (2020a) pointed out that COVID-19 affected the services sector of Pakistan including the financial sector. The vulnerability of microfinance clients during COVID-19 severely affected the profitability and asset quality of the sector as clients were unable to repay. MFBs were allowed to conduct operational activities, however, NBMFCs were shut down completely for a few months.

Table 5: Total Revenue and Net Income (PKR Billion)

Description	2015	2016	2017	2018	2019
Total Revenue	42	66	89	111	111
Net Income	07	10	10	-06	-02

Source: Pakistan Microfinance Network 2020.

Although total revenue of the industry remained the same in 2019 as compared to 2018, however, losses incurred during this period decreased from PKR 6 billion to 2 billion (Table 5).

6.3 Target Market of MFBs and NBMFCs

The target markets of MFBs and NBMFCs are ostensibly different, with NBMFCs generally focusing more on rural and peri-urban areas while MFBs targeting urban centres alongside rural areas, especially for lucrative enterprise and affordable housing loans.

NBMFCs operate in the lower loan size zone compared to MFBs who have a much higher risk appetite, regulatory ceilings, and bespoke products. In fact, at times, the MFBs also compete with commercial banks offering lower interest rate consumer lending products to the lower end of the market. Generally, loan sizes for NBMFCs are below PKR 50,000 while MFBs products are above this threshold. The average loan size in December 2021 was lower than earlier years due to greater outreach of the telco-led microfinance banks. This means that their portfolio also includes top ups and other financing facilities extended to their numerous agents.

An overview of microfinance institutions and related developments in Pakistan

Another distinction lies in the ‘missing middle,’ referring to loan sizes falling between those typically offered by MFBs and commercial banks. The recent revisions in MFB limits hold promise for addressing this gap. However, to effectively serve this segment, MFBs must prioritise the development of robust cash flow lending methodologies, enhance their risk monitoring and assessment tools, and introduce a range of diversified and customized products tailored to the higher niche.

Another dynamic to consider regarding market differentiation between MFBs and NBMFCs is when the former is an investee of the latter, as seen in cases like NRSP MFB and NRSP. While their geographical boundaries are well-defined, on the ground, they may occasionally find themselves competing in the same areas with similar loan sizes. Adding to this, NBMFCs may be in a position to offer more competitive interest rates. Identifying the strategic interests of both entities and seeking alignment can unlock synergies, allowing these two segments to complement and leverage each other's strengths.

6.4 Distinct Regulatory Environments for MFBs and NBMFCs

In 2017, the SECP issued regulations to formalise the unregulated MFI sector to encourage its corporatisation and ensure its viability and efficacy as an effective tool for poverty eradication.

Table 6: Capital Requirement and Loan Size

Description	Indicators		
MFBs	Minimum capital requirement	-Nationwide MFBs -Province wide MFBs	-Paid-up capital of PKR 1000 million/USD 5.7 million -Paid-up capital of PKR 500 million/USD 2.9 million
NBMFCs	Minimum equity requirement	-	PKR 50 million /USD 286 thousand
MFBs	Maximum loan size and borrowers' income	-General loans -Housing loans -Loans to microenterprises	-Up to PKR 350,000 to a poor person with annual income (net of business expenses) up to PKR 1,200,000 -Up to PKR 3,000,000 with annual income (net of business expenses) up to PKR 1,500,000 -Up to PKR 3,000,000 to a single project or business
NBMFCs	Maximum loan size	-General loans -Housing loans -Microenterprise	-PKR 200,000 -PKR 500,000 -PKR 500,000

Source: Pakistan Microfinance Network 2020.

MFBs and NBMFCs have different capital requirements to operate as the minimum capital requirement of MFBs is PKR 1000 million whereas minimum equity requirement for NBMFCs is PKR 50 million (Table 6). MFBs can offer general loans up to PKR 350,000 whereas NBMFCs can provide maximum general loan of PKR 200,000 to an individual.

6.5 Regulatory Revisions and Industry Innovations

A significant development that must be mentioned is the transformation regulation currently being formalised by the SECP. This is based on demand from NBMFCs to be able to establish formal investment linkages beyond credit and donation support from international players along the lines of how early international investments in the MFB sector unlocked growth. Now, NBMFCs which are currently not allowed dividend distribution, will be able to spin off subsidiaries and incorporate a new license under which these entities can partake in all investment activities such as local and foreign investments, dividend distribution etc.

Recently, the SECP initiated the grant of a microfinance license to the newly established NBMFC, SAFCO Micro Finance Company (Private) Limited. Through this, the company can pay dividends to its shareholders and offer multiple avenues for new local and foreign investments. Damen is also working on strategising a similar structure. This step will help in the corporatisation of the NBMFC segment and fuel their growth to reach more clients, develop bespoke products and imbibe a corporate culture to allow better governance.

The SECP, along with the Pakistan Credit Rating Agency (PACRA), has also developed a set of specific microfinance industry performance standards and enhanced governance guidelines for NBMFCs to facilitate their corporatisation evolution. The PMIC has developed a Social Impact Fund along the lines of mutual funds in collaboration with the NIT to bring more depth to available financial instruments in the microfinance arena (PMIC 2020).

The PMN, alongside its role as an apex aggregator of data, also plays an industry development role by organising frequent roundtables for collaboration and consensus building as well as organising relevant trainings from time to time. Capacity building efforts towards these organisations is imperative for furthering the microfinance cause and footprint in Pakistan.

7. MICROFINANCE MARKET SIZE AND PENETRATION

The PMN initially estimated the potential microfinance market at 20.5 million borrowers, resulting in a penetration rate of 39%. However, following the population census of 2017, they conducted revised calculations using alternative methodologies, yielding the following adjusted market potential:

An overview of microfinance institutions and related developments in Pakistan

Table 7: Potential Market for Microfinance Segments

Potential Market (A2F)	Ages 18-65
Microdeposits	60.9 million
Microinsurance (Health)	96.8 million
Microinsurance (Life)	96.8 million
Micropayments	82.1 million
Microcredit	40.9 million
Microenterprise credit	5.8 million

Source: Pakistan Microfinance Network 2020.

Table 7 indicates that in Pakistan, the potential market for microdeposits is estimated to be approximately 60.9 million individuals. However, the current outreach levels suggest a market penetration of only 20%, underscoring a significant opportunity for the adoption of high-impact disruptive growth models. It is important to emphasise that this represents the market potential, not the current demand. Achieving or nearing this potential would necessitate different facilitators and drivers. These projects would depend upon specific scenarios, and actual penetration goals would demand a comprehensive analysis of expansion plans, strategies for market entry at governmental and operational level, and a nuanced approach. For example, the outreach objectives of a digital or nano-loan provider would differ from those of a conventional brick-and-mortar- organisation.

It is important to note that other factors to consider include non-financial outreach. For instance, certain institutions may have a limited microcredit portfolio but a more significant impact through client-centric non-financial programmes, such as literacy initiatives, health programmes, and various other services.

The market is far from saturated, albeit at times, in easy urban target markets, there may be an overflow of micro-offerings while other areas may be sparsely served. It may be relevant to empower and build the capacity of apex bodies to assess geography-wise market demand and potential. Although many institutions are carrying out their own market research to assess optimal areas for expansion, this is a service that could benefit from pooled resources to benefit the wider sector.

7.1 Recent Developments

Inclusion enthusiasts had pinned their hopes on new entrants such as Ant Financial to provide a disruptive impetus. Ant Financials' USD 184.5 million purchase of a 45% stake in Telenor Microfinance Bank, which oversees and operates Easy Paisa, injected renewed vigour into the financial ecosystem. While, the Bank is struggling with a high infection

rate in its portfolio due to nano loans and other issues; a host of payment platforms have entered the market such as ‘SadaPay’ and ‘Payoneer’ and the GoP promoted ‘Raast’ which will enable end-to-end digital payments.

Another promising indicator is the increasing investment attractiveness of Pakistani start-ups, particularly within the FinTech sector. During the first six months of 2022, Pakistani startups secured a total of USD 284.9 million in disclosed funding across 45 deals, marking a remarkable 182% surge compared to the corresponding period in 2021. This underscores a pivotal juncture in the Pakistani start-up funding landscape, with international venture capitalists making substantial investments in the country.

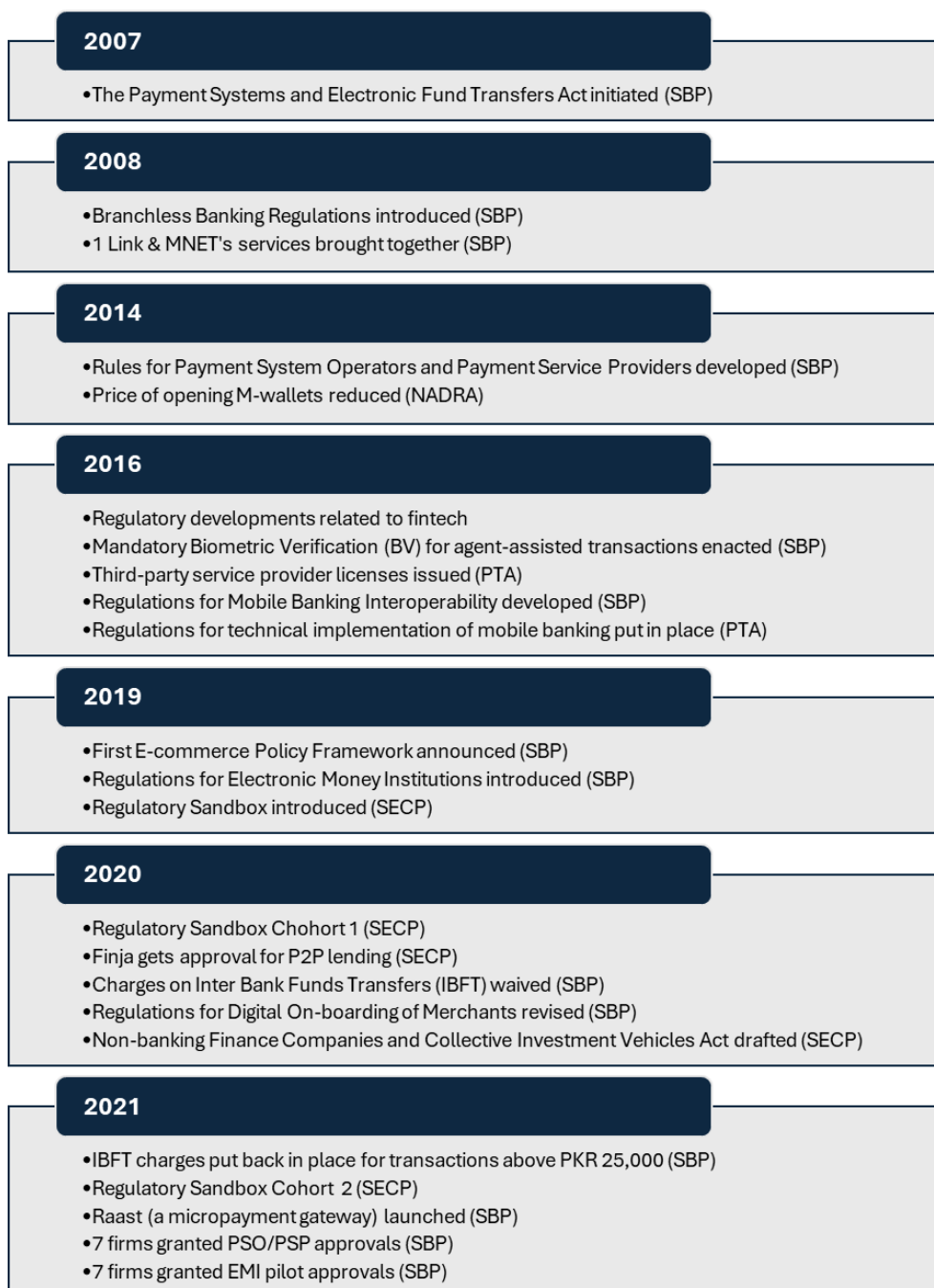
Following the Pandemic, a significant expansion in the e-commerce sector has been documented (Javed 2020b). In 2021, e-commerce ventures secured USD 202 million across 23 investment deals, while FinTech companies raised USD 95 million through 25 deals. Notably, owing to a conducive regulatory environment, FinTech start-ups outperformed their e-commerce counterparts and garnered more funding during the fourth quarter of 2021. It is worth noting that funding plays a critical role for businesses, as it is widely acknowledged as a major constraint for digital enterprises in Pakistan (Javed and Ahmed 2022).

With increasing formalisation seeping into the NBMFCs, there is potential for linkages with FinTechs, credit scoring algorithms, value chains, agri-tech, edu-tech and e-commerce players with a view to unlocking synergies and reducing costs; thus, increasing access and affordability to the last mile client. Pakistan faces many financial inclusion challenges, but other countries have experienced strong growth in financial inclusion through sound approaches that are well documented, and Pakistan appears to be following a similar trajectory.

The SECP introduced the ‘Non-Banking Microfinance Regulatory Framework’ to facilitate the microfinance sector (SECP 2016). Under this regulatory framework, Non-Governmental Organisations (NGOs) registered with SECP under section 42 of the Companies Ordinance, 1984 as a not-for-profit company, limited by guarantee can directly apply for Investment Finance Services (IFS) license to undertake micro finance business. This is significant from the perspective of foreign investors desirous of engaging with Pakistan’s NBMFC sector as well as unlock funding for the NBMFCs who want to graduate. It is probable that there may be some Mergers and Acquisitions (M&A) activity, with the Bank of Punjab currently in the process of conducting due diligence on NRSP Bank.

An overview of microfinance institutions and related developments in Pakistan

Figure 1: Regulatory Developments related to Fintech



Source: Invest to Innovate 2021.

The SBP initiated the ‘Electronic Funds Transfer Act’ in 2007 and ‘Branchless Banking Regulations’ in 2008 (Figure 1). This paved the way for payment solutions such as ‘Easypaisa’ and ‘JazzCash.’

In 2019, the SECP unveiled a programme aimed at assisting start-ups in piloting their innovative concepts. Successful pilots received expedited approval to transition into commercial operations. One notable outcome is ‘Raast’ - a micropayment gateway that interconnects financial institutions throughout Pakistan, facilitating digital transactions and promoting financial inclusion.

7.2 Digital Financial Services (DFS)

Microfinance in the present day cannot be examined in isolation without taking into account the pivotal role of digital finance. Digital Financial Services (DFS) are acknowledged as a credible alternative to traditional banking channels (Kumar et al., 2011). DFS plays a significant role in advancing financial inclusion, as exemplified by Hasan et al.’s (2020) study of China, where financial inclusion was facilitated through the adoption of DFS. Across the spectrum, be it MFBs or NBMFCs, the challenges of high operational costs remain a constraint in delivering affordable financial services to clients while maintaining sustainable margins.

In the post-COVID economic landscape, one of the most noteworthy newcomers as a solution-provider for systemic pandemic challenges has been DFS. The adoption of DFS experienced significant growth following the pandemic, as noted by Agur et al. in 2020. On a global scale, the market was valued at approximately USD 127.66 billion in 2018, with expectations of reaching USD 309.98 billion by 2022. Undoubtedly, the COVID-19 Pandemic has expedited this transformation, prompting businesses to re-evaluate their models and incorporate new capabilities to address various use-case solutions.

Individuals have also preferred digital solutions after the pandemic which require less involvement of human contact (Al-Qudah et al., 2022). The role of DFS as a protagonist on the global stage is now firmly entrenched, with FinTechs having bridged some of the immediate challenges in the wake of the global crisis and bigger FIs expediting their digitalisation roadmaps to deliver innovative solutions (Fersi et al., 2023).

In Pakistan, too, the growing DFS ecosystem has been propelled into a prominent position within the altered global landscape, where COVID-19 considerations have become integral to the new reality. Pakistan boasts a robust ecosystem capable of quickly establishing relevant connections with the microfinance industry and other markets. The significance of DFS for Pakistan is underscored by their potential to augment the GDP and create millions of job opportunities, as highlighted in Javed’s work in 2020.

An overview of microfinance institutions and related developments in Pakistan

Table 8: Mobile Subscribers (Million)

Description	2017-18	2018-19	2019-20	2020-21
Mobile Subscribers (Million)	99.3	105.2	133.1	182.5
Broadband Penetration (Million)	58.7	71.5	83.9	102.7
Mobile Wallet Accounts	39.2	35.7	52.5	74.6

Source: Pakistan Telecommunication Authority.

Mobile subscribers in Pakistan increased significantly from 99.3 million in 2017-18 to 182.5 million in 2020-21 (Table 8). Broadband penetration and mobile wallet accounts also demonstrated considerable growth. Broadband penetration showed 75% growth in subscribers from 2017-18 to 2020-21 whereas 90% growth was observed in mobile wallet accounts during the same period. Rizvi et al. (2017) takes account of mobile banking growth in Pakistan and noted that this played a key role in promoting financial inclusion in Pakistan. However, extensive efforts are required to expand the digital financial network since low levels of formal financial services and inadequate banking facilities are key challenges in promoting digital financial services in the country (Manzoor et al., 2021).

8. POLICY RECOMMENDATIONS

Financial firms must understand the domestic market and structure their products accordingly, as this will help increase their outreach and minimise any credit risks involved in the process. In order to avoid any financial crises, it is crucial for both the government and investors to focus on introducing risk-sharing instruments. Furthermore, there is a pressing need to enhance the capacity and ambition of financial services providers, particularly with regard to mobile wallet account ownership. To effectively contribute to the social empowerment of the financially excluded population, innovative solutions, and specialised products, especially tailored for women, are required. Lastly, the microfinance industry can attain financial stability by actively promoting linkages with incubation centres and Chambers of Commerce.

9. CONCLUSION

The study finds that partnerships within the microfinance industry have been limited. One sees the flux of microfinance institutions in other geographies such as Kenya where nano loans were deployed through digital lending and served as a catalyst for financial inclusion (albeit with challenges-3 million Kenyans came on the defaulter list due to micro payments outstanding on their digital accounts). In Pakistan, the digital partnership model has been limited to using payment platforms such as 'Omni' and 'HBL Konnect.' However, there is a real opportunity to use digital means to conduct client assessments by embedding credit scoring models (using metrics such as family size, soil quality for a

certain region, historic prices of crops grown by a particular farmer, weather patterns and so on) to be able to accord quick loans as well as to be able to develop the right product for the right niche. This opportunity can be facilitated by the regulator and apex bodies by allowing data sharing (anonymised) and a sandbox environment for banks to experiment. International investors can facilitate this by providing enough funds for the institution to comfortably explore and experiment. A digital partnership was explored between NRSP and NRSP Bank, where the former served as a super-agent for the digital offerings of the latter. Nevertheless, a significant challenge encountered was aligning the commercial and mission interests of both entities. Gradually, with the development and use case success of digital ecosystem, institutions will be forced to forge such ties, provided leadership of such institutions is able to align their interests through strategic brainstorming sessions which require a visionary approach.

Another area with significant potential for collaboration is gender-related initiatives. Banks are struggling with outreach to female borrowers (around 18% average female portfolio). whereby NBMFCs have strong female portfolios (sometimes 100%) due to their innate strength of being closer to the client on the ground and having more informal structures where women are comfortable approaching the institution. Efforts were made to explore partnerships wherein a MFB aimed to provide financing for the gender portfolio of RCDP. Unfortunately, this endeavour did not come to fruition as the issue of which entity would officially carry the portfolio remained unresolved. Again, there are solutions to such dilemmas but require time and interest investment from the leadership of both institutions. This can be facilitated by the regulators, apex bodies and development institutions such as The World Bank, International Finance Corporation (IFC) and Japan International Cooperation Agency (JICA) etc. by showcasing partnership models from across the world. Pakistan need not reinvent the wheel.

COVID-19 is possibly the punctuation mark that elicited existential questions for most people and businesses, underlining the core human ability to adapt, embrace and ultimately thrive for survival. Most individuals turned to a ritualistic reliance on digital mediums which provides new prospects for a digital revolution that is inevitable and indispensable. Promoting DFS will not only help in expanding the percentage of financially included population but will also increase the GDP and employment opportunities. SBP in its action plan under NFIS aims to expand financial inclusion through increasing access points including bank branches, banking agents, ATMs, Point of Sale (PoS) machines. The SBP should ensure that these action plans are being followed particularly in those areas which are still excluded from the financial network.

Pakistan has time and again proved its resilience to internal and external challenges and has been incisively touted as a land of opportunity. Its burgeoning professional cadres have embraced the surge in data solutions for payments, logistics, Go-to-Market and other

An overview of microfinance institutions and related developments in Pakistan

avenues during the recent past. FinTechs, MFIs and start-ups have all aggregated to deliver solutions with the support of the regulators. The post-COVID ecosystem serves as a reminder that bridging the digital divide and nimbly adapting digital transformation has boons for all and can spur the country's society and economy towards inclusiveness and productive growth. For the government as well as the private sector, it is imperative to soldier on along the digital path to anticipate the prerequisite digital capabilities of the future and unlock the gains of financial inclusion.

The young generation needs more contemporary banking and microfinancing solutions that speak to their fast-paced lifestyle requirements, regardless of the economic strata they belong to. Service providers can seize the opportunity to tap into new frontiers by leveraging technology and deploying interfaces and services that speak to the soul of the young entrepreneur, craftsman/woman, or farmer. Investments in ICT (Information and Communication Technology) infrastructure, particularly in rural areas, have the potential to enhance the availability and accessibility of digital financial services.

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Annex A: List of Institutions

Description	Institutions
Public Sector	-First Women Bank Limited - National Bank of Pakistan
Commercial Banks	-The Bank of Khyber - The Bank of Punjab -Sindh Bank Limited
Specialised Banks	-Zarai Taraqati Bank Limited -SME Bank Limited -Punjab Provincial Cooperative Bank Limited -Industrial Development Bank of Pakistan Limited
Local Private Banks	-Habib Bank Limited -United Bank Limited -MCB Bank Limited -Allied Bank Limited -Bank Al-Falah Limited -Bank Al-Habib Limited -Habib Metropolitan Bank Limited -JS Bank Limited -Faysal Bank Limited -Askari Bank Limited -Samba Bank Limited -Soneri Bank Limited -Silk Bank Limited -Summit Bank Limited -Standard Chartered Bank (Pakistan) Limited
Islamic Banks	-Mezan Bank Limited -Bank Islami Pakistan Limited -Al-Baraka Bank (Pakistan) Limited -MCB Islamic Bank Limited -Dubai Islamic Bank Pakistan
Foreign Banks	-Industrial & Commercial Bank of China -Citi Bank -Deutsche Bank AG -Bank of China Limited

Source: State Bank of Pakistan.

Development Finance Institutions

Institutions
-Pakistan Kuwait Investment Company Limited
-Pak Oman Investment Company Limited
-Pak-Brunei Investment Company Limited
-Pak-Libya Holding Company Limited
-Saudi-Pak Industrial & Agricultural Investment Company Limited
-House Building Finance Company Limited
-PAIR Investment Company Limited
-Pak-China Joint Investment Company Limited
-Pakistan Mortgage Refinance Company Limited

Source: State Bank of Pakistan.

An overview of microfinance institutions and related developments in Pakistan

Microfinance Banks

Institutions
-HBL Microfinance Bank Limited
-NRSP Microfinance Bank Limited
-Khushhali Microfinance Bank Limited
-Telenor Microfinance Bank Limited
-Pak-Oman Microfinance Bank Limited
-U Microfinance Bank Limited
-Mobilink Micro Bank Limited
-APNA Micro Bank Limited
-Advans Pakistan Micro Bank Limited
-Sindh Micro Bank Limited
-FINCA Micro Bank Limited

Source: State Bank of Pakistan.

Credit Bureaus

Institutions
-Aequitas Information Services Limited
-Data Check Limited

Source: State Bank of Pakistan.

Payment System Operators

Institutions
-iLink Private Limited
-Virtual Remittance Gateway Private Limited
-National Institutional Facilitations Technologies (NIFT) Private Limited

Source: State Bank of Pakistan.

Annex B: List of Key Informant Interviews (KIIs)

Institute	Designation
Securities and Exchange Commission of Pakistan	Executive Director, Policy Development and Regulations Department, Specialised Companies
Securities and Exchange Commission of Pakistan	Additional Director, Specialised Companies & NBMFCs
Pakistan Microfinance Network	CEO
Pakistan Microfinance Network	Head of Operations
Pakistan Microfinance Investment Company Limited	CEO
Pakistan Microfinance Investment Company Limited	Head of Sector Development
Khushhali Microfinance Bank	Group Head Business
Pakistan Single Window	CFO
The Bank of Punjab	Senior Vice President-Liability Products
NRSP	International Finance Corporation's Board Member on NRSP
International Finance Corporation	Global Head Microfinance
International Finance Corporation	Country Leads for Microfinance-Investment and Advisory
International Finance Corporation	Corporate Governance
Karandaaz	Group Head Risk