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The Bulletin

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Welcome to the second issue of The Bulletin, our quarterly newsletter covering U Bank's innovation and research work.

With this newsletter we not only seek to highlight our own work but also deep-dive into global and local financial sector trends and developments. It is meant to be an exploration of the various sectors and topics that intersect with banking, microfinance, financial inclusion and sustainable development in an effort to encourage dialogue on the key challenges and opportunities; while working on pushing forward the frontier when it comes to ensuring financial access & coverage. In this issue, we talk about the business side of things when it comes to microfinance and a deep dive into how the financial services sector is looking at collaborating with startups to innovate.

We welcome thoughts and feedback, as well as suggestions on topics to cover in future issues. Our hope with this newsletter is to build a community of engaged readers interested in sincere discourse about the challenges and opportunities we face as a sector, the disruptions (technological or otherwise) required to serve our customers better and build an inclusive Pakistan.

Yours sincerely,
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ARE THE HIGH INTEREST RATES ASSOCIATED WITH MICROFINANCE LOANS JUSTIFIED?

Breaking down the business of microfinance and what drives the rates of lending.

The profitability of a microfinance provider has always been a hotly contested topic, especially given their dual mission of achieving financial sustainability and creating social impact. Since the beginning, the higher interest rates associated with microfinance loans have been criticized as exploiting the very customers that they exist to service. Taken at face value this criticism does not seem entirely unfounded especially when lending rates are compared to the rates associated with traditional banks.

While this debate has been going-on since the beginning, it has come into even sharper focus over recent years following research that concludes that more than poverty alleviation, microfinance functions as a tool that helps borrowers sustain financial shocks (i.e. illness, death, natural disaster and crop failure etc.) and slowing down of the economy and rising inflation within Pakistan. The current economic condition has translated into rising cost of living and hence it's reasonable to argue that the higher loan interest rates put these loans even further out of the reach of the micro-entrepreneurs who need them the most.

However, the public conversation around the topic rarely includes the flip side of things that examine how the economic conditions affect the microfinance business and plays the pivotal role in deciding the loan interest rates. Microfinance banks are in the business of volumes i.e. number of loans drive the profit rather than the value of these loans unlike commercial banks. Hence it is common sense to conclude that the cost of doing business (administrative costs of lending along with cost of regulatory compliance) for microfinance banks, by virtue of extending many smaller sized loans rather than a few big ticket loans, would be much higher. There has been clear evidence since the beginning that the cost of delivery of microfinance services is much higher than that of commercial banking services.

Another factor driving the lending rates upwards, is the rising cost of funds that microfinance banks have to pay. A typical Pakistani microfinance bank faces a cost of funds of k+2 or k+4, linked to the KIBOR. A rising KIBOR has translated into rising cost of funds for microfinance banks. The profit margins for microfinance after taking the cost of funds and administrative costs associated with lending remain very low. However, despite these facts the main question regarding the legitimacy of microfinance remains whether the borrowers can continue to afford the loans or not? While this question cannot be answered with 100% certainty, evidence and research over the last several years does seem to suggest that the answer is in the affirmative.

According to a recent MIMOSA evaluation for Pakistan conducted by the Pakistan Microfinance Network (PMN), Department for International Development (DFID), PROPARCO and Pakistan Microfinance Investment Company (PMIC), the risk for over-indebtedness remains modest. According the report, there is very little evidence of severe debt pressures being faced by the borrowers, and only 8% of respondents indicated facing significant repayment challenges (on par with India where this stat stands at 9%). In 2011, PMN also conducted a study analyzing enterprise level financial data to understand the profitability of borrower's businesses to estimate their ability to repay loans. The study found that overall microenterprises were able to afford the prevailing average interest rates (35.9% at the time). The average profitability for these microenterprises, measured through ROA, was found to be ranging between 79% for the livestock/poultry sector to 226% for the services sector. While these results are admittedly a bit dated and no recent direct data on repayment is available, in our recently conducted impact measurement study, only 13% of U Bank customers (out of a sample of 2100) indicated that they face repayment difficulties.

The most prominent mediums of repayment for those who faced difficulty paying back were through savings (24.47%) and borrowing from friends and family (16.31%). These results also align with previous results that indicate that repayment difficulties remain a minor concern among borrowers, despite what are perceived to be high interest rates. Furthermore, historic trends in similar economies show that in periods of economic slowdown the negative effects seldom trickle down to the borrowers. Business owners continue to borrow because they pass on the majority of the financial burden to their customers.

However, despite the evidence that borrowers are not worse-off as a result of the high-interest rates it is likely that they are impacted indirectly especially when their purchasing power continues to be eroded. If interest rates were to go down it would most probably lead to an improvement in the quality of life and purchasing power of our customers. However, this change in interest rate may not be as much in the hand of the banks as it may appear. The key element remains the very high cost of funds that microfinance banks have to face. There is a need for subsidies, better credit-lines from lenders to banks and policy level changes within the sector if microfinance banks are ever going to be able to bring the costs of lending down. Another strategy that many banks are engaged in currently is to bulk-up low-cost current account in order to bring down the cost of funding. In fact, forecasts for the future indicate that over the next 5 year horizon, some MFPs may become full menu commercial banks, either through merger or transformation as the market starts approaching saturation. The current MIMOSA score, 2, indicates that the Pakistani market is normal-to-moderately underserved. By 2025, given current growth rates for the sector, it is expected that this score will have moved to a score of 4 i.e. moderately saturated.

THINK PIECE

Are Banks Taking the Right Approach When It Comes to Partnering with Startups and Innovating?

A deeper look into why the promise of the fintech revolution still seems like a far off dream

While the financial services sector has traditionally been considered as one of the most archaic systems by consumers, technology and innovation has in fact always played a key role in product and service developments e.g. credit cards and internet banking. However, Financial Technology (fintech) has become a buzzword in recent years within the startup ecosystem as the next promising frontier and the vehicle for disruptions to the outdated banking system. This promise is reflected in the fact that according to KPMG the global fintech investments more than doubled in 2018 (compared to the previous year) closing at $111.8B, mainly due to three mega deals. But it regardless represents the immense opportunity attached to the space.

However, despite new startups having cropped-up within the space, progress has been slow especially in highly regulated countries for fintechs such as Pakistan. The main reason for this is mainly that the bigger banks have remained caught-up in their legacy systems and traditional way of doing business. On the flip side, while fintechs are quick to create innovative solutions they're usually unable to scale due to tight regulations and expensive licenses. In such conditions, the natural solution appears to be greater collaboration between the more traditional banks and disruptive and technology-forward startups. In an era where big technology giants like Facebook and Google are making fintech plays, banks can no longer ignore fintech startups if they seek to remain relevant in the future. However, while banks have been taking keen interest in startups over the last few years, there are still limited examples of what successful partnerships look like for a variety of reasons. One of these reasons is that the banking industry has been taking a rather conservative approach towards these kinds of partnerships. A majority of such endeavors have resulted in the financial institutions setting up in-house accelerators, co-working spaces, investing in startups (only the case for financial institutions that already have investment arms i.e. Goldman Sachs Strategic Investments and Citi Ventures etc.) or merely hosting/sponsoring a startup pitching competition. While there is nothing wrong in essence with these methods, the execution strategy and intent behind them is often lacking. Part of the problem lies in the fact that these two kinds of organizations, traditional banks and start-ups, operate in completely different contexts.

Within the formal banking sector "partnerships" is the strategic buzzword of the era, and at the top of every institution's agenda. However, many of the current players have jumped into engaging with the "hot" startup space without careful consideration of what the aim and outcome of such partnerships should be beyond the branding and PR associated with "driving innovation" within the ecosystem. One of the reasons behind this weak attempt at innovating is due to the reason that the banks have been unable to recruit the right type of human capital to drive this thought leadership. The human resources involved tend to either be from within the ranks of the institution itself (i.e. traditional banking sector professionals) or new recruits who lack exposure to and experience with the startup ecosystem. This results in any innovative initiatives ending up being out-of-touch with the ground realities of what startups need and with no bridge between the two worlds to help them communicate and collaborate better. Furthermore, in case of competitions there often is a lack of follow-up engagement with the winners – which may give the startup in question a temporary marketing boost but rarely results in improvements to their product offerings that would help them scale or close investment.

Another reason behind the limited success of fintech-bank partnerships, is the lack of strategic buy-in and acceptance of innovative culture within the traditional institutions themselves. While every bank, partnering with startups or engaging in other innovative projects, claims to be open to disrupting the way of doing business-as-usual, both within the industry and the bank itself, very rarely are these institutions able to translate this into concrete action. The primary reason behind this failure to sustain innovation is often banks forgetting to ensure that all key stakeholders at the management and execution levels are on-board with this culture and mind-set shift. Innovation often becomes tied to only the relevant team members (and their KPIs) rather than the organization as a whole. Without consistent efforts to create cross-departmental awareness and buy-in such initiatives will never be able to truly scale and showcase demonstrable impact. In certain cases, this lack of buy-in and resistance to changes in the status quo also leads to efforts being nipped in the bud due to low risk appetite or due to poor execution. Many financial institutions end up believing that just partnering with fintechs will do the trick. But it takes a lot more to shift institutional mind-set and culture. However, unless and until there is a dedicated senior team sponsoring and driving this effort within the institution this change can never be achieved.

Lastly, traditional financial institutions tend to often structure partnerships with startups in a way that actually stifles innovation and growth of the space rather than aiding it. Many institutions tend to use startup partnerships as a third-party service provision arm under the guise of innovation. The truth of the matter is that these partnerships are in fact only a fancy way of getting into contract with a “vendor” for a specific service provision. Many small companies naively enter into such contracts for a variety of reasons including but not limited to – having a big client on-board, bootstrapping, survival etc. However, when a company is made to become just another vendor not only are banks missing out on the opportunity to designing solutions that truly push the ecosystem forward but also deprive the startup itself from being able to create a brand and market recognition for its products and services. Such projects defeat the purpose of a mutually beneficial collaboration or partnership.

Our drive at U Bank is to ensure that we learn from these lessons as we embark on the journey of building the bank of the future. We strongly believe that the biggest value for our investment lies in working with startups whose mission aligns with our financial and social impact goals. Given our current context, we also believe that the need of the hour is for financial institutions to work together with the central bank to set-up a regulatory and fintech sandbox where innovative products and services can be tested, iterated and scaled to unlock progress for the entire ecosystem without facing the normal regulatory challenges.

For startups, this collaboration is a chance to seek validation for their product offering by accessing the banking institutions customers and balance sheets, a chance at understanding and complying with the regulations typical of the financial sector without investing in expensive licenses before they are ready for them to scale and become investment ready.

In Pakistan, the seed capital and VC investment space has been heating-up quite a bit (despite hurdles associated with the international movement of money and the tough regulatory environment). Despite increasing interest from investors deal flow remains a common pain-point with many claiming that there aren’t enough solutions that pass the due-diligence associated with investment readiness. Big institutions can make a significant contribution in bridging this gap by building sandboxes where they run pilots that allow startups to scale, iterate and become investment ready by being able to show the numbers that investors are interested in.

As a microfinance bank, a bulk of our portfolio is in agriculture and livestock, therefore for us any startups working at affecting and improving the value-chains within these sectors are potential innovation partners. Improved value-chains translate into improved repayments for the bank as well as an achievement of our dual mission of being financially sustainable and creating social impact. At the same time it offers the money, resources and access to customers that these startups need to validate and scale their solutions, creating a win-win opportunity made in innovation heaven.

The future of banking lies within unlocking the promise of partnerships, and our prediction is that 2020 will be the big year where some successful case studies of partnerships between banks and the startup ecosystem will start to emerge. Perhaps this is due to the fact that with big technology companies making bids into the financial services space, if banks are to continue to exist there will be no option forward but to partner with innovative and lean startups (who by virtue of being closer to the ground, take a truly customer centric approach to solution design) in order to test, iterate, launch and scale solutions fast enough to keep the creative solutions coming and to keep the big tech on their toes.