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The Bulletin

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Welcome to 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 edition, we dissect the exposure draft of the Digital Bank Regulatory Framework and breakdown what it may translate into for the microfinance sector. Read on to hear our thoughts on whether the recent licenses offer any new avenues for MFBs and if not what possible changes to the regulation could go a long way. We also take a look back at the last 5 years of existence for U Bank and the important milestones and achievements along the way. In the midst of a global pandemic, the business community has been struggling to weather the resulting market pressures but it is at times like these that it is most important to take stock of and celebrate our achievements.

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. Wishing you all are staying safe and healthy.

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The SBP's 'Digital Bank Regulatory Framework (Exposure Draft)' and its implications on microfinance banks

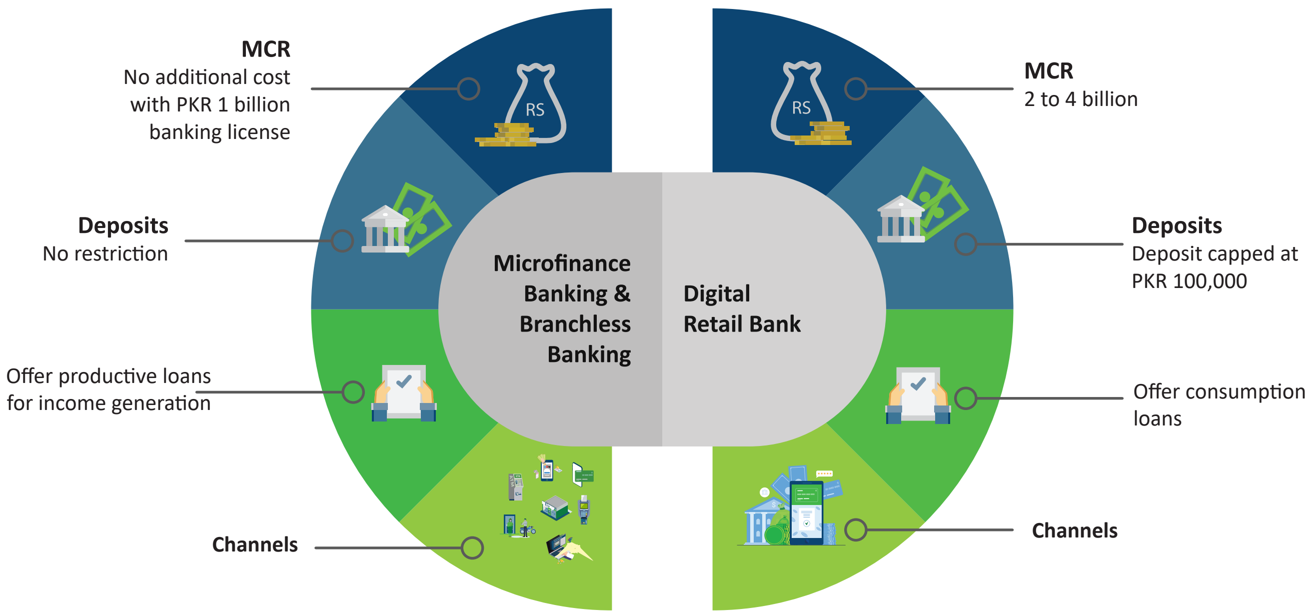
The Digital Bank Regulatory Framework has been the cause of much anticipation since its announcement and was believed to be a game changer for the financial inclusion space, especially when it came to Fintechs and other financial service providers. The primary focus of the framework was to introduce a new category of banking institutions – the challenger banks – to take on and compete with traditional banking institutions. The premise being that the birth of such institutions would lead to greater innovation in financial service provision as well as even out the playing field when it comes to financial inclusion.

Challenger banks, i.e. small retail banks, first cropped up in the United Kingdom to take on the big four banks (Barclays, HSBC, Lloyds Banking Group and NatWest Group) by providing niche services to underserved segments. A typical distinguishing feature of challenger banks is their usage of next-gen financial technology, e.g. online-only operations, which helps them compete with traditional banks and disrupt the sector.

According to the regulatory framework, two types of licenses will be offered to institutions – 1) Digital Retail Bank (DRB) and 2) Digital Full Bank (DFB). In order to get a DFB license, an institution must have a DRB license. In addition, DRBs will need to be operational for 3 financial years before they can apply for a DFB license and both licenses may have conventional and Islamic variants. The framework dictates that while a DFB will be able to serve all customer segments including commercial and corporate, a DRB license will limit institutions to serving only the retail customer segments i.e. consumer, SME, agri and micro. While the DRB license does not have any product, service or account restrictions, they may not deal with the corporate or commercial segments beyond digital cash management services (up to 40% of total deposits). Furthermore, DRBs are subject to a deposit cap throughout their transition phase i.e. 3 years from commercial launch (post a 3 to 9 month long pilot).

While the two licenses have been drafted keeping in mind fintechs, Electronic Money Institutions (EMIs), traditional banks looking to set-up digital banking arms and international sponsors looking to offer digital financial solutions in the country, the framework also deems majority stakeholders of a microfinance bank as eligible for a DRB license. However, does the DRB license offer any concrete incentives to companies already exercising control over MFBs with a Branchless Banking (BB) License? In its current iteration, the DRB license is actually quite limited when compared to the BB license.

FIGURE 1: COMPARISON: MFB/BB AND DIGITAL BANK LICENSE



For starters the minimum capital requirement (MCR) for a branchless banking license comes at no additional cost with the PKR 1 billion banking license for microfinance banks. In comparison the MCR for a DRB license is PKR 1.5 billion for the pilot stage proceeding to PKR 2 billion and increasing to PKR 4 billion over a three year period. A BB license has no deposit restrictions attached to it unlike the DRB license, which caps deposit at PKR 100,000/ customer during the pilot stage and to "6 times of the MCR, progressively increasing to 12 times" during the transition phase. The BB license is also much more versatile when it comes to the delivery channels it can utilize to reach customers including retail networks, bank branches, ATMs, POS machines, web and corporate portals and mobile applications and even a roaming agent network. A digital bank on the other hand is limited to a mobile and internet applications, their own or other bank's ATMs, CDMs and digital kiosks only. While they are allowed to leverage up to 25 smart branches, all these are mandated to be phased out within 5 years from commercial launch. While digitizing the financial services space should remain the ultimate north star of the industry, it is important to note that the technological infrastructure, literacy rates, internet and smartphone penetration rates in the country still lag behind considerably. For MFBs, their branch and retail network remains an important channel of financial service delivery to ensure financial inclusion.

Considering these factors, it is quite clear that for an MFB, the proposed DRB license would actually limit the financial activities that the institution can engage in. Could changes be made to the current framework to make the prospect of getting a DRB license for parent companies of MFBs? We have a couple of recommendations:

- Making it so that when a company has control over/majority stake in an MFB, it does not have to pay any additional costs to acquire the digital retail banking license, similar to how the BB license works currently.
- Allowing higher loan limits and/or access to new customer segments and thereby allowing MFBs access to new customer segments via consumption lending and trade finance.
- Eliminating the deposit cap restriction for the MFB owning entities at least.

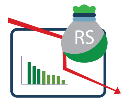
Making these recommended changes to the regulation, would make it so that the Digital Banking License is not a limited scope replication of the currently existing branchless banking license. However, the important question to ask for the microfinance industry is whether DRBs present a serious threat to the banks in the sector in the foreseeable future? In our opinion, there is no significant threat that these digital banks present to MFB's at least for the next three years. It is also too early to predict how many of those that qualify for the DRB license will successfully graduate to a DFB and become Challenger banks. Perhaps that conversation is better to be had after three years when we have a more accurate picture of how many fintechs that qualified for the DRB license are able to successfully transition into DFBs.

Covid Update: Covid-19 and the Microfinance Sector

After WHO declared a global pandemic in March 2020, the Pakistani government initiated its first line of defense by ordaining a nation-wide lock-down. However, implications of this restriction included pilling social, economic and financial pressures, particularly on lower income groups – who are catered by the microfinance industry. To combat this, on 30th March 2020, SBP launched a regulatory response i.e. 'Debt Relief Scheme' to facilitate borrowers in restructuring of due loans. This loan restructuring scheme recently officially came to an end on March 31, 2021, and the Central Bank reports that the deferred and restructured loans include Rs. 121 billion worth of microfinance loans. While all MFBs are principally on board with this decision, the industry as a whole has been impacted by this.

FIGURE 2: 2020 YEAR END DATA TRENDS

Active browsers
7 million



Industry GLP
324 billion

Depositors stand at
64 million

Insurance policy holders
7.3 million

Industry portfolio at risk
ratio increased 1% to 3.4%

Source: PMN Microwatch – Issue 58

Whereas at the end of 2020, the major services provided by MFBs i.e. micro-credit, micro-savings and micro-insurance have increased at the surface level, it is important to go further to understand these numbers. According to data released by the PMN, in reality projections for active borrowers were 10 million i.e. the industry fell 3 million short and projections for insurance were 11 million i.e. industry fell 3.7 million short. The only metric where the industry exceeded expectations was micro-savings i.e. 64 million depositors against a target of 50 million. These numbers confirm that the Microfinance industry has seen a dent in business due to the ongoing pandemic.

Throughout the pandemic, U Bank has been among the leaders in implementing the Covid relief measures. Furthermore, owing to the bank's strategic foresight in combatting pandemic related pressures on the market, we have positioned ourselves in a favorably. 48.7% of our portfolio is gold-backed and our restructured portfolio (24.5% of our portfolio) stands at significantly lower than the current industry average (~ 37%). Additionally, our NPL and NPL % are the lowest in the industry at 38 Mn and 0.13% respectively. This gives us a unique edge in the sector by protecting us against the current market vulnerability and the NPL impact as the rescheduled loans become due.

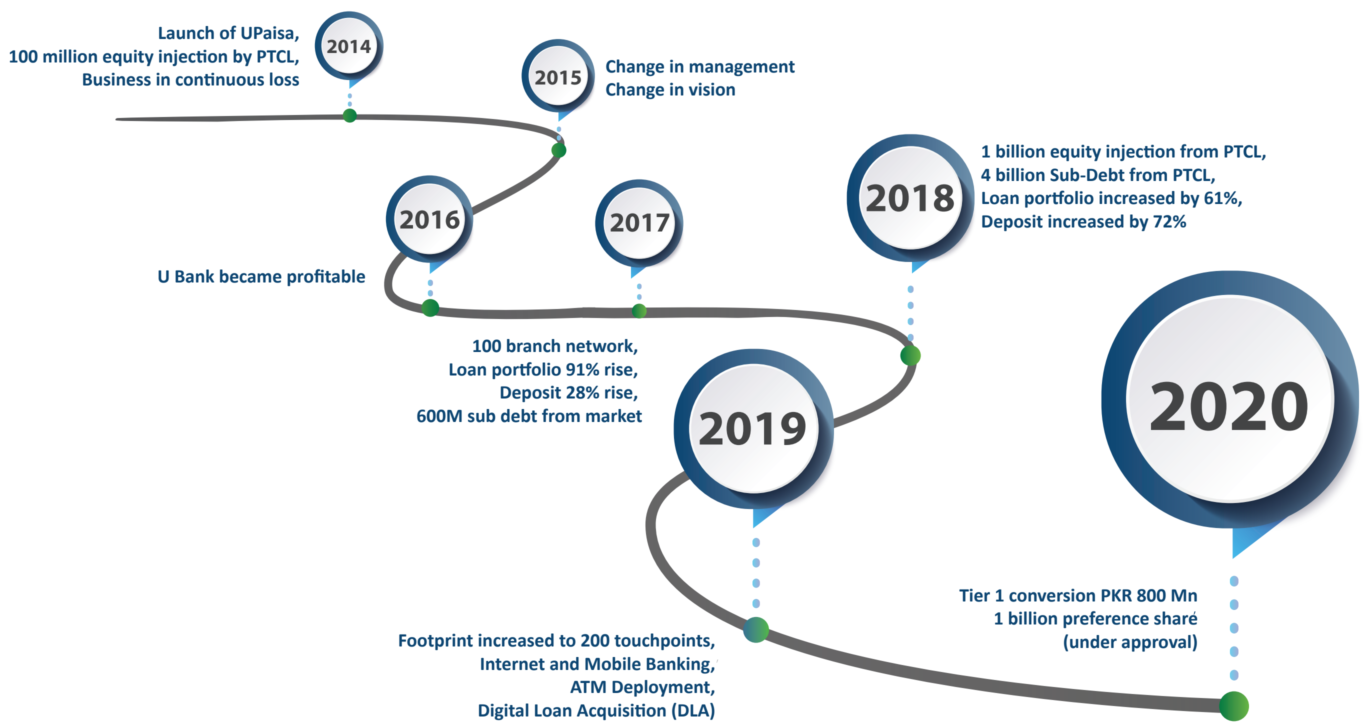
Now, that the restructuring of loans is over, what remains to be seen is whether customer loan repayment can re-start the industry's business engine. It is expected that the majority of MFB borrowers will start repaying their loans in June 2021 and according to industry experts, this is the precise time when the Covid-19 impact on the microfinance banks will be felt at its peak. This impact could be heavily felt considering that the customer's ability to repay loans could be affected by external factors e.g. changing weather patterns affecting crop yield and increasing possibility of another nation-wide lockdown being imposed as cases continue to surge.

Special Feature: The U Bank Story

Our Journey over the Last Five Years

Today, Asia stands as the largest recipient of microfinance in the world. Particularly, South Asia dominates the global microfinance industry, representing two-thirds of global borrowers. At country level, the Pakistani microfinance ecosystem serves 7 million borrowers with a total GLP of PKR 324 Billion (PMN MicroWatch). This ecosystem comprises 29 MFIs and 11 MFBs. Among the latter, U Microfinance Bank operates as a significant industry player, which currently serves 346,258 active borrowers, with a GLP of PKR 31.31 Billion. It is impossible to understand and appreciate these numbers and U Bank's contribution to the sector in isolation, without exploring what has been a steady, accelerated and one of its kind journey towards success.

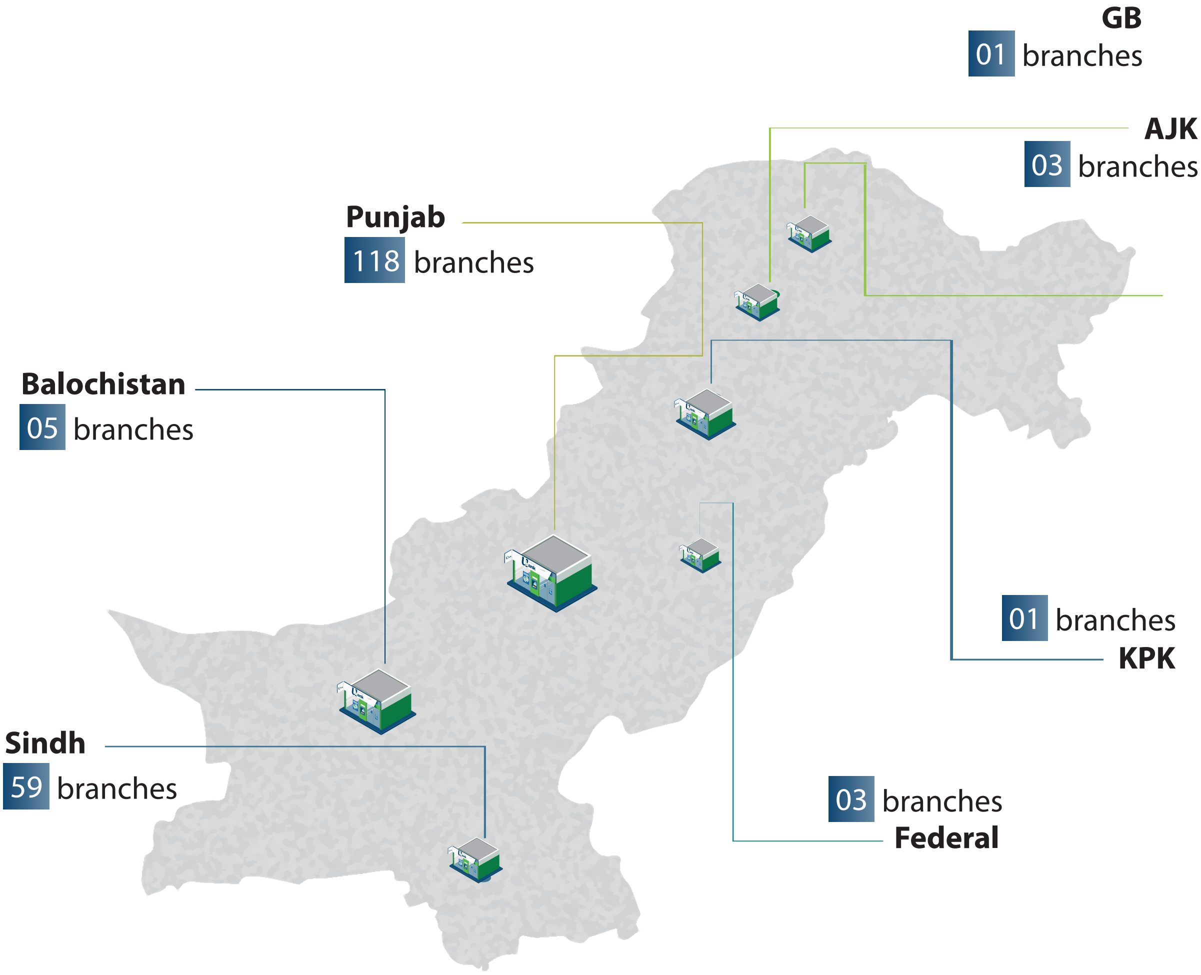
FIGURE 3: U BANK JOURNEY



Birthed in 2013, among major players in the industry, U Microfinance Bank is the youngest microfinance bank in the ecosystem. However, what we lack in years, we more than make up for in achievements and accolades, as we have covered the greatest distance in the smallest amount of time. Since inception, U Bank has successfully cemented its place not just in the microfinance ecosystem but, also the industry at large.

Our extensive brick and mortar presence provides us with a unique advantage in terms of serving the majority of our customer base i.e. the economically active poor. U Bank is the largest microfinance bank in terms of our network of 201 branches and 200 ATMs across 183 cities and rural areas in Pakistan, offering a wide range of microfinance loans, deposit products and branchless banking solutions. We are strategically located in places, where our bank's branch and ATM network is the only one available to customers for a 30 to 50 km radius. Additionally, our branches are often also in areas where tele-density and banking density is low, thus ensuring an avenue of access to financial services to Pakistan's rural population who are disproportionately financially excluded.

FIGURE 4: U BANK'S BRANCH NETWORK ACROSS PAKISTAN



Our steady growth trajectory over the last 5 years indicates expansion across various metrics i.e. number of borrowers, customer deposit volume, gross loan portfolio, number of employees and total touch points. Furthermore, data from the PMN MicroWatch suggests that U Bank ranks among the top 5 fastest growing MFIS in terms of Compound Annual Growth Rate (CAGR). The bank's strategic vision and its commitment to top-notch performance helped U Bank close the year 2020 rated number 2 in profitability, the 3rd largest in terms of GLP and deposit and with a market share that has increased from 0.6% to 10% (where the total market size of the industry has almost doubled).

FIGURE 5: U BANK'S PERFORMANCE

	15	16	17	18	19	20	21
NO. OF BORROWERS	22,254	118,160	187,667	287,320	314,064	346,258	354,302
CUSTOMER DEPOSIT VOLUME	1.1 Bn	8.1 Bn	11.97 Bn	20.5 Bn	23.3 Bn	52.10 Bn	52.4 Bn
VOLUME / GLP	919 Mn	5.57 Bn	10.6 Bn	17.2 Bn	21.88 Bn	31.31 Bn	34.1 Bn
NO. OF EMPLOYEES	409	939	1,321	2,112	2,600	2,695	2,695
TOUCH POINTS	38	75	100	141	200	200	200

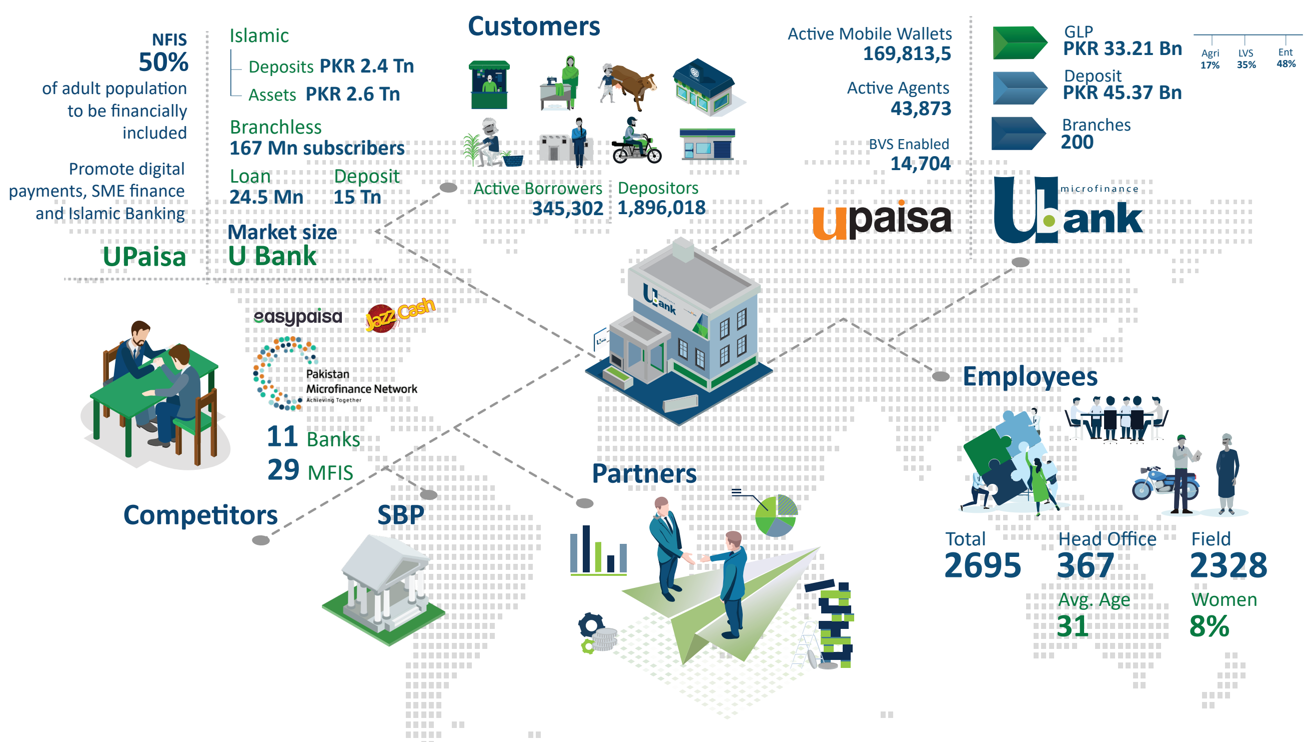
Our success lies not only in consistently setting performance benchmarks as an organization, but also in understanding that we are part of a broader ecosystem, which can ultimately only flourish through collaboration. For this, U Bank's strategy arm engages in extensive exercises annually, to understand where we stand in the microfinance ecosystem, assess our relationship with other stakeholders e.g. competitors, partners, customers - and how we should maneuver to push forward the broader goal of financial inclusion and socio-economic empowerment, through our core values of merit, ethics, transparency, commitment and innovation.

We believe that the future of the sector lies in leveraging creative partnerships and revenue sharing agreements to provide more products and services to our existing customers and reaching new customer segments. To spearhead these partnerships, U Bank launched its dedicated Innovation and Digitization Center (IDC) in 2019, to keep a pulse on upcoming disruptions and technology breakthroughs and design programs, pilots and/or tests to help serve the bank's triple bottom line of people, planet and profits in more innovative ways.

Some of these partnerships already underway include bringing on TCS as a super-agent, digital asset-based lending pilot partnership with CreditFix (loan powered by U Bank), a pilot with Ricult to provide satellite imagery based harvesting time updates to improve RO efficiency when engaged in recoveries, partnership with Bykea for doorstep cash-in and cash-out services and other partnerships to improve the utility and use case of our service delivery channels and product suite.

But the work does not stop at operational performance alone. At the bank we are hyper aware of the value of engaging in advocacy efforts to ensure that we keep pushing the frontier for the overall impact and expansion of the microfinance sector as a whole. One outcome of this initiative has been the recent revisions in the Naya Pakistan Housing Scheme regulations which now includes the microfinance sector under its purview, a process which was spearheaded by the leadership at U Bank in collaboration with the wider industry. The first section in this newsletter analyzing the SBP’s Digital Bank Regulatory Frameworks Exposure draft is another example. Awareness and proactive attitude and planning in light of changing ecosystem regulations will ultimately allow us to claim our place as a potential challenger retail bank.

FIGURE 6: U BANK IN THE PAKISTANI MICROFINANCE ECOSYSTEM



U Bank is also committed to evolving its way of performing business, as the world changes. The modern banking system is all about providing access to banking services and funds to customers anytime, anywhere for customers who are increasingly tech savvy. U Bank believes that digitization and process automation are the essential railroads for leapfrog innovation and a powerful force for financial inclusion. U Bank has launched a variety of digital banking initiatives across the last 12 months – e.g. ATM network, mobile application, corporate portal for commercial clients, Digital Loan Acquisition system. In addition to these services, our broader ambition lies in accelerating the bank’s digital transformation journey to increase our process and service automation to bring more efficiency to our operations as well as leverage the power of technologies such as cloud computing, robotic process automation (RPA), Internet of Things (IoT) and Artificial Intelligence to develop and deliver the next generation of digital first offerings for our customers.

As we continue to expand, our growth is currently still going through gestation period and in the next 5 years, with the exceptional talent of our employees, both in head office and in field, across Pakistan, we envision great impact across our financial and social performance metrics.