

## **Sustainability of Micro Finance Banks: A comparative Case study from Pakistan**

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### **Abstract**

Microfinance Banks (MFBs) have recently emerged to seal the gap between the many formal and informal financial institutions such as banks, credit unions and moneylenders. The foremost objective of MFBs is to alleviate poverty within a country by offering loans and related financial services to the poor: individuals who are not self-sufficient. This paper aims to understand the extent to which MFBs have attained sustainability in Pakistan a developing country scenario. The paper examines the sustainability attained by Microfinance banks in Pakistan by measuring their Outreach, Financial sustainability and Welfare impact. The data was collected with the help of semistructured interviews and focus group discussions of 3 Micro Finance Banks in twin cities of Pakistan and data collection through secondary sources available in Pakistan on MFB`s. A descriptive analysis was carried out by using triangle theory of Meyer and Zeller (2002) the researcher found that MFBs of Pakistan are not quite sustainable especially after the natural disaster in the country in year 2009-2010.

Keywords: Microfinance Institute, Outreach, financial sustainability, welfare

### **1. Introduction**

Researchers have explained the term ‘Microfinance’ as the “provision of financial services and loans to the poor in which sum of money loaned out is repaid in small installments over a certain period of time” (Morduch, 2000). Evolution of microfinance has transformed the attitudes of several countries towards assisting the poor financially, and has enabled the extension of credit, to lower income households and groups who tend to be deprived off financial services by conventional financial organizations (Weiss et al, 2003). Participation of MFBs in developing countries has been escalating in previous years. Evidence is provided by numerous studies carried out on performance of MFBs in different countries (Zeller & Meyer 2002). Pakistan, with a current population of 180 million, comprises of less than 8000 bank branches which appears insufficient to financially assist the population living below poverty line (World Bank, 2006). At present, approximately, 33% of the total population falls below national poverty line and an estimated 7-10 million households require microfinance. Until late 1980’s Pakistan had no established MFB to deliver micro credit to the underprivileged (World Bank, 2006). Therefore, most clients faced difficulties in attaining short term loans.

Microfinance institutions confront high transaction costs of delivering loans and other financial services to the poor and less than one third of total MFBs in Pakistan are financially

and operationally sustainable (MIX, 2006). It is crucial for MFBs to expand outreach to the country's rural population as these short term loans are a source of generating small scale entrepreneurs in rural villages, whose future prosperity is directly linked to economic uplift of the country. In context of above discussions it is therefore, essential to explore issues confronting these MFBs, through an evaluation of their current outreach and financial sustainability situation. The specific objectives for this particular research are to examine extent to which MFBs have expanded outreach in Pakistan and a critical evaluation of problems confronted by MFBs in expanding outreach. Currently there are 23 major Microfinance Institutions in Pakistan (including NGO's) and this paper has attempted to cover 3 MFBs (situated in twin cities) including Khushali Bank Ltd., Kashf Bank and The First Microfinance Bank Ltd.

### **1.2. Objective of the study**

The main aim of proposed research is to understand sustainability of MFBs of Pakistan. Objectives of this study are:

- To examine extent to which MFBs have expanded outreach in Pakistan
- To examine the extent to which MFBs are financially stable
- To examine welfare impact of these MFBs on society

## **2 . Literature Review**

### *2.1 Microfinance Institutions*

Ledgerwood (2006) states that the term Microfinance is self-explanatory and can be disintegrated into two components: Micro and Finance. The former emphasizes the degree of finance involved (as it mainly comprises of small loans), while the latter relates to elements associated with the discipline of finance. Otero and Rhyne (1994, pg7) defines Microfinance as "the provision of financial services to the extremely poor self-employed people and those earning a lower than the national average income." Similarly, Schreiner (2001) has defined microfinance as an attempt to enhance accessibility to small loans and deposits for poor households who are overlooked by banks.

### *2.2 Role of Microfinance in Alleviating Poverty*

Research has shown that MFBs play a crucial role in alleviating poverty mainly by providing access to credit to the under-privileged poor population. In support of this stance, Otero (1999) also defines various techniques adopted by MFBs to fight poverty. Drawing upon her study of 41 MFBs, it is deduced that, besides generating productive capital access for the poor, MFBs also impart necessary training and education to those in need in order to boost their morale, eventually moving the under-privileged poor, out of the vicious poverty circle. According to Otero's research, provision of investment capital and related financial services to poor individuals, results in their empowerment and builds up their self-esteem, so they are prepared to participate in the society and economy. In a similar context, Littlefield, Murdugh and Hashemi (2003), state that various researches certify a rise in earnings and assets and a reduction in susceptibility of MFB clients. They have cited examples of MFBs in developing

countries like Bangladesh, India, Zimbabwe, Uganda and Indonesia, and that, all of them have depicted a positive influence on poverty alleviation.

### *2.3 Sustainability of MFBs*

Sustainability in general terms is referred to as the self-sufficiency of Microfinance Institutions (Braun and Woller, 2004). However there are two different approaches pertaining to the concept of sustainability: Institutional approach and Welfarist approach. Research shows that Microfinance Industry is significantly characterized by the institutionalist approach to sustainability.

#### *2.3.1 Institutionalize Approach*

Most research on MFBs of developing countries, during late 1990's, has adopted the institutionalize approach to analyze sustainability situation of these institutions (Rhyne, 1998). Table 3.1 summarizes the variables, most frequently used by eminent researchers, to measure the sustainability of MFBs under the institutionalize paradigm.

#### *2.3.2 Welfarist Approach*

In contrast to institutionalize paradigm, the Welfare approach argues that attaining financial sustainability is not a pre-requisite for becoming a sustainable MFB (Woller et al, 1999a). According to welfare, funds and grants is a type of equity which is donated by social investors. By social investors it implies that they are distinguished from private investors as they are willing to sacrifice financial returns (or earn minimal financial returns) by investing in an institution (MFB) that utilizes funds for social uplift. Therefore, welfare emphasize on measurement of variables that determine level of social impact. This approach does not imply that variables for measurement of financial sustainability, are useless, but they believe that the former needs to be given greater consideration by MFBs. Table 3.2 summarizes sustainability indicators most frequently used by researchers under the welfare approach. Most research carried out during late 1990's and early 2000's indicates that researchers do not evaluate sustainability by restricting to just one of the two approaches mentioned above. It is observed that, in fact, they have adopted a multi-dimensional approach to determine sustainability of MFBs. This is evident by the fact that researchers have analyzed sustainability by combining relevant variables under the welfarist and institutionalist approach. For example, Conning (1999) developed a theoretical model for MFBs that intend to become sustainable in the long run. He uses a combination of variables under both approaches for his analysis.

### *2.4 Types of Sustainability*

#### *2.4.1 Sustainability in terms of Financial Self Sufficiency of MFBs:*

Theoretical basis of institutionalize approach to sustainability originated from an extensive research carried out by the Rural Finance Program at Ohio State University. According to the research, it was analyzed that failure of many rural credit programs during 1960-1970 was a direct result of a lacking "institutional viability". This analysis derived two key conclusions:

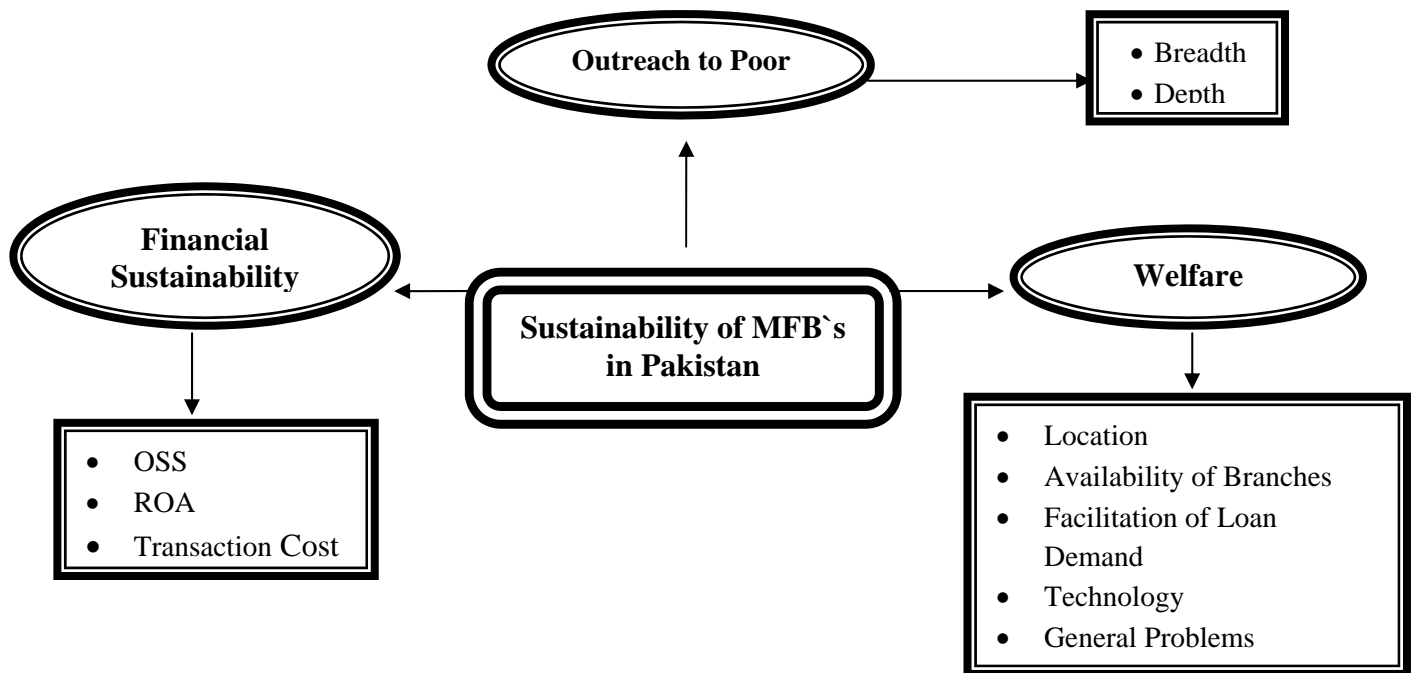
1. To deliver financial services to the poor, successfully, it is crucial to have institutional sustainability
2. Financial sustainability is a pre-requisite for institutional sustainability (Gonzalez-Vega (1994).

Therefore, most literature pertaining to Microfinance, relates the concept of sustainability to attainment of 'financial' sustainability. In context of financial sustainability concept, being referred to as 'sustainability', most researchers have disintegrated the terms into two distinct levels, these are: Operational Self sufficiency and Financial Self sufficiency (Schreiner, 2001). The first level refers to cost-covering capability of MFBs, that is, whether they are able to generate sufficient revenues to cover operational costs (not essentially the entire cost of capital). The subsequent level of Financial Sustainability refers to ability of MFBs, to utilize subsidized funds and grants effectively, to generate revenue.

#### *2.4.2 Sustainability in terms of Outreach*

Literature states that sustainability of MFBs also encompasses measurement of indicators related to outreach (Meyer and Zeller 2002). According to Schreiner (1997), outreach is defined as an assessment of the number of under-privileged clients served by MFBs. Based on Meyer and Zeller (2002) framework; outreach needs to be measured through different dimensions. According to MIX (2005), outreach can be assessed by an annual comparative analysis through measurement of several variables including number of personnel and active borrowers, percentage of clients served below poverty line, average loan balance per borrower, percentage of woman borrowers, number of savers etc. Navajas et al (2000), has identified six main attributes for outreach measurement. These include, Breadth, worth to borrowers, cost to borrowers, Scope and Length. Meyer and Zeller (2002) have used similar indicators in their framework, for measuring MFB outreach. Their research has most specifically preferred measuring variables such as Depth and Breadth.

### 3. Theoretical Framework



#### 3.1. Research Methodology

Theoretical framework was developed on the basis of the literature review. Keeping in view the theoretical frame work the study requires the collection of primary and secondary data both.

##### 3.1.1 Sample

There are about 8 MFB's currently operating in Pakistan, sample of 1/3 of the population is taken for study. For sample 3 Micro Finance banks are taken under study i.e. KASHF Microfinance Bank Limited, Khushhali Bank Limited and The First Micro Finance Bank Limited. Study is conducted in the branches of these three banks operating in Rawalpindi and Islamabad.

##### 3.1.2 Data collection

- Multi dimensional research strategy for data collection was adopted.
- The strategy employed for data collection comprised of semi structured interviews, and collection of data through secondary sources.
- Open ended questions were used in the interviews in order to collect information from MFBs, related to the current degree of outreach, constraints of obsolete delivery channels and use of innovative delivery mechanisms for expanding outreach.
- For the purpose of exploiting data on MFBs and their developments in Pakistan, an extensive use of relevant tertiary and secondary resources is also undertaken by the researcher.

These resources comprise of the following:-

1. Discussion and research papers published by the Consultative Group for Assisting the Poor (CGAP).
  2. Reports generated by the Microfinance Information Exchange market (MIX market) on MFBs operating in Pakistan.
  3. Research papers published by Asian Development Bank Institute.
  4. Research papers and Annual Reports of MFBs in Pakistan.
- Apart from these journal articles, research and discussion papers, the research objectives are analyzed through various websites that provide relevant and latest information on global Microfinance sector along with developments and innovations taking their toll in MFBs established in developing countries.

### 3.1.3 Analysis Tool

- MS Excel: Used for data analysis and descriptive statistics.
- Data analysis: Interviews and focus group data was converted into the ordinal scale measure and then analysed on data analysis of MS Excel.
- OSS, Breadth & depth outreach, ROA were measured with the respective formulas

## 4. Analysis of the Variables

Sustainability of MFBs is measured in terms of outreach expansion, financial sustainability and welfare impact. As some of the variables in the literature review are impractical or cannot be calculated for Pakistan's MFBs, therefore only BREADTH and DEPTH are used. Similarly, the analysis of financial sustainability of these MFBs is done by analyzing their ROA and OSS. Analysis of welfare impact of microfinance institutions is done with the help of *location, availability of branches, facilitation of loan demand, technology and general problems*. Based on interpretation of variables from data collected, the researcher has identified problems associated with outreach expansion through existing financial delivery systems of MFBs of Pakistan and its impact on sustainability. Data for measuring variables pertaining to the research objectives is interpreted for years 2009 and 2010. It is analyzed whether MFBs of Pakistan have become financially sustainable and expanded outreach or not. Details on type, year of inception and number of branches, of the MFBs interviewed, are provided in Table 4.1 in Annexure

### 4.1 Findings of Outreach Indicators

Microfinance industry in Pakistan grew from 0.5 million active borrowers to 1.7 million during 2005- 2008 (Sulaiman D.Muhammad, 2010). It has been estimated that, by 2010, total number of active borrowers in Pakistan has reached to three million, which would constitute to, approximately, 70% of rural borrowers being loaned out by MFBs (Burki et al, 2006). Currently, the population of Islamabad and Rawalpindi city is estimated to be about 5 million. As mentioned in literature review and methodology, outreach is measured by six variables; breadth, cost to borrowers, depth, worth to users, scope and length (Zeller & Meyer, 2002). However, this particular research has chosen to maintain a balance between

the 'welfare and institutionalize' approach to sustainability and therefore, outreach will be measured by the following two variables used most frequently by researchers: Depth and Breadth of outreach.

#### 4.2 Breadth and Depth of Outreach

Breadth of outreach means the number of active borrowers of a microfinance institution and Depth of outreach is measured by dividing average loan per borrower with the GNI per capita (PKR).

Breadth of outreach = Number of active borrowers

Depth of outreach =  $\frac{\text{Average loan per borrower}}{\text{GNI}}$

Figure 4.1 and Figure 4.3 indicates the breadth and depth for MFBs in the sample and Figure 4.2 indicates the change in total outreach in year 2009 and 2010. It was found that the 'Breadth' of outreach of two MFBs was reduced to a considerable degree. A significant reason for this reduction is explained by the floods that hit Pakistani rural areas in 2010 which resulted in high number of non-performing loans. MFBs were forced to limit their new lending because old loans were not recovered. As far as depth is concerned, from the perspective of poverty alleviation, a smaller depth value is preferred by MFBs (Meyer and Zeller, 2002). A smaller depth value indicates a decline in loan demand of potential borrowers, which preceded a resultant rise in annual GNI per capita, in the subsequent year. The values of depth of outreach of MFBs were not consistent in the years under study. There was a slight increase in the depth value for MF-A (First Micro Finance Bank) Whereas for MF-B (Kashaf Bank), there was a significant drop in the year 2010. Depth value for MFC (Khushali Bank) was almost stable.

The most significant reductions in the value explain their considerable share in expanding breadth of outreach. From this trend it is analyzed that a rise in total number of active borrowers will automatically reduce average loan size per borrower, consequently expanding the breadth and reducing value of depth of outreach. Therefore it is observed from Table 4.3 that MFBs recording a percentage increase in breadth values will consequently produce a percentage decline in values for depth. Figure 4.4 explains this trend graphically.

From data findings it is estimated that on an aggregate level, MFBs in the sample reported a net decline of -2.28% in Breadth of outreach and a net decline of -5.69% in Depth of outreach. Based upon rating scale, MFBs of Pakistan fall in ratings 10 for depth and 6 for breadth. Therefore, on an aggregate level, an overall decrease in sustainability of MFBs is observed, in context of the active number of borrowers loaned out.

#### 4.3 The Financial Sustainability Dimension

In order to analyze financial sustainability of MFBs, the author has calculated Operational Self Sufficiency (OSS), Return on Assets (ROA), and Transaction Cost per borrower of these institutions during 2009-2010. OSS measures the degree to which operating income covers operating expenses.

OSS =  $\frac{\text{Financial revenue}}{\text{Financial expense} + \text{Net impairment loss} + \text{Operating expense}}$

(Financial expense + Net impairment loss + Operating expense)

ROA is an indicator of how profitable a company is relative to its total assets.

$$\text{ROA} = \frac{\text{Net operating income-Taxes}}{\text{Average Total Assets}}$$

Table 4.4 and Figure 4.5 and 4.6 explain the extent to which MFBs have registered growth, in terms of OSS and ROA respectively and table 4.5 and figure 4.7 indicate the trends in transaction costs during these two years.

From figure 4.5, it can be inferred that MF A reported a net decline in OSS and fall in a rating of 9; while MFBs-B and C, indicated a positive change in OSS and fall in rating 7 and 10 respectively (based on most recent values). This implies that the latter were able to recover their operational costs through revenues generated annually. The highest percentage increase in OSS was recorded by MFB-C followed by MFB-B, which can be attributed to development of effective technological solutions and MIS for delivering financial services. ). From this data it is evident that, 2 out of 3 MFBs interviewed, reported a percentage rise in OSS which testifies their growth in context of financial sustainability dimension.

Results depicted that MFB-A and B, reported a decline in ROA, while MFB C depicted a rise in ROA. This implies that the latter was able to utilize its funds and grants efficiently in generating interest income (revenues). Hence, assets are utilized effectively to generate micro-credit. It is worth noting that except MFB-C, no other MFBs in the sample was able to generate a positive ROA; hence, individually it falls in rating 1. According to Hartarska (2005) and Meyer & Zeller (2002), MFBs in developing countries require 5-6 years to report positive ROA's depending upon the type of technology they incorporate to deliver financial services which is a fundamental rationale behind trend observed for MFBs of Pakistan.

Results of analysis of transaction cost per borrower are also in accordance with the results of ROA i.e. only MFB-C has decreased its transaction cost with the rating of 1. Both the other two banks have increased their transaction cost per borrower and fall in the rating 6 and 3. So here also an overall decrease in financial sustainability is noticeable.

From these results it is evident that growth in the financial sustainability dimension was achieved by only one of the MFBs in the sample i.e. MF-C. Also, after carefully scrutinizing the data it is identified that, on an aggregate level, MFBs reported a net decrease in adjusted ROA of - 2.46%, and a net decline in OSS of -4.46%. It is therefore established that, on an aggregate level, growth in terms of financial sustainability was not achieved.

## 5. Conclusion

Microfinance Institutions have been established in Pakistan for only about 14 years. The research pertaining to impact and sustainability of MFBs in Pakistan is, therefore, at its initial stages, on both practical and academic accounts. In this study the researcher used data acquired from MFBs of Pakistan related to the previous 2 years combined with secondary data collected through sources mentioned in methodology. By using triangle theory of Meyer and Zeller (2002) the researcher found that MFBs of Pakistan are not quite sustainable, and this is mainly due to floods of 2010 because of which lenders were not able to repay loans of these institutions. From the findings the researcher inferred that firstly there is definitely an



expansion in outreach of these institutions within the last two years but this expansion in both the depth and breadth of outreach has been at the expense of a few well performing MFBs. However, MFBs have also depicted low financial sustainability with reference to the aggregate ROA and OSS values.

### **6. Recommendations**

MFBs need to clarify their aims and objectives in order to manipulate their future strategies. This will attract a greater number of donor agencies and investors. MFBs must grow in both the outreach and financial sustainability dimensions if they are to produce a positive social impact (the third dimension). The three dimensional growth must be achieved by use of technological solutions/devices for delivering financial services. A complete cost/benefit analysis of the desired technology must be carried out before its implementation and appropriate staff training process must be carried out; if a three dimensional growth is required. In order to expand outreach and become financially sustainable, MFBs must reduce the interest rate on loans. A reduction in repayment rates will attract greater number of rural borrowers and the institutions will result in a more positive social impact. It is also recommended that MFBs must reduce their overall operational expenses by minimizing the transaction cost per borrower. They can achieve this by, either, relocating their branches closer to their target market in rural/secluded areas, or, by using innovative technological solutions to serve a greater population more efficiently.

### **7. Limitation**

- Sample size was limited to the MFB of Rawalpindi and Islamabad only.
- There was lack of availability of secondary data on MFB`s and resistance was shown by MFB`s staff in terms of focus group discussions and structured interviews.
- The study only focused the microfinance Banks where as a comprehensive study could be conducted by taking all microfinance institutes.

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**Annexure**

**Table 3.1 Sustainability Indicators According to Intuitionist Paradigm**

Sustainability Indicator	Variables	References
Return on Assets	ROA	Conning (1999); Meyer and Zeller (2002); Hulme and Mosley (1996); Schreiner and Woller (2003)
Operational Self Sufficiency	OSS	Meyer and Zeller (2002); Schreiner and Woller (2003); Khandker (1998); Hulme and Mosley (1996)
Return on Equity	ROE	Conning (1999); Morduch (1999); Andogo and Stork (2005)
Debt to Equity Ratio	DE	Quyyum and Ahmad (2007)
Number of Active Borrowers	Breadth	Meyer and Zeller (2002); Morduch (1999); Shreiner (1997) Hulme and Mosley (1996); Conning (1999) Quyyum and Ahmad (2007)
Transaction Cost per Borrower	COST	Meyer and Zeller (2002); Hulme and Mosley (1996)

**Table 3.2 Sustainability Indicators According to Welfarist Paradigm**

Sustainability Indicator	Variables	References
Cost to Borrowers	CB	
Depth of Outreach	DEPTH	Navajas et al (2000), Meyer and Zeller (2002); Morduch (1999); Coleman (2004); Conning (1999) Schreiner (1997, 2003); Hulme and Mosley (1996) Quyyum and Ahmad (2007); Andogo and Stork (2005)
Proportion of Women Borrowers	WOB	Meyer and Zeller (2002); Amin et al (2003); Pitt et al 2003
Borrowers below Poverty Line	BBPL	Gertler et al (2003); Khandker (1998:2003)

**RATING CHARTS FOR ANALYSIS**

**Sustainability Rating**

Sustainability Indicator / Rating	1	2	3	4	5	6	7	8	9	10
<b>BREADTH</b>	<500	500-2000	>2000	2000-4000	>4000	4000-6000	>6000	6000-8000	>8000	>10,000
<b>DEPTH (% change)</b>	>30%	20-30%	<20%	15-20%	<15%	10-15%	<10%	<5%	0-5%	<0%(-ve)
<b>ROA (%)</b>	<5%	5-10%	>10%	10-20%	>20%	20-30%	>30%	40-45%	45-50%	>50%
<b>OSS (%)</b>	<20%	20-30%	>30%	30-40%	>40%	45-50%	>50%	60-80%	80-100%	>100%
<b>COST (% Change)</b>	>50%	40-50%	<40%	20-30%	<20%	10-15%	<10%	5-10%	0-5%	<0%
<b>WOB (%)</b>	<5%	5-10%	>10%	15-20%	>20%	20-30%	>30%	30-40%	40-50%	>50%
<b>BBPL(%)</b>	<20%	25-35%	>35%	35-45%	>45%	45-50%	>50%	50-70%	>70%	90-100%

*Source: Meyer and Zeller (2002)*

**Sustainability Criteria**

Financial Sustainability Indicators (% Change)	Variables	Sustainability Criteria
Return on Assets	ROA	positive
operational self Sufficiency	OSS	Positive
Transaction cost per Borrower	COST	<5%
Outreach Indicators	Variables	Sustainability Criteria
Depth of Outreach	DEPTH	negative
Number of Active borrowers	BREADTH	>10,000
Cost to Borrowers	CB	<10%
Social Impact Indicators	Variables	Sustainability Criteria
Proportion of Women Borrowers	WOB	>50%
Borrowers below poverty line	BBPL	90-100%

*Source: Meyer and Zeller (2002)*

**Table 4.1**

Sr #	Name of Institute	Label of Institutes	Type of Institute	Year of Inception	No. of Branches
1	First Microfinance Institute of Pakistan	MF-A	Pure MFI	2001	147
3	Kashf Foundation	MF-B	Pure MFI	1996	154
4	Khushhali Bank	MF-C	Pure MFI	2000	108

**Table 4.2 BREADTH AND DEPTH OF OUTREACH DURING 2009-2010**

	Breadth (2009)	Breadth (2010)	Depth (2009)	Depth (2010)
MF A	199,792	151,797	16.21%	17.42%
MF B	14,192	17,445	35.41%	28.59%
MF C	329,421	325,523	12.84%	12.76%
<b>Total Outreach</b>	<b>543,405</b>	<b>494,765</b>	-	-

**Table 4.3**

	<u>DEPTH</u> (% Change)	<u>BREADTH</u> (% Change)
MF A	1.21%	-24.02%
MF B	-6.82%	22.92%
MF C	-0.08%	-1.18%

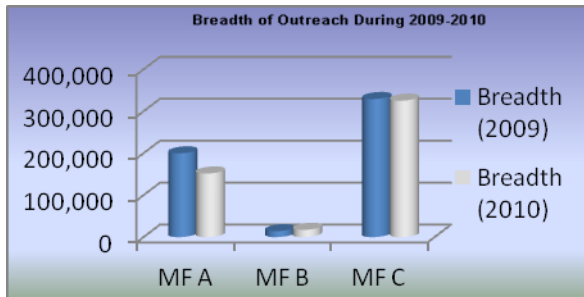
**Table 4.4**

Financial Sustainability in terms of OSS and ROA								
	<u>OSS – 2009</u>	<u>OSS – 2010</u>	<u>% Change in OSS</u>	<u>Ratings</u>	<u>ROA-2009</u>	<u>ROA-2010</u>	<u>%Change in ROA</u>	<u>Ratings</u>
MF A	102.74%	88.83%	-13.91%	9	0.46%	-2.73%	-3.19%	Not sustainable
MF B	51.64%	54.80%	3.16%	7	-15.65%	-16.09%	-0.44%	Not sustainable
MF C	100.12%	106.41%	6.29%	10	-0.07%	1.10%	1.17%	1

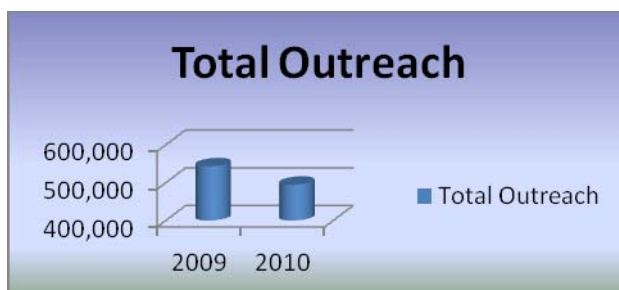
**Table 4.5**

Financial Sustainability in terms of Transaction Cost				
	Transaction Cost – 2009	Transaction Cost – 2010	% Change in Transaction Cost	Ratings
MF A	550	625	13.63%	6
MF B	925	970	4.86%	3
MF C	980	860	-5.49%	1

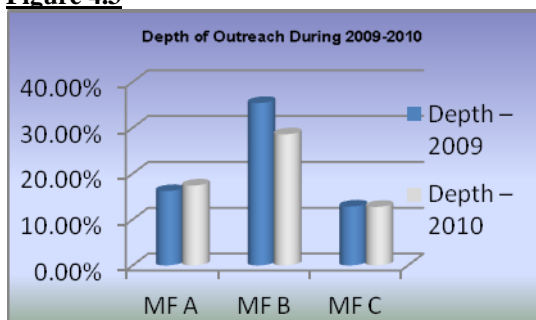
**Figure 4.1**



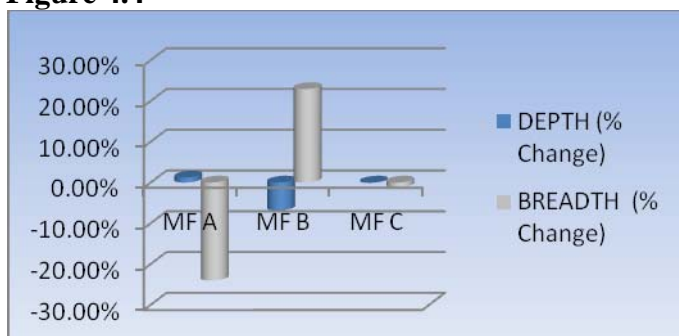
**Figure 4.2**



**Figure 4.3**

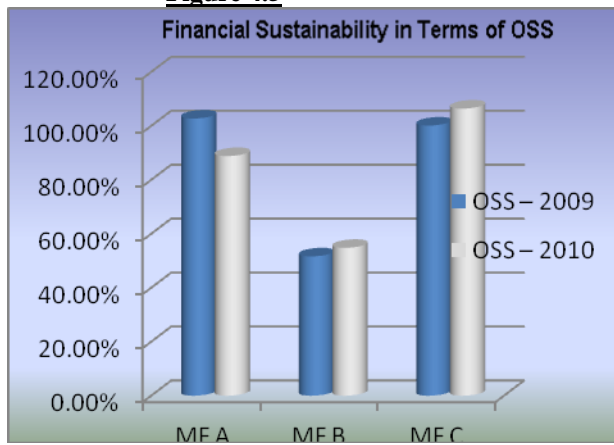


**Figure 4.4**

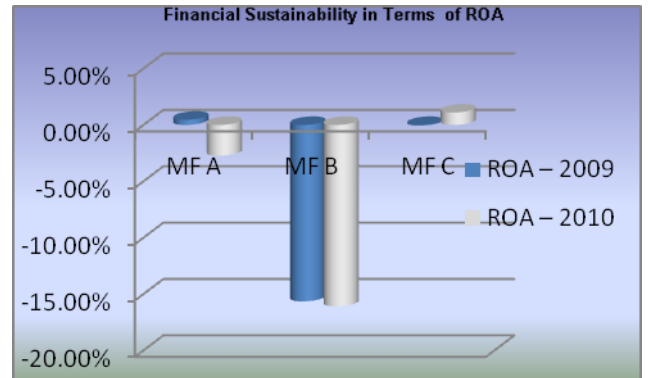


**Percentage Changes in Depth and Breadth**

**Figure 4.5**



**Figure 4.6**



**Figure 4.7 Transaction Costs**

