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WHY DO MICROFINANCE LOANS TURN NON-PERFORMING? EVIDENCE FROM PAKISTAN'S MICROFINANCE BANKING SECTOR

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Abstract

This study aims at exploring the causes of high non-performing loans in the Microfinance Banks (MFBs) in Pakistan. The main objective of the study is to identify the causes of non-performing loans of MFBs in Pakistan. The findings have been gathered using face-to-face in depth semi structured interviews from five MFBs, researchers and members of rating agencies. The findings reveal that main root causes of the Non-Performing Loans (NPLs) are high cost of borrowing, lack of technological awareness, lack of mitigating measures to control the natural calamities, lack of insurance coverage, high weightage consumption loans, delayed accounting for provisioning, insufficient government support and regulatory gaps. These factors are the primary barriers preventing MFBs from expanding their lending portfolios. To avoid NPLs and mitigate risk, MFBs increasingly prefer investing in government securities over supporting financial inclusion.

Introduction

In the age of the richest and the poorest, the role of state, governments and donor agencies remains critical to flourishing the economic development (Kosack & Tobin, 2006) . The financial sector of an economy, individual or global, is assumed to be an important source of financing while better functions and actions can be performed with better financial management (Herring et al., 1995). The people and companies working on a bigger scale have easy access to finance to increase their capital base and generate economic activities (Bates & Robb, 2013). Nevertheless, the poor and middle classes were always and are undergoing difficulties in accessing finance in the existing financial institutions (Bell et al., 2015).

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Volume. 4, Issue No. 5 (2025)

Over the years multiple agencies have been formulated to increase the financial inclusion and to reduce challenges. The first such organization which have been established to alleviate poverty was the World Bank (WB), created in 1944 (Easterly., 2001). The primary aim of WB was to offer loans to the poor countries of world. Following its strategy, in 1970, the WB re-conceptualized its mission of facilitating development as being oriented around poverty alleviation. The WB is working through its five financial arms: Multilateral Investments Guarantee Agency (MIGA), International Development Association (IDA), International Finance Corporation (IFC), International Bank for Reconstruction and Development (IBRD), and International Center for Settlement of Investment Disputes (ICSID).

Microfinance can be considered as one of the sources of delivering financial services that may involve both deposits and credits. The low-income people are utilizing it to create assets and generate economic activities like running small enterprises, operating a retail shop, fishing, farming, living stocking, purchasing an animal and some machinery (Srinivasan & Sriram, 2003). Entrepreneurs who have limited access to any conventional banking means can access microfinance for financing needs (Prabhu & Jain, 2012; Ali, 2015). Hence, microfinance is improving the living standards and production by enhancing capital investment and elevating the productivity (Augsburg et al., 2013a; Ali, 2018).

The microfinance sector is operating under the umbrella of two objectives i.e. social and financial (Ali et al., 2023) . Over the last two decades, microfinance has been aggressively promoted. It is viewed as an essential element to the socio-economic growth of the weak part of society. In poorer countries, rural populations are large, characterized by high birth rates, low literacy, and high population growth. It disturbs the capital labor ratio, resulting in increasing unemployment and further poverty (Augsburg et al., 2013b) . Microfinance can assist in alleviating the rising problems by enhancing agricultural productivity and allowing households to create small businesses, thus creating alternative self-employment opportunities (Goldberg, 2016) . However, according to a study in South Asian Countries (India, Bangladesh, Nepal and Pakistan) microfinance institutions are inclined more towards financial goals rather than social objectives (Ali et al., 2023).

With the expansion of microfinance sector in Pakistan which currently comprises of rural support program institutions and banks, the challenges associated with the sector also grew

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Volume. 4, Issue No. 5 (2025)

significantly (PACRA, 2024) . Considering these challenges following questions arise to be investigated. Are MFBs and MFIs meeting their objective for poverty alleviation? Is there significant support available for the growth of the sector? Is there expansion of economic activities with the increased microlending? What are the hindrances in extending the micro credit to the people? Why do MFBs come under financial distress? Why are MFBs merged and why did their profitability come under pressure whether due to bad loans or some management issues? Why is the recovery ratio in MFBs lower as compared to MFIs?

Evidence from Pakistan's banking sector also shows a strong link between macroeconomic performance, credit quality, and banking stability (Ali & Bibi, 2017; Hassana & Khanb, 2024) . Improvements in the economy are connected to better asset quality, while economic slowdowns lead to poorer credit performance (Mohanty & Mishra, 2021). The COVID-19 pandemic made this situation more complicated (Ansari et al., 2021b) . Banks often delayed recognizing NPLs in their financial statements, which postponed the acknowledgment of capital losses (Ansari et al., 2021b) . The operational definition of NPLs differs slightly from one institution to another, although the general rule is the same (Nyambu, 2024) . The International Monetary Fund (IMF) define NPLs as loans on which neither interest nor principal payment has been made for 90 days and more (Easterly, 2001).

Loan repayment difficulties continue to be one of the most serious risks confronting financial institutions, whether they have a commercial, Islamic or microfinance model. The continuation of such delinquencies undermines profitability, curtails new lending, and eventually financial stability. In the long run, credit defaults adversely affect the MFBs and MFIs. The purpose of this study is to combine the findings of this research and to explore the determinants of NPLs in the MFBs on account of bad loans. Furthermore, it is to find that why and how loan delinquencies arise and what are the major causes behind such delinquencies.

Literature Review

MFBs are facing high rates of NPLs and increased cases of debt restructuring and default cases which are creating hindrances in the growth of the sector (Ali & Audi, 2016; Ansari et al., 2021b) . A financial sector with deteriorating health represents the high level of NPLs within the sector (Sindhiya et al., 2022). It has been documented in numerous empirical studies that high level of delinquent loans is usually the cause for bank collapses (Ali et al., 2021) . Historically, the incident of bank failure reported around the world depicts that

Journal of Management Science Research Review

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 4, Issue No. 5 (2025)

defaults/bad loans are the main cause. (Keshani & Jayatilake, 2021b). Higher default rates or NPLs are relatively higher in the banks who charge relatively high interest cost (Ali & Rehman, 2015; Keshani & Jayatilake, 2021b) . Over the last decade, deposit-taking microfinance institutions have suffered from increased losses, resulting in declining profitability. The institutions experienced increased level of NPLs over the last decade (Akhter, 2023; Khalil et al., 2025). In countries with emerging economies the level of credit risk and non-performing loans is influenced by both external and internal factors (Hania, 2023).

Non-compliance with the loan policy provisions and credit monitoring policy are cited as factors leading to the non-performing loans (Jacob et al., 2023b; Nasir et al., 2025). Nyamai & Aluoch (2023b) identify NPLs as one of the key issues facing MFIs, which has resulted in declining profitability and institutional failure in other cases. The failure to adhere to credit monitoring and provisions of the loan policy have been highlighted as a few of the causes of the growth of the NPLs (Wafula, 2023). According to Nyamai & Aluoch (2023b) , the management of NPLs is related to higher operating cost which results in the reduction of capital growth in the concerned financial firms.

The asset quality of the financial institutions amid high rate of default risk, has been enhanced on the back of partnerships among the financial institutes (Isinta, 2025). This results in the reduction of loan granting. Resultant to the high level of NPLs, the financial institutes recorded the high provisioning for bad loans, which lowered the revenue and reduced availability of funds for new lending. This has harmed the finance industry as it struggles to expand its working capital (Nugroho & Nugroho, 2024; Longston et al., 2025).

Recently, there has been increasing discussion about impaired loans and ways to address them. This is a positive trend since it implies that banks will undertake measures to address damaged assets, revitalize the stability of their balance sheets, and establish the possibility of sustainable lending growth to companies and individuals (Mezghani et al., 2021; Marc et al., 2022). Nevertheless, the current increase in NPLs indicates the deficiency in control and preventive strategies (Gupta et al., 2023). Although banks may not issue insolvencies, elevated amounts of NPLs are damaging to efficiency, influence cost frameworks, and decrease the readiness to lend. This restricts the availability of credit in the whole economy (Banna & Alam, 2021; Marc & Ali, 2023).

One more detail of the debate is the gender and access to finance. According to Shaikh et al. (2020b) female entrepreneurs in third world economies, particularly in Pakistan, continue to struggle with the structural challenges such as the lack of credit and the chance to compete in the competitive markets. Such institutionalized restrictions not only suffocate women economic participation but also negatively affect the general developmental outcomes with half of the citizens not being involved in significant financial participation (Maeenuddin et al., 2024) . There is also some indication in the evidence of Pakistan that the financial performance of the MFIs can be greatly influenced by the composition of the borrowers (Bros et al., 2023b; Marc et al., 2026).

According to Messai & Jouini (2013b) the drivers of NPLs both at the macroeconomic level and microeconomic level work as follows: At the institution level, loan quality, bank capital adequacy, profitability, and operational efficiency all have an impact on repayment performance. Deterioration in credit risk assessment, poor monitoring, and lack of training in loan officers frequently lead to the accumulation of NPLs. At the macro level inflation, direction of interest rates, and general level of economic activity determine borrower repayment ability. Yet, interest rate and NPLs remain controversial and complex in their relationship.

Adverse Selection theory

This theory explains that adverse selection in the financial industry specifically insurance, financial markets, labor markets and healthcare. The theory refers to a situation wherein due to lack of information from the buyer side leads to insufficient market outcome. Where the lenders cannot distinguish between high risk and low risk borrowers which lead to risky portfolio. The situation becomes where the borrower knows more about their repayment ability while the lenders have limited information (Mccaskie, 1999; and Aidoo, 2020b).

MFIs face significant challenges related to moral hazard, a common issue in credit markets to which microfinance is no exception (Aidoo, 2020b) . Originating from insurance theory, moral hazard occurs when one party in a transaction has more information than the other and avoids the full consequences of risky behavior (Krugman, 2009) . In lending, this manifests in loan defaults. Borrowers often secure credit to finance projects expected to generate returns, but defaults occur when these expectations fail; whether due to poor fund management or risky investment choices (Aidoo, 2020b) . Moral hazard arises when individuals alter their behavior because the risks of poor decisions are borne by others.

In microfinance, two forms of moral hazard are particularly relevant: ex-ante and ex-post. Ex-ante moral hazard happens before

Journal of Management Science Research Review

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 4, Issue No. 5 (2025)

borrowers generate returns from their investments. Here, the loan structure may not encourage them to put in the effort needed to ensure repayment. Ex-post moral hazard occurs once returns are realized, in the case of which it is possible that borrowers decide not to make repayments once the returns are available (Giné et al., 2006a).

The ex-ante moral hazards typically succeed the loaning after it is disbursed and preceding the realization of the project returns. Borrowers can change to riskier projects at the expense of the less risky projects, taking advantage of the opportunity generated by credit contracts. Ex-post moral hazard on the other hand occurs when borrowers avoid repayment or strategically default until the realization of project returns. Both scenarios may compromise repayment discipline and play out in the lending program sustainability (Giné et al., 2006a).

The moral hazard dilemma established that the borrowers would make more defaults if there were no consequences for their forthcoming loan requests. This situation arises because the creditor's assessment of the borrower's assets at the time of maturity date of the debt is not accurate as they may find it difficult. Batabyal & Beladi (2010) established that if the obligor is unable to assess the financial health of the borrower, the borrower may default at the loan amount. Hence, to avoid this situation, the obligor raises the interest rates which would eventually result in the market collapse.

Methodology

The research adopted an exploratory design to collect data considering the aim of getting in-depth insights into the causes of high NPLs in the microfinance banks and potential mitigating measures. This phenomenological research study is based to qualitative aspects which are established through exploratory means by interviewing the social actors of the industry.

Sampling Technique

In accordance with the requirements of this study, the purposive sampling technique is used. Total fifteen participants have been selected comprising heads, managers and analysts of the sector from major cities, Karachi, Islamabad and Lahore. The organizations in this study have been selected based on their experiences in the microfinance industry and their degree of involvement in this context. Out of total eleven microfinance banks, the selection criteria is based on the geographical coverage across the country, experience of the bank in the microfinance industry, business acumen of the respondent, experience of the respondent in the microfinance banks, standing of the bank in the industry. A cross-representative selection approach

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 4, Issue No. 5 (2025)

has been used to select the industry's experts representing the south, north and central region of Pakistan.

In addition, the banks selected in this study have been chosen based on their vast experiences in the management of non-performing loans specifically in times of crisis and natural calamities. Each respondent has almost same approach to sharing the views and experiences however, slightly different with reference to his industry experience. Other organizations which are significantly associated with the microfinance banks have been chosen. The brief profile of the organizations other than MFBs is mentioned below:

Table 1: Details of Interviewees

Sr. No.	Organization	Department	Position	Respondent ID
1	HBL Microfinance Bank Limited	Risk	Head	R-01
2	HBL Microfinance Bank Limited	Finance	Head	R-02
3	NRSP Bank Limited	Finance	Head	R-03
4	NRSP Bank Limited	Risk	Senior Manager	R-04
5	Sindh Microfinance Bank Limited	Risk	Head	R-05
6	Sindh Microfinance Bank Limited	Risk	Senior Manager	R-06
7	Easypaisa Digital Bank Limited	Product Development	Head	R-07
8	Pakistan Microfinance Network	Operations	Chief Operating Officer	R-08
9	Pakistan Microfinance Network	Ratings	Senior Analyst	R-09
10	The Pakistan Credit Rating Agency Limited	Ratings	Senior Analyst	R-10
11	The Pakistan Credit Rating Agency Limited	Ratings	Senior Analyst	R-11
12	The Pakistan Credit Rating Agency	Ratings	Senior Analyst	R-12

Journal of Management Science Research Review

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 4, Issue No. 5 (2025)

	Limited			
13	The Pakistan Credit Rating Agency Limited	Ratings	Senior Manager	R-13
14	The Pakistan Credit Rating Agency Limited	Research	Head	R-14
15	The Pakistan Credit Rating Agency Limited	Research	Senior Manager	R-15

Procedure

The data collected for this study has been done through primary mode. The primary data was directly collected from the selective organization's respondents. To gather the data, authors conducted semi-structured in-depth interviews and shared interview questionnaires with the respective departments of the organizations before conducting the interviews. Semi-structured interviews facilitated on follow up questions with each respondent wherein each respondent can talk about his/her own practical experience. We approached these organizations officially through invitation via telephonic call and explained to them briefly regarding study objective, tentative research schedule, and a questionnaire. These respondents of this study initially confirmed their availability. After receiving confirmation, we sent the interview invitation via MS Teams, along with the interview schedule. Interview guide questions were discussed in online and face meetings to conduct more free-flowing discussions; in most cases, they continued for an hour. The saturation point came following the 10th interview. The interview guide and the interview guide questions were built upon the assumption of credit rationing theory and realistic challenges placed on the microfinance sector. The questions were well appreciated by the respondents wherein they shared their comments and ideas.

i. What are the main causes of NPLs in your bank?
ii. Does the structure of the loan have any impact on the non-performing loans?

Analysis Technique

Thematic Analysis is a data analysis approach that involves the identification, analysis, and reporting of trends (Braun & Clarke, 2006) . Thematic Analysis of open-ended survey results or transcripts of interviews may uncover the context of the teaching and learning in a depth that cannot be achieved through quantitative analysis but with flexibility and interpretation in the analysis of the data so that one can be assured of the reliability of the results (Braun & Clarke, 2006) .

Journal of Management Science Research Review
ISSN Online: 3006-2047
ISSN Print: 3006-2039
Volume. 4, Issue No. 5 (2025)

Thematic Analysis is a using deductive approach has been used to analyze the date which involves searching for similarities and patterns in qualitative data sets. The technique comprises of six stages: 1) Creating folders in NVIVIO 12, 2) Importing interview transcripts into NVIVO 12, 3) Skimming through interview transcripts, 4) Coming up with primary themes, 5) Categorizing each code under a primary theme 6) Exporting a hierarchy chart, 7) Exporting a code book and 8) Developing result report. Within the thematic analysis context, raw data creates codes and themes and thematic maps. These themes can be identified and defined, which results in interpretations. The answer to the research questions or purpose of the study is in the form of conclusions (Robert K. Yin. (2014).

Findings

Through data analysis, eight categories have emerged. The data analysis revealed the below the summary points of all the interviews are transcribed below as most of the points were common in many interviews hence in order to avoid duplication and repetition, the summary is recapitulated below:

Theme findings

Composition of the lending portfolio

In Pakistan's Microfinance banking sector, livestock has the highest contribution in total gross loan portfolio, while agriculture stood at second highest number. While in terms of NPLs contribution agriculture remained on higher side due to natural calamities specifically during Covid-19 and heavy flooding in Junly-2022. Precautionary measures to control the NPLs in these situations must be taken through insurance coverage, diversification in the portfolio lending, managing the loan size, and through proper awareness sessions.

Sector lending, however, has changed more noticeably. Agriculture's share in microfinance dropped from 17% in 2020 to 6% in 2024. Livestock and poultry also fell from 25% to 13%. These declines are linked to repeated shocks—from COVID-19 and the 2022 floods to high inflation—that reduced borrowers' ability to invest in these areas. Rising risks also pushed institutions to cut back on lending to these sectors.

Loan Structure

It was highlighted by many interviewers that the loan structure in case of most of the MFB is still on the bullet loan as compared to equal monthly instalment (EMI) specifically in the agricultural loans and livestock as the loan repayment is designed according to the cycle of the product. Another interviewee highlighted product design doesn't matter it's the borrower behavior which matters. There are a few main reasons why repayment became harder in FY24. First, Pakistan's economy has been under stress. High inflation, rising food and fuel prices, and falling household

Journal of Management Science Research Review

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 4, Issue No. 5 (2025)

incomes made it tough for families to set aside money for loan instalments. Second, many borrowers in rural areas depend on seasonal incomes like farming. If the harvest is delayed or damaged, they do not have cash available when payments are due. Third, some loans were given with rigid repayment schedules, which do not always match the borrower's income cycle. This creates pressure even for honest borrowers who want to pay back.

Secured Based Lending

In the microfinance industry, there are four major segments in which lending is being done namely i) Agriculture ii) Livestock iii) Enterprise and iv) Nano lending (general purpose). Now banks are progressing towards secured lending against assets like tractor, agricultural animals, cash flows from enterprises or agricultural activity, against salaries or against pension if any. As the unsecured lending led to higher non-performing loans.

Debt management

Yet, one of the most persistent barriers remains debt management. Limited education and poor financial literacy often lead to mismanagement of loans, which in turn disrupts repayment schedules and strains institutional resources. Poor debt management not only hampers individual borrowers but also restricts the overall growth and expansion potential of MFIs.

There are outside pressures that add to this dilemma. Nowadays, microfinance has developed so rapidly that competition among the lenders has increased, borrowers have begun to take more debt than they can service, and the general environment is one of financial instability, thereby raising the risk of Microfinance. The challenges Microfinance face has put even more pressure on such institutions to better assess and manage the risk of borrower default.

Concentration

In Pakistan, MFB outreach is low as compared to MFIs. In Pakistan the total population is approximately 25 million out of which ~65% is rural and 35% is urban. While the MFB majority portfolio is urban based. The outreach to the poor should be increased this way lending portfolio would be diversified. The concentration of the portfolio in a few or single segments welcomes the high level of NPLs and resultantly higher credit risks. Where lending is concentrated in specific jurisdiction then this may result in high NPLs like natural calamities in that area can destroy the crops which results in high NPLs. Hence diversification of the geographical area is compulsory to manage the level of NPLs.

Moral Hazards

The risks faced by MFIs/MFBs cannot be fully understood without considering moral hazard.

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 4, Issue No. 5 (2025)

The problem is magnified when entities knowingly increase their exposure to risk, expecting others to absorb the cost. Government bailouts of large corporations, for example, encourage executives to pursue risky strategies under the assumption that they will be rescued if things go wrong. In microfinance, similar dynamics can lead institutions to extend credit without rigorous due diligence, while borrowers themselves may feel less compelled to repay once they perceive external safety nets. This creates a cycle of personal moral hazard that undermines institutional stability.

Control Environment

The stronger the control framework of an MFB the stronger the management of NPLs. It was highlighted that where controls are weak like Know Your Customer (KYC) and Anti Money Laundering (AML) is not done properly, the chances of NPLs remain high. It was further highlighted that in case of gold backed lending proper KYC is not followed which compromises the credit assessment.

Conclusion

Since inception microfinance played a pivotal role in the alleviation of poverty across nations. Many regulatory and foreign bodies played their part in the sustainability and growth of this sector.

However, with the passage of time as the sector entered a maturity phase it encountered with multiple challenges both manageable and unmanageable. Today, Microfinance banks are one of the most significant entities that address such challenges. However, a few challenges are those which originated since inception of microfinancing across the globe. Amongst those challenges the existence of non-performing loans persists and it significantly raises concerns over the long-term sustainability of the Microfinance Banks in the country. The study is contributing to assessing the root causes which are aggravating the levels of NPLs in the microfinance industry.

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