8 PERFORMANCE REVIEW OF NON-BANK FINANCIAL INSTITUTIONS

8.1 Overview

Non-Bank Financial Institutions (NBFIs) include Non-Bank Finance Companies (NBFCs), Mutual Funds, Modarabas and Development Finance Institutions (DFIs). During FY08,[1] NBFIs' assets grew by only 3.2 percent, as against a robust growth of 22.7 percent in FY07, to reach Rs. 585.6 billion. The number of operative entities in FY08 was 237[2] (subsequently decreasing to 233 in FY09) in comparison with 209 in FY07. The size of the total assets of the sector relative to GDP at 5 percent, and total financial sector assets at 7.6 percent, is small, as is the proportion of its deposits in the total deposits of the financial sector at 0.98 percent. Notably, while NBFCs, Mutual Funds and Modarabas are regulated by the Securities and Exchange Commission of Pakistan (SECP), DFIs are regulated by the State Bank of Pakistan (SBP): together, the NBFCs, Modarabas and DFIs are termed as NBFIs.

Table 8.1: Assets of NBFIs

Growth rates and share in percent

	FY04	FY05	FY06	FY07	FY08
Assets (Rs. Billion)	318.1	393.7	462.3	567.0	585.6
Growth rate	22.7	23.8	17.4	22.7	3.3
			Share in Assets		
Mutual Funds	32.4	34.6	38.3	55.3	58.5
DFIs*	29.8	27.4	25.3	16.8	14.5
Leasing	14.1	13.6	13.8	11.3	11.0
Investment Finance	11.2	13.0	11.8	7.9	7.4
Modarabas	5.7	5.5	5.2	4.6	5.1
Housing Finance*	6.1	4.7	4.3	3.1	3.1
Venture Capital	0.3	0.3	0.7	0.7	0.3
Discounting	0.4	0.4	0.4	0.2	0.0

*Assets of HBFC, a DFI engaged in providing housing finance, have been included in the Housing Finance category

Source: Annual Audited Accounts

The relative position of various NBFIs' sub-categories in term of their share in total assets is presented in **Table 8.1**. As is clearly visible from the data, mutual funds lead the sector in terms of their share in total assets, which strengthened further to 58.5 percent during FY08, as against 55.3 percent in FY07. Notably, Mutual Funds represent the only sub-category which has recorded remarkable growth year after year, despite the setback in H1-FY09 (Special Section: An Assessment of Mutual Funds' Performance). If mutual funds are excluded from NBFIs' assets, total assets reduce to Rs. 242.97 billion which is less than half of the original amount, and constitutes only 3.2 percent of total financial sector assets. Notably, DFIs which used to dominate the sector, have seen a rapid deterioration in their share of assets which has reduced by 15.3 percentage points since end-CY04.

In November FY09, SECP implemented some necessary measures to revamp the regulatory framework for NBFCs and amended the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003, in addition to issuing the Non-Banking Finance Companies and Notified Regulations, 2008.[3] These new NBFC Regulations aim to address ongoing concerns

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[1] The analysis of NBFCs and Modarabas is based on Annual Audited Statements as of June 30, 2008, whereas DFIs' data is of end-December 2008. Since annual audited data is received with a lag of several months, it is not possible to give an analysis of the consolidated position as on June 30, 2009 in this report. However, where possible, statistics on numbers of companies and licenses issued etc have been updated upto June 30, 2009, in line with the information received from SECP.

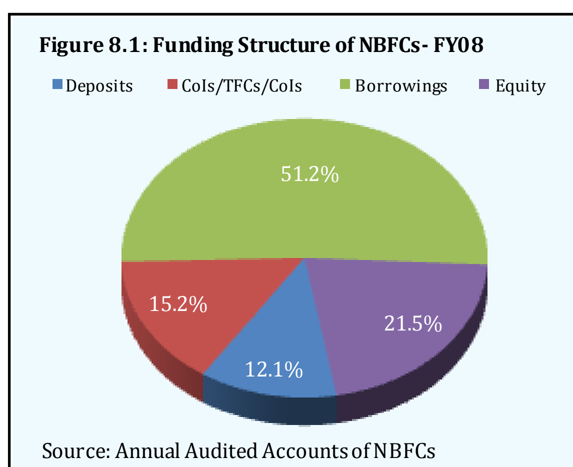
[2] This number counts all the mutual funds as separate entities.

[3] Details of NBFCs and NE Regulations, 2008 is given in Chapter 10, FSR 2007-08, SBP.

regarding the need to foster sustained growth of the sector by enhancing market outreach, promoting product innovation, and enhancing the capital base.

Notably, undertaking an impact analysis of the new regulations on the growth prospects of NBFCs would be a bit premature at this stage, especially in view of the challenges emanating from the operating environment in FY09. These institutions have been particularly hit hard by the slowdown in the economy and associated deterioration in macroeconomic indicators, virtual closure of the stock market for almost 4 months, high interest rates and liquidity strains in the banking sector. Among various issues, concerns regarding NBFCs' commercial viability took center stage in FY09, given their continued dependence on the banking sector for resource mobilization. Although the regulatory framework allows some NBFCs to raise retail deposits in the form of Certificates of Investment (CoIs), Certificate of Deposits (CoDs), etc.[4] but the amount so raised is generally not sufficient for them to finance their business activities and expand their operations. NBFCs' funding composition shows that they are primarily dependent on borrowings from financial institutions (**Figure 8.1**), with relatively less support from deposit generation and equity.

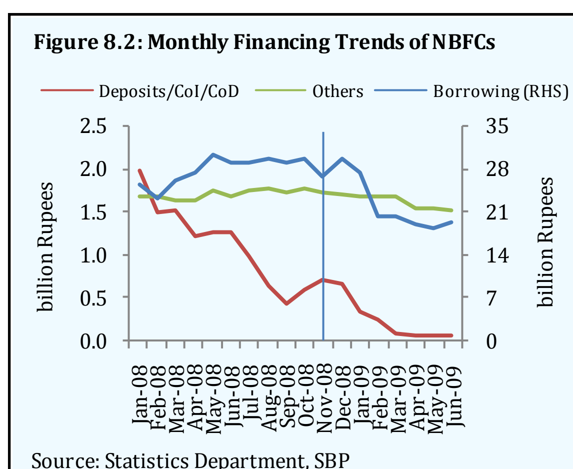
Figure 8.1: Funding Structure of NBFCs- FY08



Source: Annual Audited Accounts of NBFCs

The extensive reliance on credit lines from banks and other financial institutions has continued to pose problems for NBFCs in terms of the high cost of funding, in addition to being a potential source of systemic risk if and when these credit lines dry up, as seen most recently in October FY09. Liquidity strains in the banking sector observed in September-October FY09,[5] had an adverse impact on the business operations of Investment Finance companies, Leasing companies, Mutual Funds and other entities. This is clearly visible in **Figure 8.2** which shows the repercussions of the liquidity strains in the banking sector on NBFCs' resource mobilization efforts from October FY09 onwards; NBFCs' borrowings from banks against their credit lines declined by 34.7 percent from October FY09 to end-June FY09. Given the perceived lack of confidence in the economy and to some extent, in the financial sector, during that time, financing raised through deposits/CoDs/CoIs declined even more drastically by 91.3 percent, whereas financing from other funding sources declined by 15.3 percent. While access to bank borrowing was restored to some extent in subsequent months, the fact remains that NBFCs continue to operate at a disadvantage in comparison with the banking sector which has access to relatively low cost funds and is also able to provide various financial services that at one time were the specialized domain of these institutions.

Figure 8.2: Monthly Financing Trends of NBFCs



Source: Statistics Department, SBP

[4] Minimum tenor of these instruments cannot be less than 30 days, Non-Banking Finance Companies and Notified Entities Regulations, 2008.

[5] Detailed analysis of the temporary liquidity stress is given in Chapter 4, "Stability of the Banking System", in this edition of the FSR.

Notably, in its capacity as the regulator of NBFCs, SECP faces certain limitations in its regulatory framework, the foremost of which is its inability to provide a requisite framework of financial safety nets (FSN)[6] for the financial institutions in its regulatory domain. At a minimum, the discount window facility which was available for Investment Banks from January 2002 was withdrawn by SBP in July 2007,[7] and is currently only available for DFIs (which are regulated by SBP) among all NBFIs, given the nature of their deposits in comparison with the banking industry, which drives the liquidity management considerations. Consequently, during the liquidity crunch in Q2-FY09, SECP was rendered helpless in meeting NBFCs' liquidity requirements due to its inability to intervene directly to provide liquidity. This is a critical area of concern for the smooth functioning of the NBFCs sector.

To address this issue and other related concerns, such as the need for safety net to be provided by the proposed deposit insurance scheme for the banking sector, SBP had proposed in July FY09 that all deposit-taking NBFCs be shifted back to its regulatory domain.[8] However, due to reluctance shown by both the relevant NBFCs and the SECP, this plan was subsequently shelved. It remains to be seen how the regulators intend to address these concerns.

With this overview in mind, the chapter is focused on providing a detailed review of the financial performance and developments in each NBFI sub-sector, based on audited data as of end-June FY08.

8.2 Performance Review

Over the last few years, a significant degree of fragmentation has been seen in the NBFC sector which is inundated with a large number of small and weak entities unable to withstand any adverse developments in their operating environment due to their fragile financial position. To overcome this problem and to enhance the resilience of the sector as a whole, SECP has continued to incorporate necessary amendments in the NBFCs Rules and Regulations over time, and has undertaken a comprehensive process of reforms. As a consequence, a number of NBFCs have joined hands with each other to operate on a stronger footing as evidenced by the number of mergers and acquisitions (**Table 8.2**).

Resultantly then, there has been a decline in the number of operational entities across the various sub-categories except mutual funds, the number of which has been growing consistently over the last several years**.** The composition of the NBFIs sector as of end-FY09 is presented in **Table 8.3**. As SECP allows each NBFC to hold multiple licenses, 76 NBFCs hold 83 licenses for providing various financial services as permissible under the NBFCs rules (**Table 8.4**).

Table 8.5 lists the key performance indicators of NBFIs (excluding mutual funds and venture capital companies), showing that during FY08, the share of advances in total assets increased to a 6-year high of 52.5 percent, which emanates largely from growth in advances of leasing companies and modarabas. The share of investments, on the other hand, has declined by 8.0 percentage points since FY03, to constitute 28.6 percent of assets in FY08, during which again only leasing companies and modarabas registered growth in investments. Decline in the overall share of investments has had a slight impact on the earning assets to total assets ratio which declined to 82.6 percent in FY08 as against 85.2 percent in FY07. This indicates

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[6] Details in Chapter 3, "Framework for Problem Bank Management", in this edition of the FSR.

[7] Investment Banks and DFIs were allowed access to the Discount window facility vide BSD Circular No.6 dated January 31, 2002. This facility was later withdrawn for Investment Banks vide FSCD Circular No. 13, dated July 6, 2007, while it continues to be in place for DFIs and any non-bank institutions which is also a primary dealer as detailed in FSCD Circular No. 2 dated February 21, 2008.

[8] NBFCs used to be regulated by the SBP until 2002 when their regulatory responsibility was shifted to the SECP.

that a large portion of earning assets are driven by advances rather than investments, which is an encouraging sign.

Table 8.2: Mergers and Acquisitions from FY03 to FY09

	Name of NBFC/ Modaraba	Name of Company/Modaraba Merged with	Date of Merger
1	Crescent Investment Bank Limited	Mashreq Bank Pakistan Limited	09-07-2003
2	Industrial Capital Modaraba	First Dawood Investment Bank Limited	12-05-2004
3	First General Leasing Modaraba	First Dawood Investment Bank Limited	12-05-2004
4	Trust Investment Bank Limited	Trust Commercial Bank Limited	30-04-2004
5	Fidelity Investment Bank Limited	Trust Commercial Bank Limited	30-04-2004
6	Pacific Leasing Limited	First Standard Investment Bank Limited	18-06-2004
7	Paramount Leasing Limited	First Standard Investment Bank Limited	18-06-2004
8	First Leasing Corporation Limited	First Standard Investment Bank Limited	18-06-2004
9	First Hajveri Modaraba	First Fidelity Leasing Modaraba	22-10-2004
10	First National Modaraba	First Paramount Modaraba	11-09-2004
11	Ibrahim Leasing Limited	Allied Bank Limited	31-05-2005
12	Second Tri-Star Modaraba	First Tri-Star Modaraba	24-02-2006
13	Modaraba Al-Tijarah	Modaraba Al-Mali	06-12-2006
14	First Allied Bank Modaraba	Allied Bank Limited	07-12-2006
15	Atlas Investment Bank Limited	Atlas Bank Limited	26-07-2006
16	Jahangir Siddiqui Investment Bank Limited	JS Bank Limited	30-12-2006
17	Guardian Modaraba Limited	B.R.R. International Modaraba	25-05-2007
18	Crescent Standard Investment Bank Limited	Innovative Housing Finance Limited	20-07-2007
19	International Housing Finance Limited	KASB Bank Limited	22-11-2007
20	Pakistan industrial & Credit Investment Corp. Ltd.	NIB Bank Limited	01-01-2008
21	Universal Leasing Corporation Limited	Al-Zamin Leasing Corporation Limited	06-06-2008
22	KASB Capital Limited	KASB Bank Limited	03-01-2009
23	International Multi Leasing	Al-Zamin Leasing Modaraba	19-01-2009
24	Network Leasing Corporation Limited	KASB Bank Limited	17-02-2009

Source: SECP & KSE

From FY05 onwards, in large part due to rising interest rates, the cost of deposits and borrowings has seen a rising trend, and increased to 10.0 percent as against 8.0 percent during FY07. On the funding side, NBFIs continue to rely largely on borrowings due to weak deposit mobilization (as mentioned earlier), as indicated by their borrowing to liability ratio which has generally seen a rising trend in recent years. With this heavy reliance on borrowings alongwith a declining deposits to liability ratio, the average spread for NBFIs increased to 3.2 percent (highest since FY05), as against 2.7 percent in FY07.

Table 8.3 : Number of NBFIs

	FY03	FY07	FY08	FY09
DHs	4	1	1	0
VCCs	3	4	4	3
HFCs	3	3	2	1
DFIs	6	5	6	8
IFCs	12	8	11	9
Leasing	27	12	12	11
Modarabas	37	27	27	27
M. Funds	38	66	95	102
Total	130	126	158	161

Source: SECP

Table 8.4: Licenses held by NBFIs in FY09

NBFIs	No. of Entities	No. of Licenses
DFIs	8	
NBFCs	24	
-Investment Finance		11
-Leasing		15
-Housing Finance		2
-Venture Capital Investment		3
-Discounting		0
-Investment Advisory and Asset management		52
Mutual Funds	102	
Modaraba Management Companies	40	
Modarabas	27	

Source: SECP

Despite some of the positive developments mentioned above, NBFIs' profitability indicators have been consistently declining from FY03 onwards, as indicated by the return on average assets (RoA) and return on average equity (RoE) which deteriorated further to 0.9 percent and 3.0 percent respectively in FY08. However, on excluding the one off provisioning losses incurred by one of the leading- IFCs, RoA and RoE

actually stand at 1.2 and 3.9 respectively for FY08.

Table 8.5: Key Performance Indicators of NBFIs*
percent (except in case of ratio)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY08
Advances to Assets	42.9	46.9	51.8	51.2	48.6	52.5
Investments to Assets	36.6	33.3	30.5	27.1	28.7	28.6
Earning Assets to Total Assets	83.9	84.9	85.6	84.5	85.2	82.6
Debt to Equity Ratio	2.6	2.5	2.8	2.9	2.3	2.0
Borrowings to Liabilities	54.7	55.0	49.0	55.1	62.3	61.1
Deposits to Liabilities	31.1	33.4	40.9	37.0	29.3	25.2
Return on Advances and Investments	11.4	9.0	8.8	10.6	10.6	13.2
Cost of Deposits and Borrowings	6.1	3.9	5.7	7.6	8.0	10.0
Average Spread	5.3	5.1	3.1	3.0	2.6	3.2
Net Interest Margin	6.6	5.9	4.1	4.3	4.5	5.6
Income to Expense	156.6	159.4	144.3	122.4	106.8	111.3
Return on Average Assets (after tax)	4.3	3.5	2.7	1.6	1.3	0.9
Return on Average Equity (after tax)	17.7	13.5	10.4	7.0	4.9	3.0

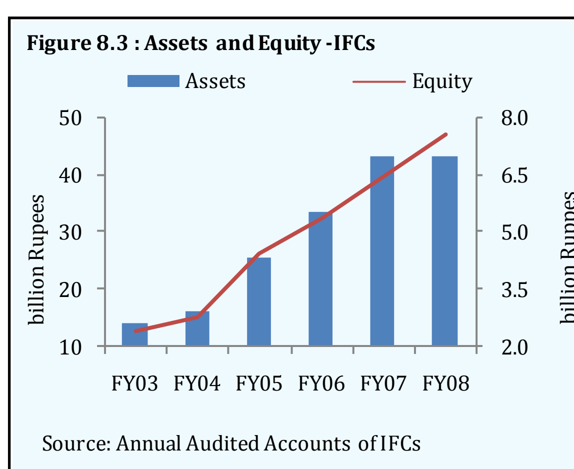
*excluding Mutual Funds and Venture Capital.
Source: Annual Audited Accounts

Given the summary trends in the key performance indicators, the sections ahead give a detailed performance review for each category of NBFIs.

8.2.1 Investment Finance Companies

The role of Investment Finance Companies (IFCs) as a viable component of the financial sector has been rather debatable. In their traditional role, investment banks render services such as investment advisory, corporate restructuring, mergers and acquisitions, equity and debt financing, etc. In doing so, investment banks offer an altogether different array of financial services in comparison with the commercial banking industry. However, IFCs in Pakistan have generally not been able to carve out a niche for themselves, and over time they have shown a preference for business activities akin to those undertaken by commercial banks, with a distinct competitive disadvantage in terms of access to low cost funds. Being unable to generate sufficient fee-based income from advisory services, or interest-based income from financing long-term projects in the economy, several investment banks have opted to merge with commercial banks over the years, and there are now very few dedicated players in this area. It is essential for these institutions to re-examine their strategies in order to optimize on their potential strengths if they are to sustain commercial viability.

Figure 8.3 : Assets and Equity -IFCs



Source: Annual Audited Accounts of IFCs

As in FY07, there were 8 operative IFCs in FY08 with a share of 7.4 percent in the aggregate assets of NBFCs (**Figure 8.3**). Encouragingly, all IFCs are compliant with SECP's minimum equity requirements (MER) for Investment Finance Companies at Rs. 300 million for FY08.

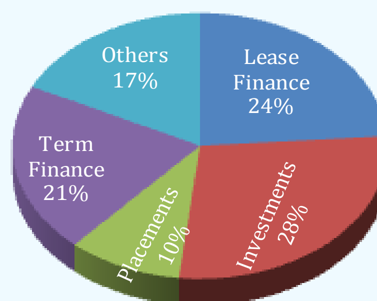
Table 8.6 : Key Performance Indicators of Operative Investment Finance Companies

percent (except in case of ratio)	FY04	FY05	FY06	FY07	FY08
Lease Finance to Total Assets	20.2	28.0	26.5	21.9	23.8
Investments to Total Assets	33.5	26.7	22.6	26.8	28.0
Placements to Total Assets	23.0	14.7	23.2	17.9	9.8
Term Finance to Total Assets	13.9	12.4	14.7	19.8	20.7
Earning Assets to Total Assets	90.7	81.8	87.0	86.5	82.4
Debt to Equity Ratio	4.6	4.5	4.9	5.2	4.5
Average Spread	4.1	5.8	4.0	2.3	2.4
Net Interest Margin	4.7	6.0	4.8	3.2	2.9
Income to Expense	159.4	166.1	136.5	111.9	114.6
Return on Average Assets (After Tax)	2.3	3.6	3.0	0.6	-0.6
Return on Average Equity (After Tax)	13.3	20.8	18.3	3.8	-3.5

Source: Annual Audited Accounts of IFCs

Table 8.6 lists the summary performance indicators for the operative IFCs in FY08, which clearly shows that except for lease finance, IFCs have earned their revenues from investments and placements with other financial institutions rather than from core business activities (**Figure 8.4**). Notably, this passive, risk-averse strategy has worked well in maintaining an above-average level of earning assets in proportion to total assets. However, high debt and inordinately high expenses in comparison with income have both had an impact on their profitability indicators. In particular, both RoA and RoE turned negative in FY08 as one of the leading players in the industry incurred high provisioning expenses against impairment in investments. Excluding this one-off case, profitability Indicators show a slight increase over FY07, such that RoA becomes 1.0 and RoE is 5.7 for FY08, which is commendable keeping in view the difficult operating environment for the financial sector.

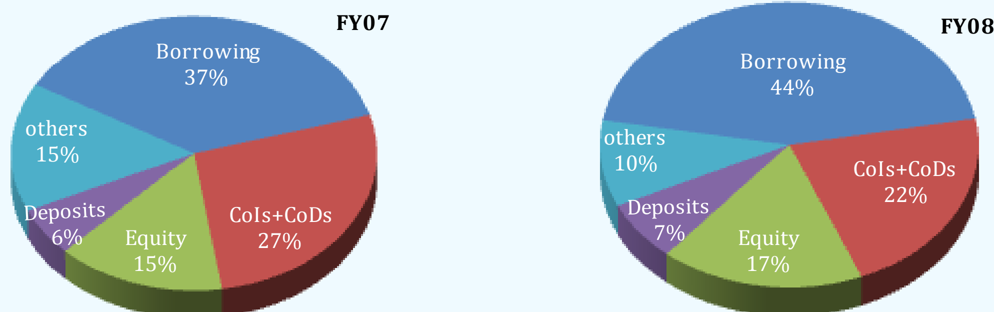
Figure 8.4: Asset Allocation of IFCs in FY08



Source: Annual Accounts of IFCs

As is true for the entire sector, IFCs have a high reliance on borrowings to fund their operations, and this dependence increased in FY08 (**Figure 8.5**), making them less competitive and hinders prospects of sustained growth and profitability based on core business activities.

Figure 8.5: Liabilities Structure of IFCs



Source: Annual Audited Accounts of IFCs

IFCs' income base in driven by gains on investments, followed by income from lease finance. This indicates shrewd investment decisions in an environment where a number of financial institutions, both NBFCs and banks, have incurred revaluation losses on their investment portfolio.

Going forward, the 8 operative IFCs need to realign their business strategies with the financing needs of the economy, foremost of which is infrastructure financing, which generally has a long gestation period. Notably, investment banking arms of leading commercial banks have taken the lead in financing infrastructure projects, while IFCs have taken a back seat and have relied more on generating income from investments. Both the SECP and market participants need to devise a sustainable business model for IFCs if these specialized institutions are to remain commercially viable in an increasingly competitive financial sector.

8.2.2 Leasing

Since the inception of the first leasing company in 1984, the leasing sector has played a prominent role in the financial sector. However competitive pressures from the banking industry have had a significant impact on its size over the years, such that the number of operating leasing companies has reduced from 27 in FY03 to 12 in FY08.

Table 8.7: Equity of Leasing Companies

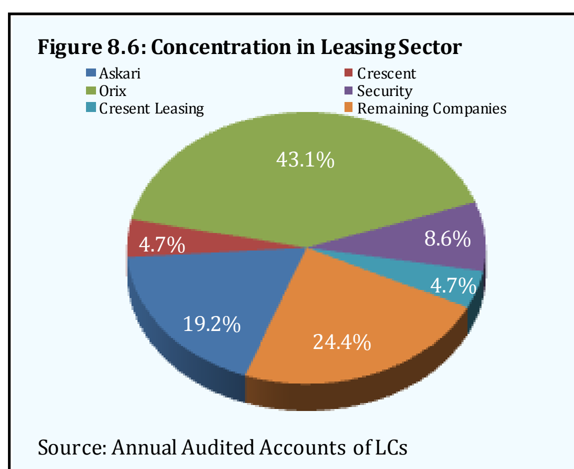
Equity	Number of Companies
Over Rs 2.0 billion	1
Between Rs 1.0 – 2.0 billion	1
Between Rs 0.5 – 1.0 billion	3
Between Rs 0.2 – 0.5 billion	5
Less than R. 0.2 billion	2

Source: SECP

Notably, only 2 of the 12 operative leasing companies were not compliant with SECP's minimum equity requirement of Rs. 200 million for leasing companies in FY08 (**Table 8.7**), and the sector is relatively well-capitalized. Both the non-compliant companies have incurred substantial losses in the last few years due to heavy provisions against NPLs emanating from inappropriate concentration of leasing assets in a narrow client base, rising interest rates and inadequate risk management systems.

Figure 8.6 shows the market share (in terms of assets) of the leading players in the sector, indicating concentration of business in the top 2 companies which together hold over 62 percent share of business, whereas the remaining 6 companies have a cumulative share of 24.4 percent. Notably, only those companies which can increase their MCR to Rs. 500,000 as required by the SECP for end-FY09 will remain commercially viable, while others would either have to consider joining hands with other players in the financial sector or simply liquidate their business.

Figure 8.6: Concentration in Leasing Sector



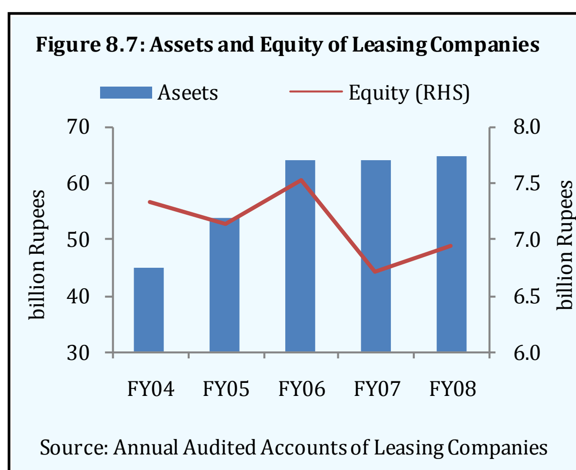
Source: Annual Audited Accounts of LCs

In terms of key financial performance indicators, the total assets of the leasing sector inched up a bit to Rs. 64.5 billion in FY08 over Rs. 64.0 billion in FY07, while the total equity base declined from Rs. 6.7 billion in FY07 to Rs. 6.6 billion in FY08 (**Figure 8.7**). While the increase in assets was constrained by factors such as high interest rates, unfavorable economic conditions, lack of product diversification, low outreach and dependence on costly

borrowings, the decrease in equity was due to the losses incurred by one of the weak companies in the sector.

Encouragingly, the leasing sector has had a consistent focus on generating revenues from core business activities rather than simply from investments, as in case of IFCs. Even though the lease finance to total assets ratio has declined slightly in FY08 over FY07 in response to the difficult macroeconomic environment and dissipating demand pressures, the share of investments is only 7.0 percent of total assets in FY08, as against 6.3 percent in FY07 (**Table 8.8**).

Figure 8.7: Assets and Equity of Leasing Companies



Source: Annual Audited Accounts of Leasing Companies

Table 8.8: Key Performance Indicators of Existing Leasing Companies

percent (except in case of ratio)

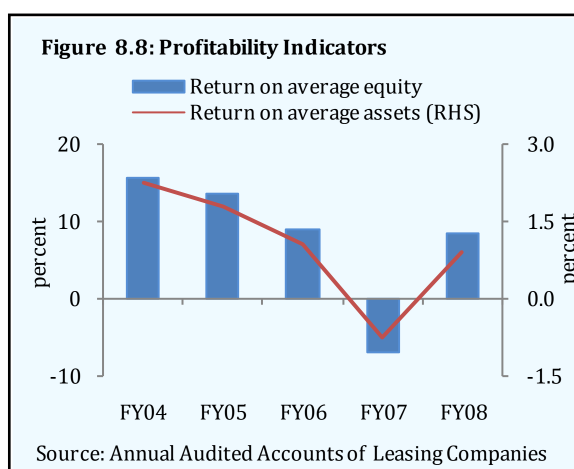
	FY03	FY04	FY05	FY06	FY07	FY08
Lease Finance to Total Assets	74.9	77.3	77.5	78.9	81.6	78.6
Investments to Total Assets	8.8	10.9	9.9	7.0	6.3	7.0
Earning Assets to Total Assets	86.4	89.8	90.1	88.5	89.8	87.9
Growth Rate of Lease Finance	55.1	19.7	29.0	24.6	4.8	-5.9
Debt to Equity Ratio	5.2	5.4	6.5	6.9	7.7	7.5
Average Spread	4.9	4.9	3.5	2.3	1.8	2.0
Net Interest Margin	6.1	5.7	4.1	3.1	2.8	2.9
Income to Expense	122.1	129.1	124.5	112.7	94.1	108.2
Return on Average Assets (After Tax)	2.1	2.3	1.8	1.1	-0.7	1.0
Return on Average Equity (After Tax)	14.4	15.7	13.7	8.9	-6.8	9.9

Source: Annual Audited Accounts of Leasing Companies

As indicated by the high gearing ratio, the leasing sector has a relatively higher dependence on borrowing, though the gradual adjustment of the leasing sector to persistently high interest rates is visible from the improvements in both the average spread and the net interest margin.

Encouragingly, the profitability indicators of the sector reflect a marked improvement in performance over the previous year. The sector has made a remarkable turnaround in FY08 by earning an aggregate profit of Rs. 574 million (**Figure 8.8**), while in FY07, the leasing sector registered a loss of Rs. 486.9 million due to high provisioning expenses and high financial cost of borrowing, with a negative impact on RoA and RoE.

Figure 8.8: Profitability Indicators



Source: Annual Audited Accounts of Leasing Companies

8.2.3 Venture Capital Investment

Venture Capital (VC) investment typically refers to capital provided for start-up businesses with potential for high growth. Due to the high risk nature of their investments, venture capital companies require a commensurate rate of return, along with some measure of control over the management and strategic orientation of the investee company. Venture capitalists usually exit from the project after a relatively short period of time i.e. 3 to 7 years,

when the equity is either sold back to the client company or offered on the stock-exchange. VC business in China and India's IT and IT enabled services' sector has emerged as a success story in the region, with investments of US$ 719 million and US$ 144 million respectively, in FY08.

VC business in Pakistan has essentially remained limited in scope despite the enabling regulatory framework provided by the SECP which has set forth the rules and requirements for VC investments in the NBFCs Rules. Some of the impediments in the growth of the VC industry in Pakistan are: (i) complex legal framework, (ii) lack of appropriate tax incentives, (iii) limited exit options, (iv) restrictions on institutional investors to participate in venture capital funds, (v) unavailability of data on foreign funds' participation in local firms and (vi) inadequate institutional support.[9] As of end-FY08, the sector accounted for a mere 0.3 percent of aggregate assets of the non-bank financial sector. Currently, there are 4 operative venture capital firms, a summary of whose financial position is given in **Table 8.9.**

Table 8.9: Financial Position of Venture Capital Companies

million Rupees

	FY04	FY05	FY06	FY07	FY08
Equity	640.1	2,614.0	2,474.4	3,931.1	1,701.8
Liabilities	364.7	586.4	1,656.5	129.9	279.2
Assets	1,004.9	3,200.4	4,130.8	4,061.0	1,980.9
Income	23.0	33.2	66.3	30.6	29.9
Expense	61.5	42.3	205.6	118.5	91.4

Source: Annual Audited Accounts

Notably, one of the 4 VC companies launched the pioneer venture capital fund in the country in 2007, which provides financing at the start-up stage for businesses in the telecom, media and technology sectors, while 2 of the companies are mainly involved in business process outsourcing since 2001.

In terms of financial performance, the asset base of the sector declined by 51 percent due to the slowdown in the economy, and the sector continues to incur a loss on an aggregate basis, which has taken its toll on the equity base which has also reduced by around 57 percent in FY08. Incidentally, one of the companies issued right share in FY08 due to which it managed to stay afloat despite incurring a loss in FY08.

With the onset of the gradual improvement in the macroeconomic environment, prospects for the growth of the sector are expected to improve. SECP's framework for the promotion and development of VC business in Pakistan i.e. the framework for "Private Equity & Venture Capital Funds" in FY09 is expected to yield results with the improvement in the economy.[10]

8.2.4 Modarabas

The concept of Modaraba, a shariah-compliant mode of financing, was first introduced in the financial sector in Pakistan in 1980 with the promulgation of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance. Since the inception of Modaraba companies, which constitute the second-largest NBFI sub-group (after mutual funds) in terms of the number of entities, various policy initiatives have been introduced for the promotion and growth of the sector. Upto FY06, the modaraba sector's operations were based on three financing agreements, namely Musharika, Murabaha and Ijarah, which were approved by the Religious Board in the early 1990s. In FY08, SECP extended the list of the approved financing modes to 11 by including 8 more Model Financing Agreements which were approved by the

[9] Details in Chapter 8, Financial Stability Review 2006, State Bank of Pakistan.
[10] Details of the framework in Chapter 10, Financial Stability Review 2007-08, State Bank of Pakistan.

Religious Board. Additionally, a conceptual framework for the issuance of sukuks by modaraba companies, with a tenor of 90 to 365 days, was also approved.[11] Both these initiatives are aimed at providing an enabling environment for modaraba companies to enhance their outreach, foster product diversification and ensure sustainable growth. Changes in the Modaraba Ordinance 1980, as well as the Prudential Regulations are underway to promote good governance and to ensure that the policy climate remains conducive to the growth of the sector.

Notably, with 27 operative modarabas as of end-FY08, the sector suffers from fragmentation given the presence of a number of small and weak players in the industry. There is heavy concentration of both assets and equity among the top 10 modarabas in the sector, which hold 86.0 percent of the total asset base and 77.0 percent of equity (**Table 8.10**).

Table 8.10: Concentration in Modaraba Sector
percent

	Assets			Equity		
	FY06	FY07	FY08	FY06	FY07	FY08
Top 3	37.7	44.6	42.0	29.6	44.8	47.0
Top 5	56.8	66.8	64.0	42.6	56.0	57.0
Top 10	77.2	76.0	86.0	59.7	76.0	77.0

Source: Annual Audited Reports

The aggregate asset base of the modarabas which had been increasing at an average rate of 20 percent per annum from FY04 to FY07, grew by only 12.4 percent in FY08, in response to dissipating demand pressures in the economy and competition from the banking sector. However in contrast with IFCs, this growth in assets is driven by expansion of the advances' portfolio rather than investments, which indicates a focus on core business activities. Notably, modarabas are relatively less dependent on borrowings as their primary source of funds, and tend to mobilize deposits in the form of Certificates of Investment (**Table 8.11**).

Table 8.11: Key Performance Indicators of Existing Modarabas
Amount in Rs. Billion, Growth in percent except in case of ratio

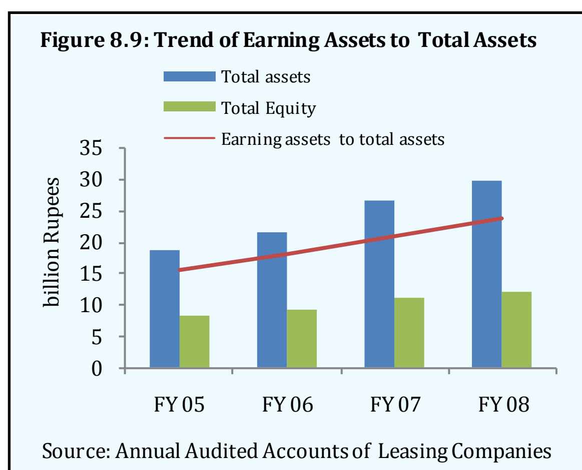
	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Total Assets	12.3	12.4	14.8	18.5	21.6	26.4	29.6
Growth in Assets	5.1	1.1	19.0	25.1	16.7	22.3	12.4
Lease finance to total assets	49.8	54.3	51.6	53.1	51.0	44.8	40.5
Investments to assets	15.6	11.5	17.2	16.7	17.5	19.6	22.2
Murabaha/Musharika to total assets	16.2	17.7	13.4	14.1	15.5	15.5	17.9
Earning assets to total assets	81.6	83.6	82.1	83.9	84.0	79.9	80.6
Debt to equity ratio	0.9	0.7	1.0	1.1	1.3	1.2	1.3
Income to expense	124.7	130.9	138.3	125.1	113.6	116.3	119.7
Return on average assets	5.6	7.1	6.1	4.1	2.3	3.2	3.3
Return on average equity	12.0	14.4	12.6	9.0	5.4	7.6	8.0

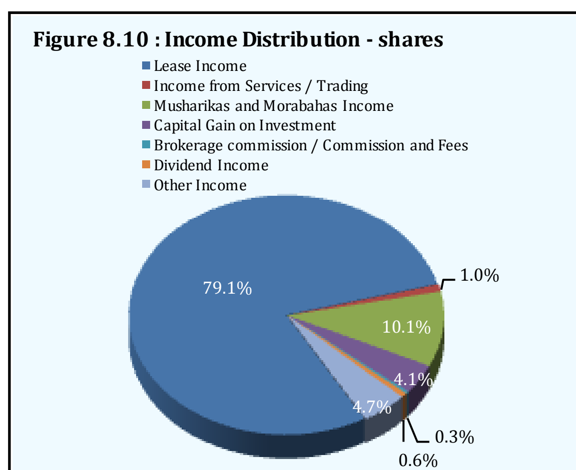
Source: Annual Audited Reports

Earning Assets of Modarabas have a predominant share of lease finance (40.5 percent) whereas financing on the basis of Musharika and Murabaha constitute 17.9 percent of total earning assets. Earning assets as a proportion of total assets have maintained an average level of 82 percent since FY02, which is a commendable achievement given the difficult economic and competitive environment, specifically over the period of assessment (**Figure 8.9**).

The composition of income (**Figure 8.10**) shows modaraba companies' reliance on lease income. Despite all odds, the modaraba sector has successfully maintained its profitability level as evidenced by the RoA and RoE at 3.3 and 8.0 respectively, for FY08.

[11] SECP Circular No. 6, dated May 8, 2008

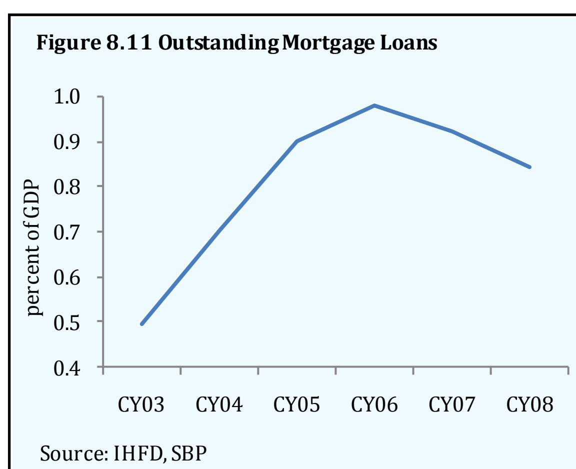




Subsequent to the enhancement in the modes of financing agreements from 3 to 12 by SECP last year, it is expected that the newly introduced modes would provide the requisite opportunities for investments in this sector over time, and contribute to the gradual expansion of Islamic financial services in the country.

8.2.5 Housing Finance

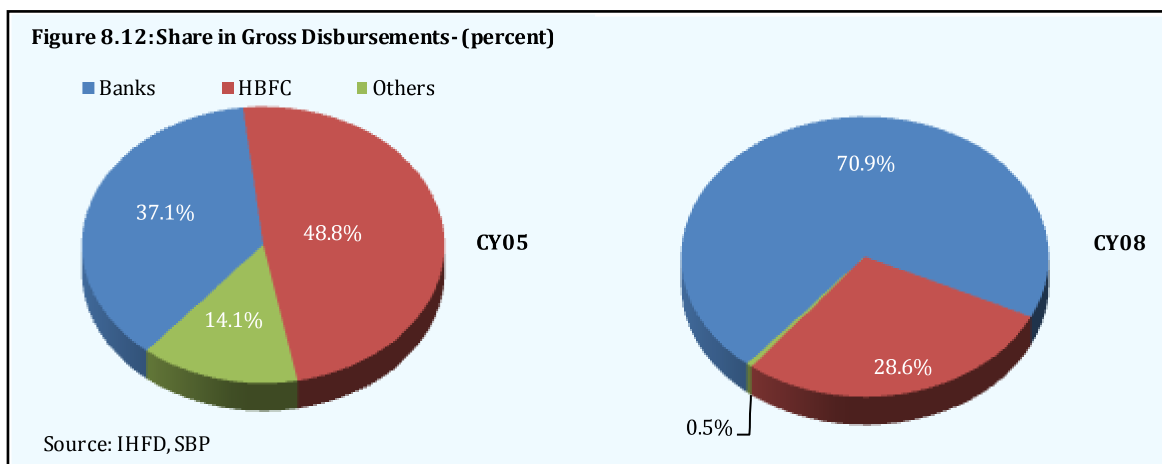
The facility of housing finance offered by various financial institutions is still at an evolutionary stage due to both demand and supply side factors. Up to CY04,[12] total outstanding housing finance was only 0.49 percent of GDP which then gradually increased to 0.98 percent by CY06. However due to the slowdown in the economic environment subsequently, outstanding finance has declined to 0.84 percent of GDP at the end-CY08 **(Figure 8.11).**



Mortgage finance in Pakistan is being offered by the Housing Building Finance Corporation Limited (HBFCL), banks and NBFCs licensed to offer housing finance facilities. Over the last three years, i.e. CY06-08, the accumulated gross disbursements (AGD) for housing finance have grown on average by around 26 percent per annum. AGD growth, which had declined by 22.5 percent in CY07, managed to exhibit a healthy growth of 25.6 percent in CY08 to reach Rs.158.9 billion, despite the difficult macroeconomic environment.

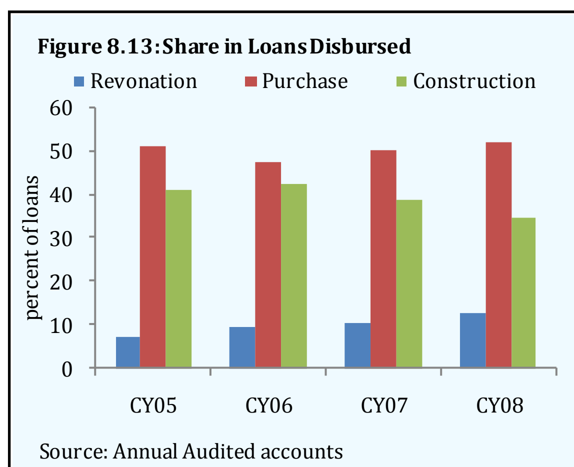
Notably, Pakistan's banking sector has a rather short history in mortgage finance but despite that it has emerged as a major provider of housing finance largely due to access to low cost funds and better outreach. Previously, the state-owned HBFC was the only player in the mortgage market. Institutional data shows that banks' share in the total gross disbursements has reached 71 percent in CY08 in comparison with 34.7 percent in CY05. HBFCL was the major provider of housing finance until CY05, subsequent to which the banking sector has gradually taken over its share in gross disbursements. HBFC's distinct competitive advantage is its outreach in 80 different cities and towns all over Pakistan, providing access to housing finance largely to the low and middle income segment, while commercial banks' preferred client base is generally the high-end income group located in the major cities of the

[12] Analysis in this section is predominantly based on HBFC's financial results reported on a calendar year basis.

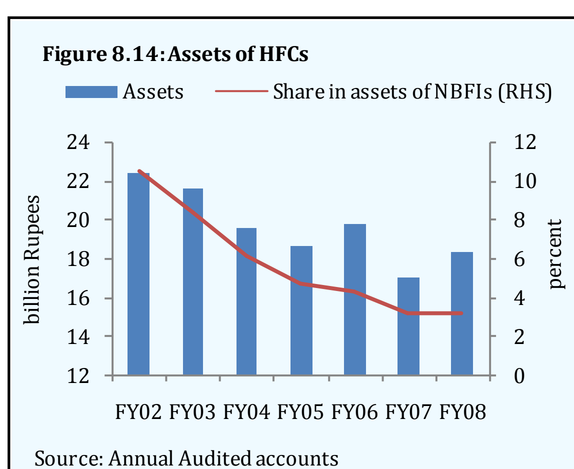


country. This is evident from the fact that out of 493,089 total borrowers, banking sector's borrowers are only 7.8 percent, but the average loan size of banks is higher, at Rs. 2.5 million against the average loan size of Rs.0.86 million for HBFCL.

Mortgage finance is generally extended for three purposes i.e. construction, outright purchases and renovation. During CY08, mortgage loans for renovation, outright purchases and constructions grew by 56.9 percent, 29.3 percent and 12.5 percent, respectively. Consequently, during CY08 the respective shares of housing finance for renovation and outright purchases were 13 percent and 52 percent, in comparison with 10.4 and 50.5 percent respectively in CY07. On the other hand, the share of construction has decline to 35.0 percent as compare to 39.1 percent in CY07 **Figure 8.13.**



The following section gives an overview of the financial performance of HBFCL and the sole NBFC offering housing finance facilities, i.e. Asian Housing finance Limited (AHFL). In term of assets, HBFC has a share of 99.2 percent. During FY08, aggregate assets of HBFCL and AHFL increased by 7.8 percent to reach Rs.18.4 billion, as compared to a decline in growth by 13.7 in FY07. As a result, the share of HFCs in the overall NBFIs assets increased marginally to 3.13 percent in FY08, as compared to 3.12 percent in FY07 **(Figure 8.14).** During FY08, HBFC's assets grew by 7.9 percent to reach Rs.18.2 billion, whereas AHFL's assets declined by 7.0 percent to Rs.146.5 million. In contrast to FY07, net housing loans of HBFCL grew by 25.3 percent to reach Rs. 18.2 billion in FY08. Notably, HBFCL which had substantially high provisioning expenses against non-performing advances of Rs.2.2 billion, recorded a reversal in provisioning of Rs. 593.2 million in FY08.



In terms of key performance indicators, both HFCs have a clear focus on sustaining core business activities as evidenced by the proportion of housing finance in total assets (**Table 8.12**) and investments form a declining share of only 13.4 percent. Earning assets, which had declined by 20.5 percent in FY07, grew significantly by 13.7 percent in FY08, due to which the earning assets to total asset ratio improved from 80.8 percent in FY07 to 85.3 percent in FY08. Notably, HFC's gearing ratio increased to 5.0 in FY08, as compare to 3.8 in FY07.

Table 8.12: Aggregate Performance Indicators of HBFCL and AHFL*

percent (except in case of ratio)

	FY04	FY05	FY06	FY07	FY08
Housing Finance to Total Assets	61.8	66.4	66.0	61.9	71.8
Investments to Total Assets	9.1	18.1	21.7	18.9	13.4
Earning Assets to Total Assets	70.9	84.5	87.7	80.8	85.3
Growth Rate of Leasing Finance	8.0	2.8	5.1	-19.0	25.1
Debt to Equity Ratio	3.1	2.8	2.8	3.8	5.0
Average Spread	8.9	9.9	10.8	12.1	4.0
Net Interest Margin	8.9	10.0	11.0	12.2	5.4
Income to Expense	57.4	110.6	176.6	43.0	97.0
Return on Average Assets (After Tax)	-3.3	-1.5	0.7	-3.2	-2.2
Return on Average Equity (After Tax)	-14.7	-6.8	3.2	-15.8	-14.0

* Asia Housing Finance Ltd (AHFL) is the only NBFC engaged in providing housing finance.

Source: Annual Audited Account and SBP Calculations

Higher financial leverage indicates a continuous reliance on borrowings particularly in case of HBFCL, which holds almost 99.96 percent of the total borrowing of HFCs at concessional rates largely from SBP and the government. Additionally, during FY08, HBFCL also raised funds through the issuance of Sukuk Certificates worth Rs. 1.5 billion, for a 5 year tenor, to various banks and other financial institutions under musharika arrangements.[13] Fund raising through Sukuk certificates is relatively costlier than the cheap funding available from SBP and the government. Since the last couple of years, HBFCL has had relatively higher spreads and net interest margins (NIM) largely due to the availability of these cheap funds, but raising funding through a market based instrument has served to narrow the spread. Resultantly, both the average spread and NIM have reduced to 4.0 percent and 5.4 percent respectively in FY08 as compared to 12.1 percent and 12.2 percent in FY07. On the other hand, both ROA and ROE continue to be negative due to the losses incurred by the HFCs during FY08.

In a bid to convert HBFCL into a commercial mortgage lender, the DFI was incorporated as "HBFC Limited" under the Banking Companies Ordinance 1984 in July, FY08. At present, its paid up capital is Rs 3.5 billion, of which 53.6 percent is held by the government and the remaining 46.4 percent is contributed by the SBP. HBFC is in the process of raising its paid-up capital to Rs 6.0 billion in line with SBP's minimum capital requirement for banks and DFIs.

The only one housing finance company i.e. AHFL operating under the NBFC regulatory framework is on the verge of closure due to its inability to comply with the minimum capital requirement set forth by SECP. During FY08, the equity of the company has eroded further to Rs 129.5 million from Rs. 133.6 million in FY07, mainly on account of the net loss incurred during the year. According to SECP's NBFC Regulations 2008, the minimum capital requirement for existing housing finance companies is Rs. 300 million as at endFY08, which would progressively increase to Rs. 700 million by end-FY10. Consequently, AHFL's management has decided to convert the company into a microfinance bank for which the

[13] These Sukuk certificates have a mark-up rate of average six months KIBOR plus 1 percent per annum. The duration of these Sukuk certificates is 5 years i.e. from November 2009 to May 2014.

capital requirements is substantially lower. A formal request has been sent to SBP for the granting of license for AHFL to operate as a microfinance bank based in the Southern Punjab Region.

8.2.6 Development Finance Institutions

Development Finance Institutions (DFIs) were first established in Pakistan during the 1950s with the objective of fostering economic development by providing long term financing facilities to the industrial sector. International Financial institutions (IFIs) played a major role in establishing DFIs in Pakistan and providing access to foreign exchange resources. In later years, a few DFIs were also formed as joint venture concerns between the Government of Pakistan and the Governments of countries such as Libya, Kuwait etc.

At the initial stage, DFIs performed remarkably well in terms of accelerating the pace of industrialization in the country. However, given that their operations were financed by foreign credit lines, their performance deteriorated when these credit lines eventually dried up. Most of these organizations were not able to mobilize a sustained flow of domestic resources for financing their operations subsequently. Additionally, some DFIs also suffered from poor governance which particularly impacted the rate of recovery of their loans, and hence their overall financial performance.[14]

Consequently, DFIs' role as providers of long term financing diminished over time; some of them were liquidated while still others chose to merge with commercial banks. The remaining few players in the industry concentrated on generating income from investments or by offering financial services best suited to commercial banks, such as consumer finance.

As of end-CY08, there are 7 DFIs operating in Pakistan, all of which are joint ventures[15] between the Government of Pakistan with
Governments of Saudi Arabia, Iran, Brunei, Kuwait, Libya, China and Oman. Both Pak-China Investment Company and Pak-Iran Investment Company started their operations in 2008. These DFIs operate under the broad objective of facilitating investment in the country and improving bi-lateral relations.

In term of financial indicators, DFIs' asset base declined by 10.7 percent to Rs. 85.1 billion by end-CY08 (**Table 8.13**), which is the upshot of slowing economic activities which have adversely impacted the entire financial sector. Distribution of assets among the 7 DFIs indicates a low degree of concentration, especially with the inclusion of the 2 new DFIs in CY08 (**Figure 8.15**).

Table 8.13: Financial Position of DFIs

billion Rupees

	CY05	CY06	CY07	CY08
Assets	107.8	116.9	95.3	85.1
Lending to FIs	8.3	17.0	18.9	7.1
Investments	43.1	37.9	37.5	36.1
Advances	42.1	41.7	23.0	23.7
Liabilities	73.8	79.6	54.6	38.8
Borrowing from FIs	35.0	50.0	44.5	32.4
Deposits/COIs	35.2	26.1	7.6	4.5
Equity	34.0	37.4	40.7	46.2

Source: Annual Audited Accounts of DFIs

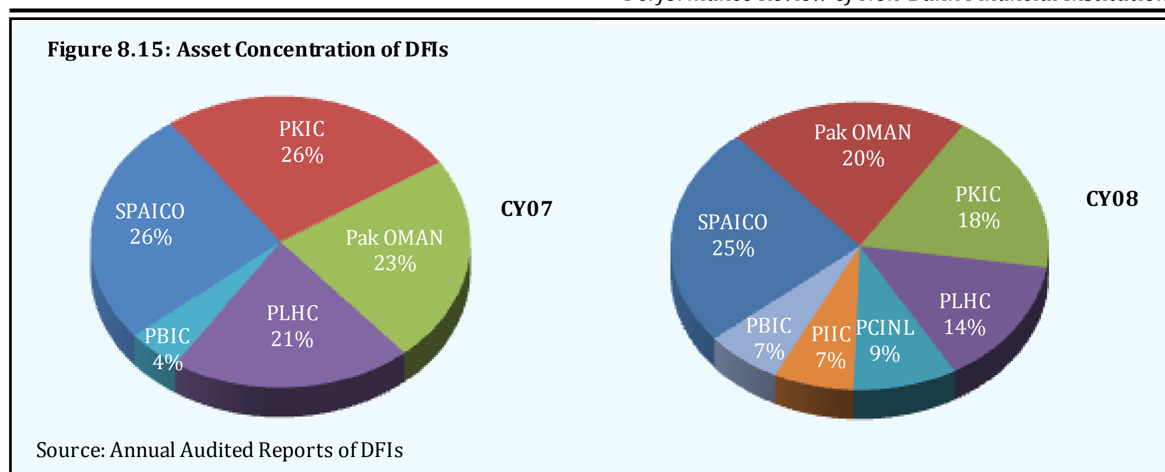
Asset composition of the DFIs indicates that in the last few years, advances have constituted a declining share, while investments and placements with other financial institutions have formed a lion's share of assets **(Table 8.14),** indicating a shift away from the core business of such institutions.

However, the performance of the new entrants in CY08 is noteworthy in terms of growth in the advances' portfolio, which has offset the negative growth in advances of the existing

[14] Detailed historical background is given in Chapter 6, Pakistan Financial Sector Assessment 2004, State Bank of Pakistan.

[15] House Building Finance Corporation is also a DFI, however its assessment is given under the category of Housing Finance Companies.

Figure 8.15: Asset Concentration of DFIs



Source: Annual Audited Reports of DFIs

players in the market. As a result, share of advances in total assets has risen to 27.8 percent in CY08, from 24.2 percent during CY07. A breakup of the investment portfolio indicates that the share of government securities, corporate debt instruments (TFCs/PTCs) and the equity market has been rising, and that collectively these securities constitute around 84 percent of total investments during CY08 (**Table 8.15).**

Funding composition of DFIs shows that 92.4 percent of total assets are primarily funded by equity and borrowings from financial institutions **(Table 8.16).** With the entry of new DFIs coupled with fresh capital injection by some existing DFIs, share of equity capital has been consistently rising, and has reached 54.4 percent by end-CY08, as compared to 42.7 percent in CY07. Notably, reliance on borrowings from financial institutions has reduced to 38 percent as compare to 46.7 percent during CY07, largely due to the high financing cost. On the other hand, the share of deposits/CoIs has been declining consistently and now constitutes 5.2 percent of total assets at end-CY08, as compared to a relatively higher share of 32.6 percent in CY05.

Table 8.14: Asset Composition of DFIs

share in assets

	CY05	CY06	CY07	CY08
Lending to FIs	7.7	14.5	19.8	8.4
Investments	40.0	32.4	39.3	42.4
Advances	39.1	35.7	24.2	27.8
Bal With Banks	8.8	9.6	9.9	12.1
Other	4.4	7.8	6.7	9.3

Source: Annual Audited Accounts of DFIs

Table 8.15: Investments Portfolio of DFIs

percent of total investment

	CY05	CY06	CY07	CY08
Govt. Securities	12.9	14.8	17.2	32.1
Quoted Shares	20.3	23.7	26.2	32.0
TFCs/PTCs	8.0	8.9	13.3	19.9
Subsidiaries	11.0	11.5	11.6	8.0
Others	47.9	41.2	31.7	7.8

Source: Annual Audited Accounts of DFIs

Table 8.16: Funding Composition of DFIs

percent of assets

	CY05	CY06	CY07	CY08
Equity	31.5	32	42.7	54.4
Borrowing from FIs	32.5	42.8	46.7	38.0
Deposits	32.6	22.4	8.0	5.2
Others	3.4	2.9	2.6	2.4

Source: Annual Audited Accounts of DFIs

The funding composition shows that DFIs lack a sustained source of funding, which is essential for the sustainability of business and commercial viability. In order to enforce their role as providers of long term finance, there is a need to supplement their fund base through low cost funds such as deposits.

During CY08, DFIs' capital to RWA and tier 1 capital to RWA ratios improved further to 58.4 percent and 57.3 percent respectively, from 44.4 percent and 42.1 percent in CY07 **(Table 8.17).** The strong capital base is a healthy sign for DFIs operating in Pakistan because it provides protection against unanticipated losses. The key asset quality indicators

deteriorated significantly during CY08. During CY08, total NPLs grew by 147 percent to Rs. 5.7 billion, whereas advances grew by only 2.3 percent. Factors such as high interest rates, inflation and a slowdown in business activities are hurting borrower's capacity. Provisioning to NPLs ratio also deteriorated to 64 percent in CY08, as compared to 87.7 percent in CY07. The impact of higher provisioning expenses is also visible in DFIs' profitability indicators.

Table 8.17: Key Performance Indicators of DFIs

percent

	CY05	CY06	CY07	CY08
Capital RWA Ratio	17.2	32.9	44.4	58.4
Tier I Capital to RWA ratio	15.1	30.4	42.1	57.3
Capital to Liability ratio	50.5	51.8	74.5	119.1
Equity to Assets ratio	34.6	35.2	42.7	54.4
NPLs to Loans (Gross)	49.4	15.2	8.6	20.9
Net NPLs to Loans	18.5	8.6	1.1	7.5
Provisions to NPLs	62.5	43.1	87.7	64.0
Earnings to total assets	86.8	82.6	83.4	91.8
Expense to total income	45.9	68.8	58.2	89.5
ROA (after tax)	5.5	2.6	2.5	1.3
ROE(after tax)	16	7.5	6.5	2.6
Net Interest Margin	1.9	1.4	2.1	4.2
Liquid assets to total assets	14.2	15.3	17.3	38.8

Source: Annual Audited Accounts of DFIs

8.2.7 Mutual Funds

Mutual fund industry in Pakistan witnessed an era of rapid growth since FY02 with an average growth rate of about 57 percent for the period FY02-FY08. Net Assets reached the highest ever level of about Rs. 425 billion in April FY08 when the stock market was at its peak. However the rapid decline of the market in FY09 had an adverse impact on the mutual funds sector. Net assets of the mutual funds industry reduced to Rs. 203.9 billion at end FY09, as compared to Rs. 334.8 billion in FY08 (**Table 8.18**). Notably, both the imposition of floor of 9,144 points on the KSE-100 index and revaluation of TFCs in an environment of rising interest rates had an influence on assets under management (AUM).

Table 8.18 : Structure of Mutual Funds

billion Rupees, Share in percent

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09*
Net Assets	24.8	51.6	93.7	125.8	159.9	289.1	334.8	203.9
Share by Ownership (in percentage)								
Public Sector	89.6	78.5	52.8	48.5	40.2	31.5	25.4	24.62
Private Sector	10.4	21.5	47.2	51.5	59.8	68.5	74.6	75.38
Share by Type (in percentage)								
Open-end Funds	78.1	78.2	73.6	70.1	72.7	82.4	86.1	86.1
Closed-end Funds	24.9	21.8	26.4	29.9	27.3	17.6	13.9	13.9
Share by Category (in percentage)								
Equity Funds	92.2	81.2	76.5	72.8	63	47.3	41.6	40.3
Income Funds	0	6.6	6.4	6.2	10.6	24.4	24.9	24.9
Money Market Funds	0	4.6	3.6	3.9	7.3	15	17.2	14.7
Balanced Funds	6.7	5.8	10.3	9	7.2	4.6	4.9	4.4
Islamic Funds	1.1	1.8	3.2	4.7	5.6	4.9	6.2	9.2
Tracker Funds	0	0	0	0	0.6	0.5	0.2	0.2
Fund of Funds	0	0	0	0.4	0.5	0.3	0.6	0.5
Others	0	0	0	0	0	3	4.5	5.8

* Data from MUFAP

Source: Annual Audited Accounts of Mutual Funds

These developments impacted both income funds and equity funds, resulting in substantial withdrawals and decline in NAV (**Table 8.19**). Alongside domestic developments, the global financial crisis has had an adverse impact on the global mutual funds industry (**Box 8.1**).

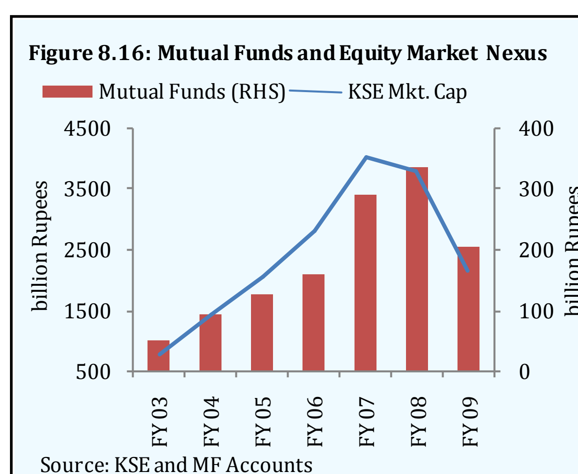
Table 8.19: Mutual Funds Performance Since October 08

billion Rupees, Share in percent

	Oct-08	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09
Net Assets	240.1	222.2	179.8	173.6	177.8	196.1	203.3	203.3	203.9	214
Share by Ownership (in percentage)										
Public Sector	23.66	25.57	23.34	24.29	24.5	24.17	24.32	24.32	24.62	23.5
Private Sector	76.34	74.43	76.66	75.71	75.5	75.83	75.68	75.68	75.38	76.5
Share by Type (in percentage)										
Open-end	78.1	78.2	73.6	70.1	72.7	82.4	86.1	86.1	86.1	85.8
Closed-end	21.9	21.8	26.4	29.9	27.3	17.6	13.9	13.9	13.9	14.2

Source: MUFAP

Figure 8.16: Mutual Funds and Equity Market Nexus



Source: KSE and MF Accounts

The mutual funds sector has grown rapidly in the last few years (**Figure 8.16**), and accounted for the largest chunk of (more than 50) percent in total assets of the non-bank financial sector in FY08. Between FY02 to FY08, net assets of mutual funds have grown by more than 13 times to reach Rs. 334.8 billion by the close of FY08. Mutual fund industry is directly related to equity market as can be seen from the figure. The correlation between KSE 100 index and mutual fund industry is quite high at 0.94. The mutual fund industry has a huge exposure in equity market and any development in equity markets directly affects the mutual fund industry. One interesting feature of the mutual fund industry is that when the equity market goes up it beats the overall market in terms of earnings and vice-versa in case of slump It could be seen in figure that equity market and mutual funds industry move in same direction with an increase in equity market activities mutual fund assets grow and vice versa when the equity market goes down.

Asset Allocation

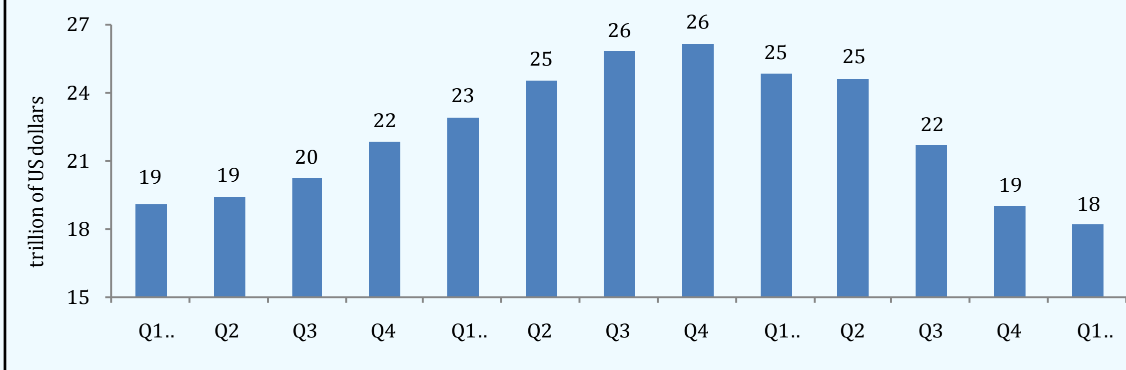
Asset allocation trends of mutual funds reveals that majority of the investments of mutual funds is in equity market (**Table 8.20**). Equity securities and CFS investments constituted about Rs. 106 billion in FY09, around 52 percent of the total assets of the mutual funds sector. Asset allocation trends indicate that there were no specific guidelines for categorization in the industry which lead to difficulties when the stock market declined in value and TFC redemptions were frozen. SECP has now introduced categorization rules for the mutual funds industry which will be implemented within 6 months from the date of issue.[16]

[16] Circular No. 7 of 2009, March6, 2009, Categorization of open-end Collective Investment schemes

Box 8.1: Worldwide Mutual Fund Assets and Flows

Mutual fund assets worldwide decreased further in first quarter CY09 by about one trillion US dollars over the last quarter CY08. Mutual fund assets globally decreased to $18.15 trillion at the end of the first quarter of CY09 from $19 trillion in last quarter of 2008 by 4.0 percent. Net cash flow to all funds stood at $45 billion in the first quarter, compared to $95 billion of inflows experienced in the last quarter of CY08. Net outflows from long-term funds slowed to $18 billion in the first quarter after an average outflow of $296 billion per quarter in the second half of CY08. Net outflows from equity funds were $41 billion and net outflows from balanced funds were $22 billion in the first quarter, decline from $121 billion and $56 billion of outflows, respectively, in the last quarter of CY08. Bond funds experienced net inflows of $59 billion in the first quarter compared with net outflows of $157 billion in the last quarter of 2008. Net flows into money market funds declined sharply to $63 billion in the first quarter of 2009 from $444 billion of net inflows in the fourth quarter of CY08.

Figure 1: Worldwide Mutual Funds Assets



The prolonged slowdown in equity markets worldwide further hampered equity fund assets. On a U.S. dollar–denominated basis, equity fund assets fell 9.0 percent in the first quarter, with $5.9 trillion in assets at the end of the first quarter of CY09. Balanced fund assets declined 5.9 percent in the first quarter. Relative to year-end CY08, both bond fund assets, at $3.4 billion, and money market fund assets, at $5.8 billion, were about unchanged at the end of the first quarter of CY09.

At the end of the first quarter of 2009, 33 percent of worldwide mutual fund assets were held in equity funds as compared to 48.2 percent in last quarter of 2007. The asset share of bond funds was 19 percent and the asset share of balanced funds was 9 percent which remains almost the same over the same period. Money market fund assets represented 32 percent of the worldwide total in last quarter of CY09 as compared to 17.7 percent in last quarter of CY07.

Table: Net Sales Of Mutual Funds Worldwide

billions U.S Dollars

	2007				2008				2009
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
All Funds	410	431	316	382	394	2	-211	95	45
Long Term	276	293	37	131	-92	73	-242	-349	-18
Equity	114	99	31	84	-132	29	-147	-121	-41
Bond	67	97	-50	-30	13	14	-67	-157	59
Balanced/Mixed	69	62	23	42	-15	15	-23	-56	-22
Other	26	35	32	36	41	15	-5	-16	-15
Money Market	133	138	279	250	486	-70	31	444	63

Source: National mutual fund associations USA

Table 8.20: Asset allocation by nature of Mutual Funds in FY09

Nature	Total Assets	Govt. Sec.	Equity Sec.	Debt Sec.	Other Inv.	CFS	Rev. Repo	Bank Bal	Others
Asset Allocation	5.4	0.2	3.5	0.3	0.1	0.1	0.1	1.1	0.2
Balanced	9.1	-	5.3	1.3	0.4	0.4	-	1.5	0.2
Capital Prot.	3.9	-	0.3	0.1	-	-	-	3.3	0.3
Equity	81.4	0.0	74.0	0.5	2.2	0.3	-	2.7	1.8
Fund of Funds	1.1	0.0	0.9	-	-	-	-	0.1	0.1
Income	70.8	0.5	0.5	27.1	6.9	9.0	0.2	22.3	4.5
Index	4.7	-	3.6	*0.0*	0.2	-	-	0.8	0.2
Islamic	14.6	0.3	7.4	2.5	0.3	-	-	3.6	0.4
Money Market	11.5	0.1	0.0	4.4	2.3	0.4	-	4.0	0.3
Sector	1.3	-	0.6	0.5	-	-	-	0.2	0.0
Total	203.9	1.1	95.8	36.7	12.3	10	0.3	39.5	8

Source: FSD Calculations

Sales and Redemption Patterns

Profitability of the mutual fund sector has remained a function of sales and investment income. The mutual fund sector has always maintained sizeable investment portfolio, predominantly concentrated in the stock market. Equity investment, while contributing significantly towards the profitability in the form of dividends and capital gains - attributable to the then booming stock market - also served as a source of liquidity.

The recent downturn in the economy, also coinciding with the turmoil in the international financial markets, has its inverse effects on the growth prospects of the mutual fund business. The meltdown of the stock market has exerted further pressure on the sector's profitability and liquidity. Although the imposition of the floor halted the rising revaluation losses, it hampered the market mechanism of price discovery and voluntary exit from the market.

Mutual funds, given their inherent advantages and tax exemptions attract both individual and corporate investors. **Table 8.21** shows the sales and redemption pattern of the mutual fund industry for the period FY01 to Q1-FY09. In FY 07 the industry managed to attract 88 billion of new investments followed by 39.5 billion in FY 08. The mutual fund industry registered growth in both number of funds and assets value. The favorable environment in equity market is a major factor behind the enormous capital gains of the mutual fund industry.

Table 8.21: Sales and Redemption Patterns

billion Rupees

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	Q1-FY09
Redemptio	0.5	3.1	8.8	20.2	26.1	52.6	148.6	465.6	76.4
Sales	0.7	2.0	12.8	30.3	29.1	66.0	236.7	505.1	64.3
Net Sales	0.3	-1.0	4.0	10.1	2.9	13.4	88.1	39.5	-12.2

Source: MUFAP

In the near future, the performance of the mutual funds industry will rest largely on the revival of the economy, restoration of investors' confidence and improvement in corporate earnings.

8.3 Conclusion

The non-bank financial sector can potentially play an important role in mobilizing financial savings, along with its significant role in meeting the diverse financing needs of various

sectors of the economy. However, banks' foray into business segments traditionally served by NBFIs has resulted in competitive pressures which the NBFIs have not been able to sustain given their dependence on borrowings from banks to finance business operations. In order to remain commercially viable, NBFIs need to re-align their business strategies with the needs of the economy, focus on their core business functions, diversify their product base, and devise new methodologies of mobilizing savings to fund their business activities to reduce their reliance on borrowings.

On the regulatory side, major differences in the regulatory approach towards banks and NBFIs can lead to regulatory arbitrage, which can pose significant challenges for financial stability. A risk-based approach to oversight and effective enforcement of laws is particularly important in the case of deposit-taking institutions, to prevent the social implications of excessive risk-taking. In the absence of a financial safety net framework and insolvency regime in the country, protecting depositor's interest is of paramount importance.

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