

5 PERFORMANCE REVIEW OF NON-BANK FINANCIAL INSTITUTIONS

5.1 Overview

Non-Bank Financial Institutions (NBFIs) include Non-Bank Finance Companies (NBFCs), Mutual Funds, Modarabas and Development Finance Institutions (DFIs). During FY09,¹ NBFIs' assets declined by 19.7 percent (YoY) to reach Rs. 470.1 billion, as against average annual growth of 18 percent from FY04-FY08. The number of operative entities in FY09 was 233,² in comparison with 237 in FY08. The size of the total assets of the sector relative to GDP at 3.4 percent, and total financial sector assets at 5.3 percent, is small, as is the proportion of its deposits in the total deposits of the financial sector at 1.0 percent.³ 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 5.1: Assets of NBFIs

Growth rates and share in percent

	FY04	FY05	FY06	FY07	FY08	FY09
Assets (Rs. Billion)	318.1	393.7	462.3	567	585.6	470.1
Growth rate	22.7	23.8	17.4	22.7	3.3	-19.7
<i>Share in Assets</i>						
Mutual Funds	32.4	34.6	38.3	55.3	58.5	47.9
DFIs*	29.8	27.4	25.3	16.8	14.5	24.2
Leasing	14.1	13.6	13.8	11.3	11.0	11.9
Investment Finance	11.2	13	11.8	7.9	7.4	6.6
Modarabas	5.7	5.5	5.2	4.6	5.1	4.9
Housing Finance*	6.1	4.7	4.3	3.1	3.1	4.0
Venture Capital	0.3	0.3	0.7	0.7	0.3	0.5
Discounting	0.4	0.4	0.4	0.2	0.0	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 terms of their share in total assets is presented in **Table 5.1**. As is clearly visible from the data, mutual funds lead the sector, even though their share in total assets declined to 47.9 percent by end-FY09, after growing consistently during FY04-FY08. Similarly, shares of Investment finance companies and modaraba companies have also reduced to 6.6 percent and 4.9 percent respectively. On the other hand, the share of DFIs, which had been consistently declining since FY04, improved to 24.2 percent in FY09, while those of leasing companies and venture capital companies also improved during the year. Notably, Mutual Funds represent the only sub-category which has recorded remarkable growth year after year, despite the setback in H1-FY09 with the virtual closure of the stock market for almost 4 months.⁴

Notably, NBFIs faced a rather difficult operating environment in FY09. Struggling to remain commercially viable even in normal circumstances, these financial institutions were particularly hit hard by the slowdown in the economy and associated deterioration in

¹ The analysis of NBFCs and Modarabas is based on Annual Audited Statements as of June 30, 2009, whereas DFIs' data is of end-December 2009. 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, 2010 in this report. However, where possible, statistics on numbers of companies and licenses issued etc have been updated upto June 30, 2010, in line with the information received from SECP.

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

³ All shares for bank data as of end-Dec CY09.

⁴ A minimum floor was placed on the KSE-100 index from end-August 2008 to mid-December 2008, effectively blocking investor's exit from the equity market.

macroeconomic indicators, substantial decline in the KSE-100 index with a major reliance of the mutual funds sector in equity investments, high interest rates and liquidity strains in the banking sector in H1-FY09 with a consequent impact on NBFCs' credit lines with them. 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-FY10 is presented in **Table 5.2**. As SECP allows each NBFC to hold multiple licenses, 72 NBFCs hold 78 licenses for providing various financial services as permissible under the NBFCs rules. During FY10, SECP granted 19 new licenses, all of which were for conducting asset management services through mutual funds, while no new license was granted for any other business category (**Table 5.3**).

5.2 Regulatory Developments

During FY09, SECP took several regulatory measures⁵ to address ongoing concerns regarding the need to foster sustained growth of the sector by enhancing market outreach, promoting product innovation, and enhancing the capital base. Furthermore, during FY10, with the objective of addressing emerging challenges for the sector, several amendments were also made by SECP in the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003.⁶ These amendments entailed extending the validity period for issued NBFC licenses from one year to three years, in order to: (1) address the 'going concern' issue often raised by the stakeholders, especially the depositors and lenders, and (2) save the time and cost in renewing these licenses every year. SECP has also provided operational flexibility to investment finance companies by allowing them to undertake brokerage business from their own platform instead of forming a separate company. This new regulatory amendment aims to encourage a more viable and sustainable business model for investment banks and enables them to focus more on non-fund based financial services.

5.3 Operating Environment

While SECP remains responsive to the sector's development needs and continues to introduce ongoing amendments to the NBFC Rules, a tangible impact of these various regulatory changes on the performance of NBFCs is still to be seen. This is mainly due to the stiff competition these financial institutions face from the banking system, in addition to the general slowdown in the economy since FY08. The financial indicators of the NBFCs as a group show that these financial institutions do not have the capacity to withstand adverse shocks or emerging economic challenges. The primary reason for this situation is their

Table 5.2 : Number of NBFIs

	FY03	FY07	FY08	FY09	FY10
DHs	4	1	1	0	0
VCCs	3	4	4	3	3
HFCs	3	3	2	1	1
DFIs	6	5	6	8	8
IFCs	12	8	11	9	8
Leasing	27	12	12	11	9
Modarabas	37	27	27	27	26
M. Funds	38	66	95	102	121
Total	130	126	158	161	176

Source: SECP

Table 5.3: Licenses held by NBFIs in FY10

NBFIs	No. of Entities	No. of Licenses
DFIs	8	
NBFCs	21	
-Investment Finance		8
-Leasing		14
-Housing Finance		2
-Venture Capital Investment		3
-Discounting		0
-Investment Advisory and Asset management		51
Mutual Funds	121	
Modaraba Management Companies	40	
Modarabas	26	

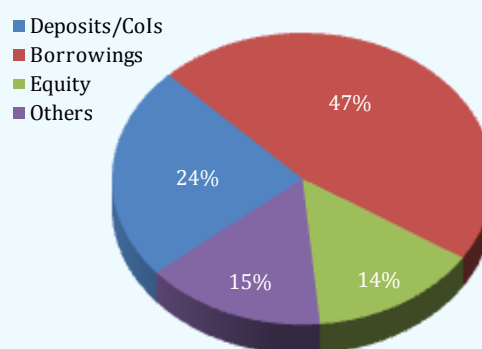
Source: SECP

⁵ Details of NBFCs and NE Regulations, 2008 is given in Chapter 10, FSR 2007-08, SBP.

⁶ SECP's Press Release dated April 28, 2010.

unsustainable business model. As evident from **Figure 5.1**, NBFCs' funding composition shows that they are primarily dependent on a costly funding source i.e. borrowings from the banking system to run their business, with relatively less support from deposit generation and equity. The extensive reliance on credit lines from banks and other financial institutions continues 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 line dry up, as seen most recently in October FY09.⁷ In order to ensure commercial viability, NBFCs need to diversify their funding base by stepping up efforts to raise funds through deposits, Certificates of Investment (CoIs), etc. Furthermore, in order to expand their outreach, there is need to explore wider target markets with greater business potential. This particularly refers to the efforts of the leasing companies to provide financial services to the Agriculture sector, enabling them to expand outreach in rural areas.

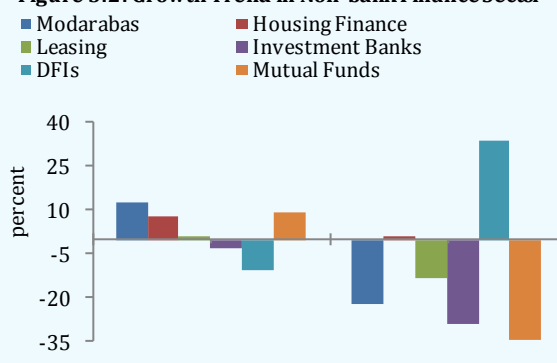
Figure 5.1: Funding Structure of NBFCs- FY09



Source: Annual Audited Accounts of NBFCs

Due to a confluence of factors, FY09 remained difficult for NBFIs as a whole as evident by the decline in asset growth by 19.7 percent, compared to the YoY growth of 3.3 percent and 22.7 percent in FY08 and FY07, respectively. This decline in assets growth emanates mainly from Mutual Funds whose assets declined by 34.4 percent in FY09, compared with average growth of 45.8 percent during FY04-FY08; consequently, the asset size of the mutual fund industry dropped to Rs. 225.2 billion in FY09 from its peak of Rs. 342.6 billion in FY08.⁸ Similarly, the leasing, investment finance, and modarabas sectors also registered negative growth, while DFIs, housing finance and venture capital companies showed some improvement in their respective asset base (**Figure 5.2**).

Figure 5.2: Growth Trend in Non-bank Finance Sector



Source: Annual Audited Accounts of NBFCs

5.4 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. With the banking sector as their predominant competitor, NBFCs' market share in total financial sector assets has been shrinking steadily over the last few years.

As mentioned above, 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 and some NBFCs have

⁷ Details in Chapter 8, FSR 2008-09, SBP.

⁸ The rapid decline of the stock market in FY09, imposition of floor of 9,144 points on the KSE-100 index and revaluation of TFCs in an environment of rising interest rates had adversely impacted the overall mutual funds sector.

Table 5.4: Mergers and Acquisitions from FY03 to FY10

	Name of NBFC/ Modaraba	Name of Company/Modaraba Merged	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.	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
25	Al-Zamin Leasing Corporation Limited	Invest Capital Investment Bank Limited	11-01-2010
26	Al-Zamin Leasing Modaraba	Invest Capital Investment Bank Limited	11-01-2010
27	Askari Leasing Limited	Askari Bank Limited	10-03-2010
28	United Money Market Fund	United Growth and Income Fund	29-06-2010

Source: SECP & KSE

also merged with banks as detailed in **Table 5.4**.

Table 5.5 presents the overall performance indicators of NBFIs (excluding mutual funds and venture capital companies). During FY09, the share of advances in total assets has dropped to a 4-year low of 47.7 percent, mainly due to negative advances' growth of leasing companies, investment finance companies and modarabas. On the other hand, share of investments in total assets has grown to a 5-year high of 34 percent, mainly due to growth in investments of DFI's and housing finance companies.

As a result of the rise in the overall share of investments, the overall earning assets to total assets ratio improved to 85.6 percent in FY09. This substitution pattern of earning assets (investment and advances) - as indicated by their respective shares in total assets - indicates NBFIs' inclination to expand their asset base by increasing investments rather than advances - a risk-averse trend similar to the one seen in the banking sector, given the weak demand for credit.

From FY05 onwards, the cost of deposits and borrowings has increased steadily, mainly due to SBP's tight monetary policy stance and rising interest rates. Owing largely to the higher interest rates, the borrowing to liabilities ratio has declined to 58.1 percent in FY08. On the other hand, deposit to liabilities ratio, after deteriorating in FY08, has improved to 28.7

Table 5.5: Key Performance Indicators of NBFIs*

percent (except in case of ratio)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY08	FY 09
Advances to Assets	42.9	46.9	51.8	51.2	48.6	52.5	47.7
Investments to Assets	36.6	33.3	30.5	27.1	28.7	28.6	34.0
Earning Assets to Total Assets	83.9	84.9	85.6	84.5	85.2	82.6	85.6
Debt to Equity Ratio	2.6	2.5	2.8	2.9	2.3	2.0	2.1
Borrowings to Liabilities	54.7	55.0	49.0	55.1	62.3	61.1	58.1
Deposits to Liabilities	31.1	33.4	40.9	37.0	29.3	25.2	28.7
Return on Advances and Investments	11.4	9.0	8.8	10.6	10.6	13.2	12.6
Cost of Deposits and Borrowings	6.1	3.9	5.7	7.6	8.0	10.0	10.8
Average Spread	5.3	5.1	3.1	3.0	2.6	3.2	1.8
Net Interest Margin	6.6	5.9	4.1	4.3	4.5	5.6	4.7
Income to Expense	156.6	159.4	144.3	122.4	106.8	111.3	92.5
Return on Average Assets (after tax)	4.3	3.5	2.7	1.6	1.3	0.9	-1.6
Return on Average Equity (after tax)	17.7	13.5	10.4	7.0	4.9	3.0	-5.1

*excluding Mutual Funds and Venture Capital.

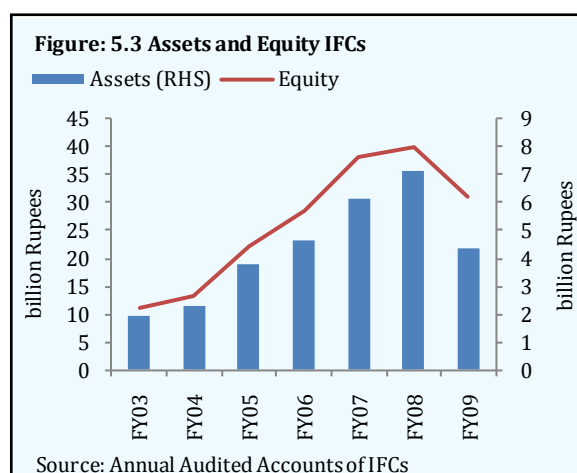
Source: Annual Audited Accounts

percent in FY09 which is mainly due to the substantial rise in the DFIs deposits (207.3 percent) with the entry of 2 new DFIs in FY09.⁹ Excluding DFIs, the deposit to liability ratio actually deteriorated to 27.8 percent in FY09, compared to 29.4 percent in FY08.

In line with these various developments, NBFIs profitability indicators, represented by Return on Assets (RoA) and Return on Equity (RoE) deteriorated to -1.6 percent and -5.1 percent respectively in FY09. With this overview in mind, the chapter focuses on providing a detailed performance review of each NBFIs sub-sector, based on audited data as of end-June FY09.

5.4.1 Investment Finance Companies

The role of Investment Finance Companies (IFCs) as a viable component of the domestic 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 operational strategy in order to optimize on their potential strengths if they are to sustain commercial viability (**Figure 5.3**).



⁹ Pak-Iran and Pak-China.

Table 5.6: Key Performance Indicators of Operative Investment Finance Companies

percent (except in case of ratio)

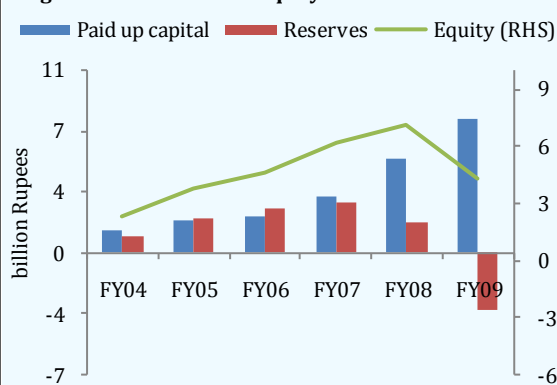
	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09
Lease finance to total assets	24.9	32.1	31.2	25.0	25.8	26.9
Investments to total assets	56.5	42.6	43.2	42.0	38.5	36.3
Placement to total assets	23.8	16.8	20.4	15.6	10.9	3.6
Term Finance to total assets	10.3	9.2	13.2	19.8	18.8	19.0
Earning assets to total assets	91.6	83.9	87.6	86.9	83.1	82.2
Debt to equity ratio	4.6	4.6	4.8	4.8	4.4	5.7
Average spread	3.7	5.5	3.9	2.3	2.6	-4.9
Net interest margin	4.3	5.7	4.7	3.3	3.1	-4.6
Interest cover	158.6	168.1	141.8	121.9	106.8	-7.6
Return on average assets (After Tax)	1.9	3.3	2.7	1.6	1.1	-8.6
Return on average equity (After Tax)	10.9	19.1	16.4	10.0	6.3	-53.3

Source: Annual Audited Accounts of IFC's

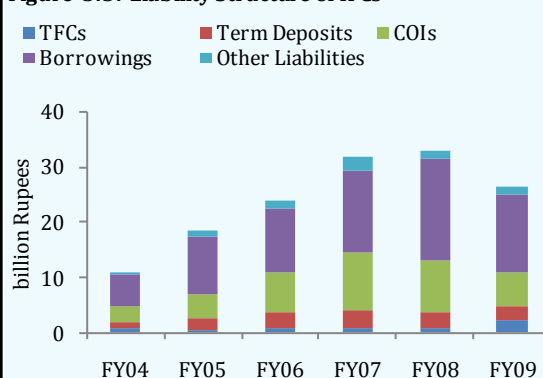
In FY09 there were 8 operative IFCs, with a share of 6.6 percent in the aggregate assets of NBFCs. **Figure 5.4** shows a rising trend in IFCs' paid-up capital in line with the increase in the minimum equity requirements (MER) by the SECP.¹⁰

An assessment of IFCs funding base indicates that these institutions have a significant reliance on borrowings from other financial institutions (**Figure 5.5**). The other main constituent of IFCs' liabilities are certificates of investments (COIs), with a share of 20.4 percent in total liabilities in FY09. From **Figure 5.6** it is evident that during FY09, IFCs relied more on investments rather than advances in expanding their asset base, such that the share of investments was 32 percent in FY09 in comparison with 28 percent in FY08.

In terms of financial performance, **Figure 5.6** shows a decline in the earning assets and hence interest income, and a rise in interest expense. These various factors have impinged on IFCs profitability position in FY09.

Figure 5.4: Structure of Equity

Source: Annual Audited Accounts of IFCs

Figure 5.5: Liability Structure of IFCs

Source: Annual Audited Accounts of IFC's

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

¹⁰ Minimum Paid up capital requirement by SECP for IFCs were Rs. 300 million up to FY08 and subsequently raised to Rs. 500 million and Rs. 700 million for existing companies for FY09 and FY10 respectively.

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.

5.4.2 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 12 in FY08 to 10 in FY09.

Table 5.7 shows the equity position of leasing companies, where it is evident that only 1 company is non-compliant with the MER for leasing companies set forth by the SECP, and that the capital position of the leasing sector has strengthened over the last three years. **Figure 5.7** gives a disaggregated position of leasing companies' funding base, indicating a more balanced position in comparison with IFCs, with reliance on term deposits, borrowings from financial institutions and CoIs etc.

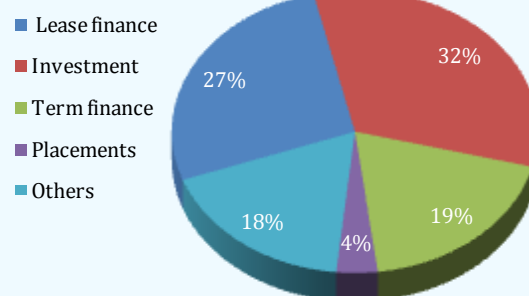
Encouragingly, the leasing sector continues to expand its asset base with a clear focus on lease finance which forms 75 percent of total assets at end-FY09. Notably, the leasing business is concentrated in the top 4 companies in the sector, as shown in **Figure 5.8**.

In FY09, profitability of the sector deteriorated due to high financial expenses and provisioning cost (**Figure 5.9**). **Table 5.8** summarises the overall performance indicators of the leasing sector

5.4.3 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,

Figure 5.6: Assets Allocation of IFCs - FY09



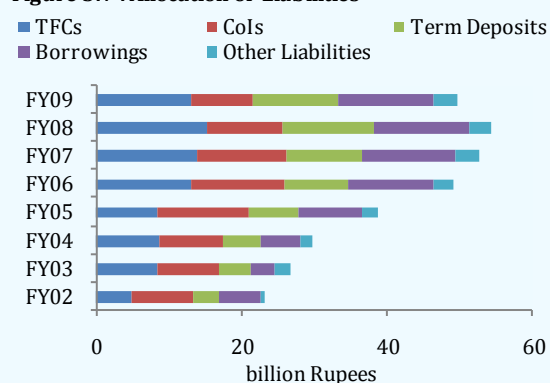
Source: Annual Audited Accounts of IFC's

Table 5.7: Equity of Leasing Companies

Equity	Number of Companies		
	FY07	FY08	FY09
Over Rs.2.0 billion	1	1	1
Between Rs. 1.0 - 2.0 billion	1	1	1
Between Rs. 0.5 - 1.0 billion	2	3	2
Between Rs. 0.2 - 0.5 billion	4	5	5
Less than Rs. 0.2 billion	6	2	1

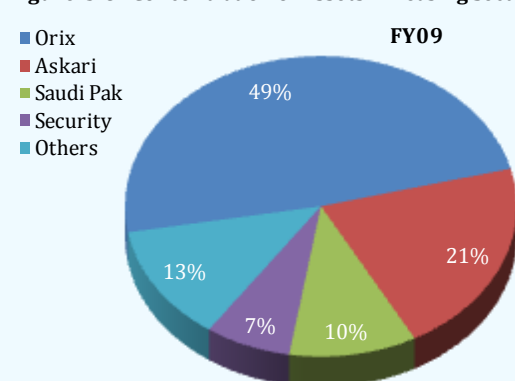
Source: Annual Audited Accounts

Figure 5.7 : Allocation of Liabilities



Source : Annual Audited accounts of Leasing Companies

Figure 5.8 : Concentration of Assets in Leasing Sector



Source: Annual Audited Accounts of Leasing Companies

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 Pakistan has essentially remained limited in scope despite the enabling regulatory framework provided by the SECP which has set forth the rules and

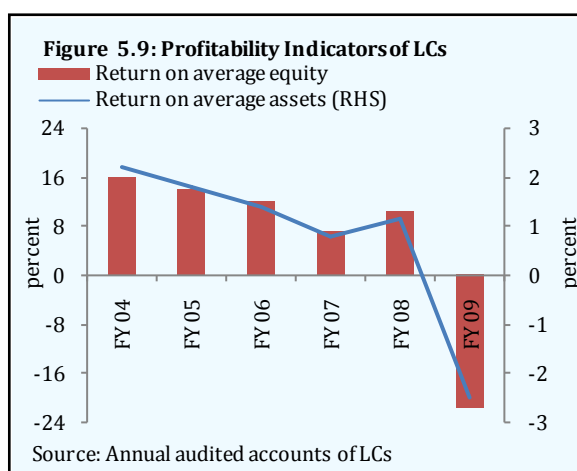


Table 5.8 : Key Performance Indicators of Existing Leasing Companies

percent (except in case of ratio)

	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09
Lease finance to Total Assets	56.6	76.7	81.0	81.3	81.8	83.7	81.1	75.5
Investments to assets ratio	4.4	8.2	8.3	8.8	6.7	5.8	7.1	9.3
Earning assets to total assets	61.6	87.1	90.6	92.4	91.3	92.1	92.6	89.6
Growth rate of Lease Finance	16.7	56.6	18.9	27.2	25.6	9.8	1.0	-15.0
Debt to equity ratio	6.6	5.9	5.8	7.1	7.7	7.8	7.2	7.3
Average spread	10.5	5.1	5.0	3.5	2.4	2.1	1.9	0.7
Net interest margin	6.6	5.9	5.6	3.9	2.9	2.8	2.7	1.5
Income to expense ratio	109.9	120.6	128.6	124.2	117.3	108.3	110.0	79.9
Return on average assets (after tax)	1.2	1.9	2.2	1.8	1.4	0.8	1.2	-2.5
Return on average equity (after tax)	9.0	14.3	16.1	14.1	12.3	7.3	10.5	-21.7
Interest cover (%)	113.3	130.8	151.0	141.1	124.9	111.9	114.4	67.9
EPS (after tax)	2.6	1.6	2.4	3.0	2.6	2.1	1.3	1.8

Source: Annual Audit Accounts of Leasing Companies

requirements for VC investments in the NBFCs Rules. Some of the impediments in the growth of the VC industry in Pakistan were: (1) complex legal framework, (2) lack of appropriate tax incentives, (3) limited exit options, (4) restrictions on institutional investors to participate in venture capital funds, (5) unavailability of data on foreign funds' participation in local firms and (6) inadequate institutional support.¹¹

Keeping in view the significant growth potential of in emerging economies like Pakistan, SECP issues the "The Private Equity and Venture Capital Fund Regulations, 2008" (PE&VCF Regulations) in August 2008. However, despite the enabling regulatory framework provided by the SECP, Venture Capital (VC) industry is developing rather gradually. At end-FY09, there were 3 operative VC companies which accounted for a mere 0.4 percent of aggregate assets of the non-bank financial sector. A summary of the sector's financial position is given in **Table 5.9**.

During FY09, asset base of the sector grew by 67 percent to Rs. 2.6 billion against decline of 57 percent in FY08, which has contributed to higher income for the sector such that FY09 recorded net profit (after tax) for the first time. SECP's enabling role is expected to promote the growth of this sector in coming years.

¹¹ Details in Chapter 8, Financial Stability Review 2006, State Bank of Pakistan.

Table 5.9: Financial Position of Existing Venture Capital Companies

million Rupees

	FY05	FY06	FY07	FY08	FY09
Equity	2,320.3	2,198.8	3,671.9	1,480.1	2,496.7
Liabilities	552.7	1,486.4	-57.3	54.1	66.0
Assets	2,873.0	3,685.2	3,614.6	1,534.2	2,562.7
Income	28.9	54.7	16.0	-2,407.5	823.1
Expense	31.6	175.9	87.6	60.9	85.0
Profit After Taxation	-2.7	-121.2	-71.5	-2,468.4	738.1

Source: Annual Report of VC

5.4.4 Modarabas

The concept of 'Modaraba' started during the 1980s with the promulgation of the 'Modaraba Companies and Modaraba (floatation & Control) Ordinance' in 1980 (the Modaraba Ordinance) that provided a statutory framework for sharia-compliant business opportunities in the country. In term of number of companies, the modaraba sector is the second largest sector after mutual funds with 26 modaraba companies; however the size of the modaraba sector, in term of its share in total NBFI assets is relatively small at 4.9 percent at end-FY09.

Major funding source of modaraba companies include floatation of modaraba in the form of equity, and financing facilities from banks and other financial institutions in the form of various Islamic financing arrangements. These funds are largely utilized in the three financing agreements, namely Musharika, Murabaha and Ijarah, which were approved by the Religious Board in the early 1990s; in addition to that these funds are also utilized for investing in shares of sharia-compliant listed companies. Over the period, in order to promote the modaraba sector, SECP has introduced various policy initiatives. Earlier in FY08, to provide diversification, SECP approved 11 new financing modes which were approved by the 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.¹² Both these initiatives were primarily aimed at providing an enabling environment for modaraba companies to enhance their outreach, foster product diversification and ensure sustainable growth.

Relative size of each modaraba company – in terms of shares in total assets and total equity - clearly indicates that the modaraba sector has suffered from widespread fragmentation in the form of a large number of small and weak entities, with limited market share (**Table 5.10**). Although the concentration indicators have shown some sign of improvement in FY09 but this was mainly due to the merger of Al-Zamin Leasing Modaraba¹³ which was the third largest modaraba in term of assets size. Consequently, share of top 10 modarabas in the total assets and total equity of the sector have reduced to 83.3 percent and 74.9 percent, respectively in FY09.

Table 5.10: Concentration in Modaraba Sector

percent

	Assets				Equity			
	FY06	FY07	FY08	FY09	FY06	FY07	FY08	FY09
Top 3	37.7	44.6	42.0	42.3	29.6	44.8	47.0	41.5
Top 5	56.8	66.8	64.0	65.8	42.6	56.0	57.0	54.1
Top 10	77.2	76.0	86.0	83.3	59.7	76.0	77.0	74.9

Source: Annual Audited Reports

¹² SECP Circular No. 6, dated May 8, 2008

¹³ Al Zamin Leasing Modaraba was merged with Invest capital investment bank limited during FY09.

Table 5.11: Key Performance Indicators of Existing Modarabas

Amount in billion Rupees, Growth in percent except in case of ratio

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Total Assets	12.3	12.4	14.8	18.5	21.6	26.4	29.6	23.1
Growth in Assets	5.1	1.1	19	25.1	16.7	22.3	12.4	-22.1
Lease finance to total assets	49.8	54.3	51.6	53.1	51	44.8	40.5	39.4
Investments to assets	15.6	11.5	17.2	16.7	17.5	19.6	22.2	17.2
Murabaha/Musharika to total assets	16.2	17.7	13.4	14.1	15.5	15.5	17.9	19.1
Earning assets to total assets	81.6	83.6	82.1	83.9	84	79.9	80.6	75.6
Debt to equity ratio	0.9	0.7	1	1.1	1.3	1.2	1.3	1.0
Income to expense	124.7	130.9	138.3	125.1	113.6	116.3	121.2	97.5
Return on average assets	5.6	7.1	6.1	4.1	2.3	3.2	3.6	-0.6
Return on average equity	12	14.4	12.6	9	5.4	7.6	8.7	-1.4

Source: Annual Audited Reports

Table 5.11 presents the key performance indicators of the modaraba sector. During FY09, modaraba sector's financial position remained stressed due to the weak macroeconomic environment and competition from the banking sector. Asset base of modaraba companies declined by 22.1 percent in FY09, after registering average growth of around 19 percent in the previous four years, with a consequent impact on the share of earning assets earning assets which reduced to 75.6 percent as against 80.6 percent in FY08. Notably, modarabas are relatively less dependent on borrowings as their primary source of funding, and tend to mobilize deposits in the form of certificates of investment.

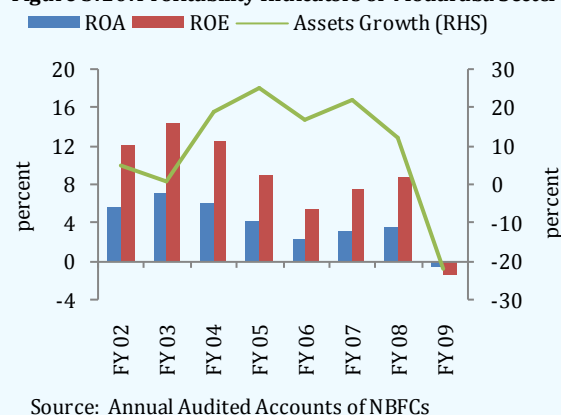
Impact of this weak performance is also evident from the profitability indicators, where both return on assets (ROA) and return on equity (ROE) turned negative in FY09 mainly due to losses incurred by 10 modaraba companies (**Figure 5.10**).

Going forward, with the objective of enhancing the modaraba sector's performance, profitability and future growth, SECP is planning to conduct the first exhaustive review of the Modaraba Ordinance of 1980 and underlying Modaraba Rules. Similarly, amendments in Prudential Regulations for Modarabas are also in process.

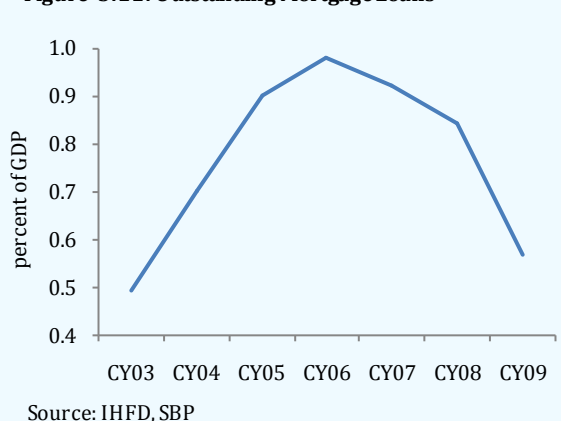
5.4.5 Housing Finance¹⁴

Housing finance services offered in Pakistan are still at an evolutionary stage due to both demand and supply side factors. As evident from **Figure 5.11**, total value of outstanding

finance is less than 1 percent of GDP, which is declining steadily from its peak value of 0.98 percent in CY06. By end-CY09, housing finance to GDP ratio declined to 0.57 percent, mainly

Figure 5.10: Profitability Indicators of Modaraba Sector

Source: Annual Audited Accounts of NBFCs

Figure 5.11: Outstanding Mortgage Loans

Source: IHFD, SBP

¹⁴ Analysis in this section is on CY basis.

due to the slowdown in the economy. Accumulated Gross Disbursements (AGD) which had demonstrated promising growth during CY06-08 (average 26 percent), registered a low growth of 1.8 percent in CY09 to reach Rs. 161.6 billion.

Mortgage finance in the domestic financial system is being offered by the Housing Building Finance Corporation Limited (HBFC), banks and NBFCs licensed to offer housing finance facilities. While banks are still relatively new in this area, they have emerged as a major provider of housing finance largely due to access to low cost funds and better outreach.

CY09, disaggregated institutional data shows no significant change in the respective shares of each institution in the total gross disbursement, in comparison with CY08 (**Figure 5.12**).

Mortgage finance is generally extended for three purposes i.e. construction, outright purchases and renovation. During CY09, as a result of slowdown in economic activities, mortgage loans for construction and outright purchases grew by only 3.4 percent and 6 percent respectively, as compared to 12.5 percent and 29 percent respectively in CY08, whereas loans for renovation depicted negative growth of 19 percent, as against significant growth of 57 percent in CY08 (**Figure 5.13**).

This section gives an overview of the financial performance of HBFC and the sole NBFC offering housing finance facilities, i.e. Asian Housing Finance Limited (AHFL). During FY09, growth in the aggregate assets of HBFC and AHFL decelerated to 1.3 percent as against 7.8 percent in FY08. Nevertheless, share of HFCs in overall assets of NBFI is improving steadily since FY07, which improved further to 4.0 percent in FY09 (**Figure 5.14**). Nevertheless, net addition of Rs. 227.1 million in the total assets of HBFC during FY09 is greater than the total assets of AHFL (Rs. 165.3 million), reflecting the difference in the scale of operations of HBFCL in relation to AHFL.

Key performance indicators of HFCs are presented in **Table 12** which indicates improvement in the overall performance of HFCs during FY09, compared to FY08. The share of investments in total assets improved to 19.1 percent in FY09, compared to 13.4 percent in the previous year, mainly due to a growth of 44.3 percent in investments. As a result of the increase in investments coupled with the 4.4 percent growth

Figure 5.12: Share in Gross Disbursements

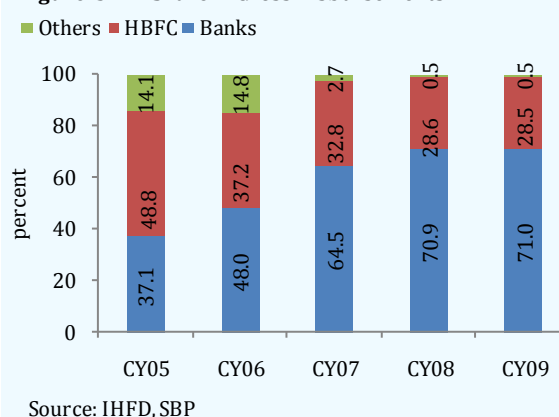


Figure 5.13: Share in Loans Disbursed

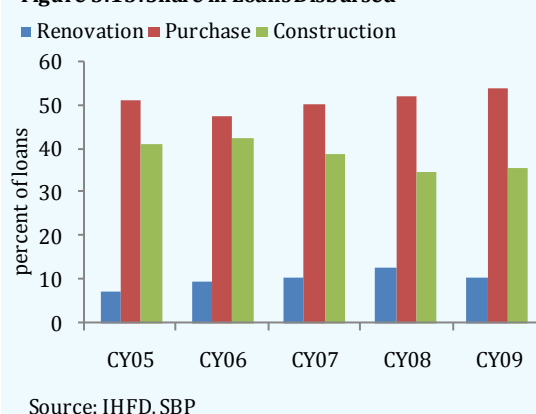
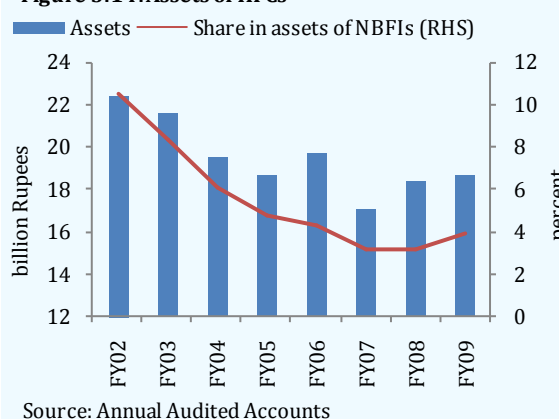


Figure 5.14: Assets of HFCs



in housing finance, the share of earning assets in total assets improved to 92 percent in FY09, from 84.2 percent in FY08.

Table 5.12: Aggregate Performance Indicators of HBFC and AHFL*

percent (except in case of ratio)

	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Housing Finance to Total Assets	51.6	61.8	66.4	66.0	61.9	70.8	72.9
Investments to Total Assets	20.1	9.1	18.1	21.7	18.9	13.4	19.1
Earning Assets to Total Assets	71.7	70.9	84.5	87.7	80.8	84.2	92.0
Growth Rate of Housing Finance	5.1	8.0	2.8	5.1	-19.0	25.1	4.4
Debt to Equity Ratio	3.0	3.1	2.8	2.8	3.8	5.0	5.0
Average Spread	8.5	8.9	9.9	10.8	12.1	4.2	5.2
Net Interest Margin	8.5	8.9	10.0	11.0	12.2	5.5	7.1
Income to Expense	142.6	57.4	110.6	176.6	43.0	97.0	98.6
Return on Average Assets (After Tax)	0.9	-3.3	-1.5	0.7	-3.2	-2.2	-0.2
Return on Average Equity (After Tax)	3.9	-14.7	-6.8	3.2	-15.8	-14.0	-1.1

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

Source: Annual Audited Account and SBP Calculations

It is pertinent to mention that high financial leverage is largely attributed to HBFC which holds around 99.98 percent of the total borrowings of HFCs. In July FY08, HBFC had acquired the status of commercial mortgage lender under the Banking Companies Ordinance 1984. The minimum capital requirement (MCR) set forth by SBP for DFIs is Rs.6.0 billion,¹⁵ however HBFC has not been able to meet the MCR. At present, its paid up capital is Rs 3.0 billion, of which 52.5 percent is held by the federal government and the remaining 37.5 is contributed by the SBP.

On the other hand, AHFL operating under the SECP' regulatory framework, is also facing severe challenges in raising its equity up to the required minimum equity set by SECP for housing finance business, raised to Rs. 300 million by June 30, 2008 and further to Rs. 700 million by end-June 2010. However, during FY09, the equity of the company eroded further mainly on account of the net loss reported during the year. The company has been granted two years' relaxation in meeting the minimum equity requirement by SECP.

5.4.6 Development Finance Institutions¹⁶

The 7 Development Finance Institutions (DFIs)¹⁷ operating in Pakistan¹⁸ are all joint ventures 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 are relatively newer DFIs, having started their operations as recently as CY08. These DFIs operate under the broad objective of facilitating investment in the country and improving bi-lateral relations.

Key financial indicators of DFIs are presented in **Table 5.13**. In CY09, despite the slow economic activities in the country, aggregate assets of DFIs grew by 33.7 percent to Rs. 113.8 billion, as against negative growths in the previous two years. This growth was largely broad based where almost all DFIs showed significant improvement in their assets (average growth 45 percent) in CY09. As a result of broad-based growth, degree of concentration in the sector

¹⁵ BSD Circular No.7 dated April 15, 2009.

¹⁶ Assessment in this section is on CY basis.

¹⁷ Saudi Pak Industrial and Agricultural Investment Company Ltd (SAPICO), Pak Oman Investment Company(POIC), Pakistan Kuwait Investment Company (Pvt) Ltd (PKICL), Pak Brunei Investment company Ltd (PBIC), Pak-Libya Holding Company (Pvt) Ltd (PLHC), Pak China Investment Company Ltd (PCIC) and Pak-Iran Investment Company Ltd (PIIC).

¹⁸ House Building Finance Corporation is also a DFI, however its assessment is given under the category of Housing Finance Companies.

declined further (**Figure 5.15**).

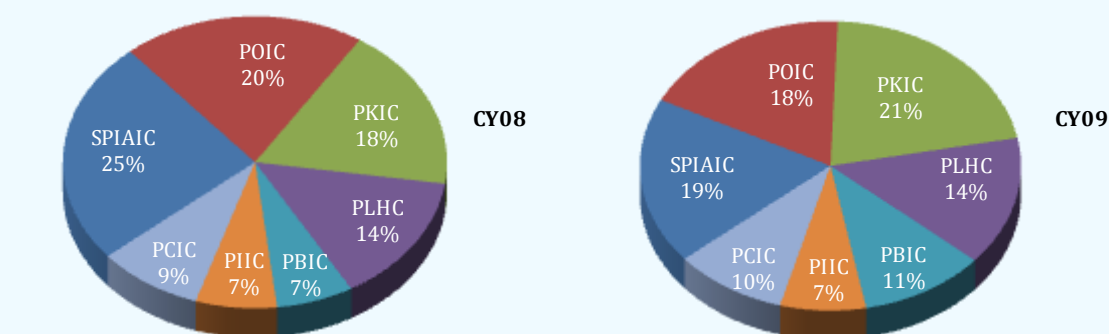
Assets composition of DFIs indicates that while DFIs have made efforts to expand their loan book, as evident by the steady rise in the share of advances since CY07, investments have grown more significantly at 62.3 percent. Consequently, the share of investments in total assets has risen to 51.5 percent in CY09, from 42.4 percent during (**Table 5.14**).

Table 5.13: Financial Position of DFIs

billion Rupees	CY06	CY07	CY08	CY09
Assets	116.9	95.3	85.1	113.8
Lending to FIs	17	17.2	7.1	9.4
Investments	37.9	37.5	36.1	58.6
Advances	41.7	23.0	23.7	29.4
Liabilities	79.6	54.6	38.8	59.4
Borrowing from FIs	50	40.3	30.9	38.8
Deposits/COIs	26.1	11.9	5.9	18.1
Equity	37.4	40.7	46.2	54.3

Source: Annual Audited Accounts of DFIs

Figure 5.15: Asset Concentration of DFIs



Source: Annual Audited Reports of DFIs

Data on DFIs' investment portfolio by category indicates significant changes in their investment preferences: like banks, DFIs are diverting their loanable pool of fund towards risk-free investment avenues i.e. government securities (**Table 5.15**).

During CY09, composition of DFIs' funding base exhibited substantial improvement in their deposit base, which grew substantially by 207 percent to Rs.18 billion, compared to negative growth of 50 percent in CY08.

Consequently, shares of both equity and borrowings have reduced to 47.8 and 34.1 percent respectively, from 54.4 and 36.4 percent in CY08 (**Table 5.16**). This increase in DFIs' deposit base bodes well for their commercial viability and for containing the cost of funds.

Table 5.14: Asset Composition of DFIs

share in assets	CY06	CY07	CY08	CY09
Lending to FIs	14.5	18.0	8.4	8.2
Investments	32.4	39.3	42.4	51.5
Advances	35.7	24.2	27.9	25.9
Bal With Banks	9.6	9.9	12.1	5.8
Other	7.8	8.6	9.3	8.7

Source: Annual Audited Accounts of DFIs

Table 5.15: Investments Portfolio of DFIs

percent of total investment	CY06	CY07	CY08	CY09
Govt. Securities	14.8	17.2	32.1	45.0
Quoted Shares	23.7	26.2	32.0	16.4
TFCs/PTCs	8.9	13.3	19.9	23.1
Subsidiaries	11.5	11.6	8.0	8.5
Others	41.2	31.7	7.8	6.9

Source: Annual Audited Accounts of DFIs

(**Table 5.17**) shows that the key asset quality indicators deteriorated slightly during CY09, due to which DFIs set aside significant provisioning as evident in the increase in the

provisions to NPLs ratio to 76.2 percent in CY09, compared to 64 percent in CY08. Profitability indicators, on the other hand, remained stressed in CY09 mainly due to the rise in provisioning expenses by 56 percent to Rs.5.7 billion. Accordingly, both ROA and ROE deteriorated to 0.9 percent and 1.9 percent respectively, compared to 1.3 percent and 2.6 percent in CY08.

Table 5.16: Funding Composition of DFIs

percent of assets	CY06	CY07	CY08	CY09
Equity	32.0	42.7	54.4	47.8
Borrowing from FIs	42.8	42.3	36.4	34.1
Deposits/CoIs	22.4	12.5	6.9	15.9
Others	2.9	2.6	2.4	2.3

Source: Annual Audited Accounts of DFIs

Table 5.17: Key Performance Indicators of DFIs

Percent

	CY05	CY06	CY07	CY08	CY09
Total Capital RWA Ratio	17.2	32.9	44.4	58.4	54.7
Tier I Capital to RWA	15.1	30.4	42.1	57.3	54.7
Equity to Liability Ratio.	50.5	51.8	74.5	119.1	91.4
Equity to Assets ratio	34.6	35.2	42.7	54.4	47.8
NPLs to Loans (Gross)	49.4	15.2	8.6	20.9	21.5
Net NPLs to Net Loans	18.5	8.6	1.1	7.5	6.1
Provisions to NPLs	62.5	43.1	87.7	64	76.2
Earning Assets to Total Assets	86.8	82.6	83.4	91.8	92.4
Expense to total income	45.9	68.8	58.2	89.5	87.1
ROA (after tax)	5.5	2.6	2.5	1.3	0.9
ROE(after tax)	16	7.5	6.5	2.6	1.9
Net Interest Margin	1.9	1.4	2.1	4.2	5.1
Liquid Assets to Total Assets	14.2	15.3	17.3	38.8	37.8

Source: BSD, SBP

5.4.7 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. 211.9 billion by end-FY09, as compared to Rs. 334.8 billion in FY08 (**Table 5.18**). Notably, both the imposition of the floor of 9,144 points on the KSE-100 index in August FY09, and the revaluation of TFCs in an environment of rising interest rates had an influence on assets under management (AUM). Mutual funds constituted around 48 percent of total NBFIs' assets at end-FY09.

On the supply-side, with a large number of funds on offer, professional asset management companies provide advice to the uninitiated investor to choose the most optimal option in line with his risk-return preferences. However, the investor also needs to be able to make his own assessment based on the available information.

Developments in the regulatory and operating environment indicate a strong potential for the mutual funds sector to continue its growth momentum albeit the challenges faced by the sector need to be addressed expeditiously. Some, significant challenges for the mutual funds industry are: (1) restrictions on institutional investors, such as provident and pension funds to invest in mutual funds; (2) availability of national savings schemes for institutional investors; (3) inadequate mobilization of investments from retail investors due to lack of financial literacy in the country; (3) lack of depth in the domestic securities market that constraints investment decisions; (4) the need to introduce stringent fit and proper test for fund managers and intermediaries, including their sales force; (5) the need to implement international best practices across the sector and improve fund governance, transparency

and disclosure; and (6) limited institutional capacity to act as trustees of funds, particularly REITs.

Table 5.18: Structure of Mutual Funds

billion Rupees

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10*
Net Assets	51.6	93.7	125.8	159.9	289.1	334.8	219.3	211.9
<i>Share by Ownership (in percentage)</i>								
Public Sector	78.5	52.8	48.5	40.2	31.5	25.4	30.8	20.5
Private Sector	21.5	47.2	51.5	59.8	68.5	74.6	69.2	79.5
<i>Share by Type (in percentage)</i>								
Open-end Funds	78.2	73.6	70.1	72.7	82.4	86.1	87.3	84.1
Closed-end Funds	21.8	26.4	29.9	27.3	17.6	13.9	12.7	15.9
<i>Share by Category (in percentage)</i>								
Equity Funds	81.2	76.5	72.8	63.0	47.3	41.6	44.5	34.7
Income Funds	6.6	6.4	6.2	10.6	24.4	24.9	23.2	32.8
Money Market Funds	4.6	3.6	3.9	7.3	15.0	17.2	13.7	11.7
Balanced Funds	5.8	10.3	9.0	7.2	4.6	4.9	4.1	3.6
Islamic Funds	1.8	3.2	4.7	5.6	4.9	6.2	8.5	10.8
Tracker Funds	0	0	0	0.6	0.5	0.2	0.1	0.1
Fund of Funds	0	0	0.4	0.5	0.3	0.6	0.5	0.6
Others	0	0	0	0	3.0	4.5	5.4	5.8

*Data from MUFAP

Source: Annual Audited Accounts of Mutual Funds