5 Non-Bank Financial Institutions (NBFIs)

NBFIs have registered average asset growth of 7 percent over the period 2012-2015. Mutual funds having almost 60 percent share in assets is leading the sector followed by DFIs having a share of 26 percent. Despite registering strong bottom-line trends, leasing sector could not contain dampening of the overall sector's profitability led by DFIs. Leasing companies are able to overtake Modaraba companies in market share despite large number of players in the latter category; while investment finance companies are continually going down in terms of profitability and sustainability of the participating businesses. The NBFIs with their small market share in financial assets are less risky for the stability of the financial system.

Besides banks, a range of other Non-bank financial intermediaries, comprising Non-Bank Financial Companies (NBFCs)[126] , Modaraba companies and Development Finance Institutions (DFIs) – collectively known as NBFIs (Non-bank Financial Institutions) – also operate in Pakistan[127].

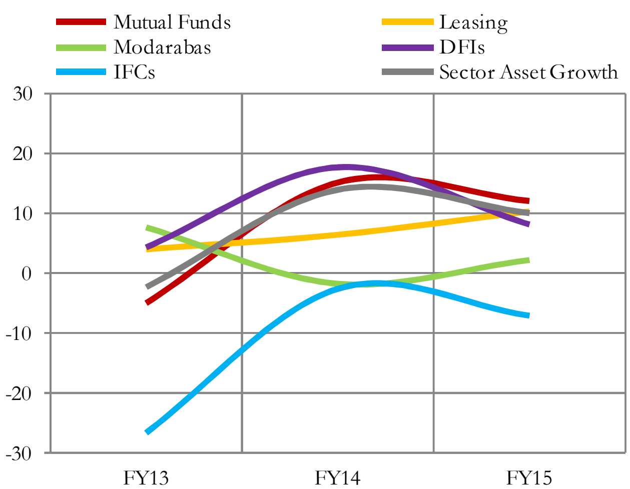
The NBFI's sector constitutes a diverse set of financial intermediaries with varying business models. Yet, the presence of an ever imposing banking sector with deep resources that offers matching products continues to challenge the existence of NBFIs. The non-bank players with an asset base of 7 percent of that of the banking sector assets in (Financial Year) FY12 have seen their share fall to 6 percent in FY15.

Decline in operating performance despite modest growth in asset base….

The NBFIs have witnessed modest growth over the period 2012-15 (7 percent on average) on the back of reasonable growth observed in all the sub-sectors of NBFIs except Investment banks **(Figure 5.1)**. The industry closed the year[128] with an asset size of PKR 738 billion. Despite expansion in balance sheet of NBFIs, profitability of the sector has declined. The sector posted profit after tax of PKR 8 billion; 12 percent lower than the previous year. With the exception of leasing, profitability in rest of the sub sectors has declined where major drop is observed under DFIs segment (**Table 5.1 and 5.2**).

Figure 5.1
Growth trends in Non-Bank Financial Institutions

Asset Growth
(Percent)



Source: MUFAP, Annual Audited Accounts of Leasing and Modaraba companies and FSD,SBP

126 As per section 282A of Companies Ordinance,1984, Non-banking finance companies (NBFCs) include companies licensed by the Commission to carry out any one or more of the following forms of business, namely Investment Finance Services, Leasing, Housing Finance Services, Venture Capital Investment, Discounting Services, Investment Advisory Services, Asset Management Services and any other form of business which the Federal Government may by notification in the official Gazette specify from time to time.
127 Our coverage of NBFIs is limited to only operative NBFIs for which data is available.

128 Financial Year (FY) for DFIs ends in December, while for other sectors their relevant FY ends in June.

Table 5.1

Asset Profile of NBFIs

	FY12	FY13	FY14	FY15
	(PKR billion)			
Mutual Funds(Net Asset Value)	377.8	356.8	407.9	429.8
Pension Funds(Net Asset Value)	2.7	4.8	8.2	13.6
REITS(Net Asset Value)	-	-	-	22.6
DFIs	143.2	149.4	176.1	190.5
Leasing companies	33.0	34.3	36.5	40.3
Modarabas	28.3	30.5	30.0	30.7
Investment Finance companies	15.8	11.6	11.3	10.5
Total Assets	**600.8**	**587.4**	**670.0**	**738.0**

Source: MUFAP, Annual Audited Accounts of Leasing, IFCs, Modaraba companies, REIT's and FSD,SBP

Table 5.2

Profitability Profile of NBFIs

	FY12	FY13	FY14	FY15
	(PKR million)			
DFIs	3,275.0	4,286.0	7,276.0	6,161.0
Leasing companies	(371.0)	498.0	563.0	640.0
Modarabas	1,225.0	1,969.0	1,410.0	1,353.0
Investment Finance companies	(1,688.0)	(783.0)	(135.0)	(162.0)
Total Profits	**2,441.0**	**5,970.0**	**9,114.0**	**7,992.0**

Source: Annual Audited Accounts of Leasing, IFCs , Modaraba companies, REIT's and FSD,SBP

Funding remained the key risk faced by NBFIs…

Funding risk remains the prominent risk faced by the sector. Also, the diversification of clientele suggested in the business models of NBFIs has yet to be achieved. NBFIs are serving similar market segments as the banks, in which they do not possess competitive advantage.

SECP revamps the regulatory framework for NBFCs in 2015…

SECP has introduced major amendments to the regulatory framework for NBFCs in November, 2015. The amendments seek to improve on the risk management practices of NBFCs, link Minimum Equity Requirements (MER) with the respective business activities of the NBFCs and enable SECP to regulate the non-bank micro finance institutions. For details please see **Box 5.1**.

Mutual funds competing for investor's interest amid falling interest rate…

Mutual Funds, leading the NBFI sector with an average growth of 6 percent in the last three years, have closed the year with Net Asset Value (NAV) of PKR 443 billion. Shariah-compliant funds and pension funds have gained increasing popularity as reflected by their share in funds market and addition of 25 new such funds in FY15. Pakistan's first Real Estate Investment Trust fund (REIT) has also been launched on June 12, 2015[129]. The share of Shariah-compliant funds has increased from 14 percent in FY12 to 29 percent in FY15; while pension funds expanded their position from 1 percent to 3 percent.

Constant Proportions Portfolio Insurance (CPPI) funds, with their unique product features of offering limited downside risk (via setting a floor for investments in money market and fixed income instruments) and simultaneous participation in the up-equity markets, have drawn attention of the investment community. This is evident from their market share which has doubled in one year from 3 percent last year to 6 percent this year and addition of 6 new funds in this category.

Nevertheless, lack of awareness about investment options among the general public coupled with expenses at the fund level, which places direct investments at an advantage, continue to constrain the emergence of mutual funds as a viable conduit for retail savings.

The sector seems promising though: a total of 26 new funds were launched in FY15. However, in the falling interest rate environment net redemptions of PKR 22 billion has been observed during FY15. Money market funds have become less attractive;

[129] Please see **Box 5.2** for details on REITs.

while equity funds are in competition with other high yielding assets (such as property market).

Despite some encouraging trends, the savings mobilized through mutual funds are still meager, in general, relative to the deposits of the banking sector (PKR 9.27 trillion in FY15) or placements under the National Savings Scheme (PKR 3.0 trillion in FY15).

Dipping DFI profitability has effected sector's bottom-line…

Asset quality of the DFI's has remained within the satisfactory limits owing to growing advances and reducing NPLs stock. Funding profile has remained tilted towards borrowings; while growth of deposits remains subdued. The DFIs profitability indicators have dwindled a bit due to abridged spreads and higher non-mark up expenses. The industry is well capitalized; though CAR has exhibited a downward trend.

DFIs profitability has dragged down NBFI's performance, as a whole, as it declined by 15 percent - largest fall among all the sub-sectors of NBFIs (**Table 5.2**). This has largely been due to increase in provision charge and other non-markup expenses incurred during FY15 by DFIs.

Leasing business: contrasting trends for leasing companies and modarabas…

Both leasing companies and modarabas are active in leasing business. However, leasing companies and modarabas have exhibited mixed business results in FY15 due to their exposures in different segments of the economy.

The leasing sector with its focus on transportation and logistical fleet has witnessed YoY asset growth of 10 percent in FY15. Profits have also increased by 14 percent- the maximum growth witnessed among the profit making entities of NBFIs.

For modarabas sector, Ijarah exposure to the plant, machinery and equipment led to build-up of impairment losses which has dented their profitability in FY15. The 24-company sector's asset base, while expanding over the years at an average rate of 3 percent, accounts for a meager 4 percent of the non-banking financial sector's assets. Despite large number of players, concentration of business is evident as seven companies represent 80 percent of the sector's assets, 70 percent of sector's equity and 86 percent of sector's income.

Modarabas, however, remained the investment choice for other modaraba management companies and Islamic banking branches of commercial banks looking for a Shariah compliant counter-party to their transactions. Bank controlled modarabas, with their ability to mobilize deposits have focused on generating income from the provision of Shariah-compliant financing facilities; while the others, depending on funds generated via IPOs and accumulated profits, have focused on trading, leasing and investment portfolios.

The diversity that the sector's business model affords is still promising as it attracted two new entrants in FY15 with a total paid-up capital of PKR 1.45 billion. Some of the weak modarabas are also in talks with textile and food companies for acquisitions and collaborative projects; should that occur it could change the face of the sector.

Investment banks continue to fade…

In the absence of funding sources from commercial banks and limited equity, investment banks have slowly been waning. The sector is unprofitable and has been operating on the sidelines owing to their inability to compete with the investment banking wings of commercial banks.

The much awaited road-map for the NBFIs introduced by SECP is expected to pull the companies out of the difficult situation of losses (with their inability to generate income sufficient to cover operational expenses) and regulatory non-compliance (Minimum Equity Requirements (MER) and exposure limits due to weak equity profile). It has given the investment banks the choice of opting out of the deposit-taking category which attracts lesser MER. Capital Adequacy Ratio has also been introduced for the deposit-taking category of investment banks.

The regulations while offering depositor protection will further limit the funding avenues for the sector which, given its resource constraints, has already shifted its focus towards non-fund based activities for income generation. They are restructuring their operations and balance sheets while focusing on NPL recoveries.

Mutual Funds[130]

Mutual funds continue to remain an important alternate avenue for investments due to their comprehensive suite of products with multiple investments classes like equity, money market and income funds.

In FY15, the NAV of equity funds observed a growth of PKR 44 billion followed by CPPI with a growth of PKR 11 billion and pension funds with growth of PKR 5.4 billion. This growth in NAV, mostly due to revaluation, has helped mutual funds retain 62 percent share in the NBFI's sector (**Table 5.1**).

Equity funds despite being volatile and risky, have received net inflows of PKR 2.69 billion; yielding maximum returns of 21.73 percent relative to 16.01 percent return on the KSE 100 Index in FY15. The excess return is indicative of fund managers' better sector and script selection (**Figure 5.2**).

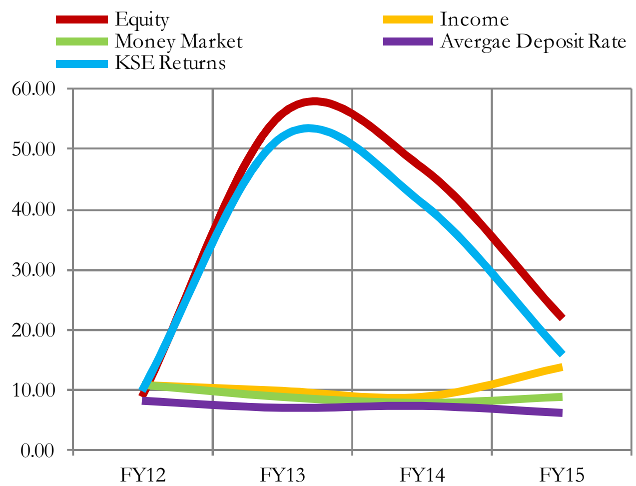
[130] Mutual Fund data has been obtained from MUFAP. The data is inclusive of pension fund statistics.

Figure 5.2

Conventional Equity-based funds offered superior yields

Yields on Mutual Funds vs KSE-100 Index and Average Deposit Rate

(Percent)



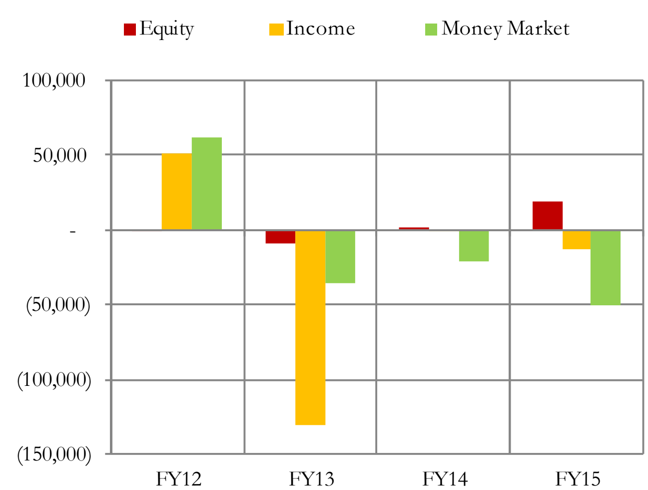
Source: MUFAP, FSD,SBP and S&DWHD,SBP

Figure 5.3

Net Redemptions from Money Market Funds

Top Fund-wise Net Sales

(PKR million)



Source: MUFAP

Interest rate trajectory has manifested itself in net redemptions in money market funds…

The mutual fund industry is no exception to the effects of easing of monetary policy. As the interest rates started to decline, money market instruments became less and less attractive for the investors.

Consequently, in FY15, net redemptions of PKR 59 billion have been witnessed in the conventional money market category **(Figure 5.3)**.

The outflow from money market funds has been large enough to more than offset the inflows observed in the rest of the funds categories. Consequently, the sector has observed overall net redemptions of PKR 22 billion in FY15.

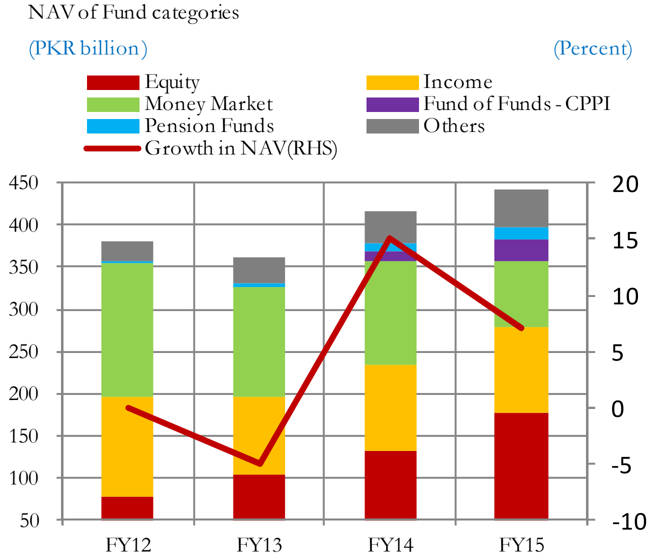
Asset price channel of monetary transmission seems operative…

The asset wise composition of the funds is also indicative of their returns. Downward trajectory of the interest rate has worked towards a reversal in the composition of the funds; placing equity funds with highest returns at the top, followed by fixed income and money market funds in FY15. This is in stark contrast to the state of affairs in FY12 when money market funds maintained highest NAV (**Figure 5.4**).

Figure 5.4

NAV growth decelerated while equity-based funds took the lead

NAV of Fund categories



Source: MUFAP

This compositional change is, however, as per expectations. Monetary easing usually has a positive impact on asset prices (equities, real estate, etc.) making them more attractive.[131] The corporates and retail investors (individuals) can then tap the revaluation gains of their balance sheets (or increase in wealth) to borrow more and invest in productive avenues. Higher investment activity could then lead to higher production. So, the first leg of the asset price transmission channel i.e. increase in equity prices, appears to be working in Pakistan as well.

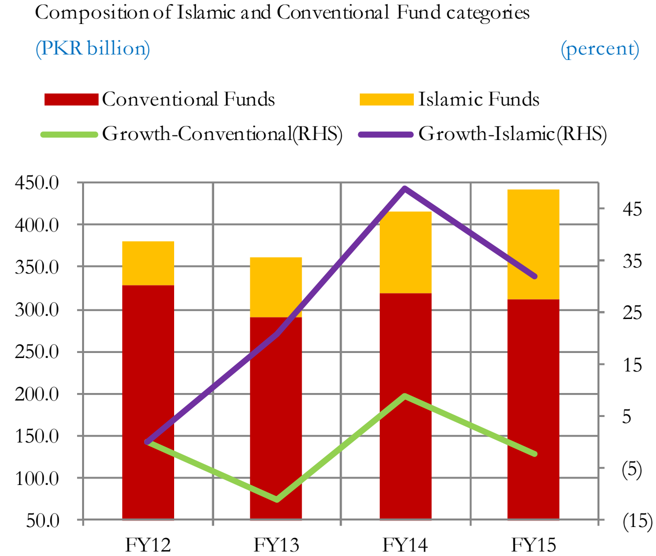
…while Shariah compliant modes gained allegiance

Behavioral factors usually have a strong bearing in investment discipline. If we divide the fund industry between conventional and Islamic categories, there is a clear inclination towards Islamic funds. The conventional funds position in net assets regressed by 15 percentage points bringing their share from 86 percent in FY12 to 71 percent in FY15. While the share in net assets value of faith based open end mutual funds jumped to 29 percent in FY15 from 14 percent in FY12 with an average YoY growth of 35 percent during this period.

Figure 5.5

Increasing popularity of shariah-compliant funds

Composition of Islamic and Conventional Fund categories



Source: MUFAP

131 For details please see "The Transmission Mechanism and the Role of Asset Prices", Frederic S. Mishkin, NBER Working Paper No. 8617, 2001.

Shariah-compliant equity funds remained the most popular category, witnessing net inflows of PKR 16 billion despite a return which was 71 bps lower than that offered by their conventional counterparts during FY15 (**Figure 5.5**).

Shifts in the investor anatomy prevailed……

Increasing popularity of the funds, especially among retail investors, is evident from the expanding investor base due to higher yield and tax advantage. The number of investment accounts has grown by 10 percent over the period FY12-15 with shifts in investor category. Institutional investment funds went down from 83 percent to 66 percent probably due to the waning of tax advantage for banks.[132] While share of individuals in total NAV increased to 34 percent from 17 percent in FY12.

Despite rising share of retail investors in funds market, their share is still low by international standards where retail participation is, generally, to the tune of 80 percent. Mutual funds are, therefore, a long way away from establishing themselves as a worthwhile alternate savings avenue in Pakistan as is the case internationally.

Sales and redemption pattern of mutual funds also provide an interesting insight. Net redemptions from money market funds were observed for all investment categories with a marked increase in equity funds by the Provident & Pension funds.

Banks, driven by the tax motives were also inclined towards the equity funds. Driven by higher returns but wary of the riskier equity funds, individuals took the mid-way of replacing their money market funds with the income funds.

Table 5.3
Shifts in Investor Base of Conventional Equity Funds

	FY14	FY15
	PKR million	
Banking & FIs	(2,161.0)	3,416.0
Provident & Pension Funds	(196.0)	1,345.0
Individuals	(982.0)	484.0
Others	(1,571.0)	(2,555.0)
Total Net Sales	**(4,910.0)**	**2,690.0**

Source:MUFAP.

Table 5.4
Shifts in Investor Base of Conventional Income Funds

	FY14	FY15
	PKR million	
Banking & FIs	(109.0)	(7,341.0)
Provident & Pension Funds	211.0	900.0
Individuals	419.0	8,647.0
Others	(883.0)	2,297.0
Total Net Sales	**(362.0)**	**4,503.0**

Source:MUFAP.

Table 5.5
Shifts in Investor Base of Conventional Money Market Funds

	FY14	FY15
	PKR million	
Banking & FIs	(9,062.0)	(34,588.0)
Provident & Pension Funds	377.0	(1,758.0)
Individuals	(8,118.0)	(8,793.0)
Others	(2,076.0)	(13,483.0)
Total Net Sales	**(18,879.0)**	**(58,622.0)**

Source:MUFAP.

The sector has also graduated itself as a recipient of idle pension and other retirement funds largely due to tax incentive[133] and increased awareness among the investor and public regarding this attractive avenue for long-term savings, particularly for their

[132] Previously under Finance Act of 2012, the income generated by banks from investment in mutual funds was taxed at 10%.

[133] Under section 63 of income tax ordinance 2015, pension fund investments are eligible for tax credit up to 20% of one's taxable income. Additional catch-up incentives are provided to participants over 40 years, with a maximum tax credit on 50% of taxable income.

old age. Investments in the offered pension schemes in FY15 are five times the level observed in FY12. The growing popularity of such funds resulted in 12 new fund offerings during the year (**Table 5.3, 5.4 and 5.5**).

Mutual funds facing stiff competition despite better returns…

Apart from direct competition from commercial banks and NSS instruments, returns offered by mutual funds is also effected by indirect cost of taxes and fees levied at the fund level. Banking sector further presents a challenging competitor not only in terms of funds mobilized but also with regards to outreach to the general public through their extended branch network.

NAV of mutual funds industry is only 4 percent of the funds parked in deposits with commercial banks offering an average return of 6.2 percent over the year when the money market mutual funds presently offer 8.8 percent on average. The investor base of around 236,000 investor accounts is meager as compared to the 38 million CASA accounts.

Expectations of a thriving stock market may prolong the current trend …

In light of the prevailing low interest rate scenario, investor interest is expected to move further towards high yielding equity funds. Some volatility may persist in the equity market in the near term but equities are expected to perform better relative to money market over the medium term. Investors with relevant risk profiles and investment horizons may profit from investing in the equity funds category. While yield on debt instruments are expected to remain subdued due to soft inflation outlook.

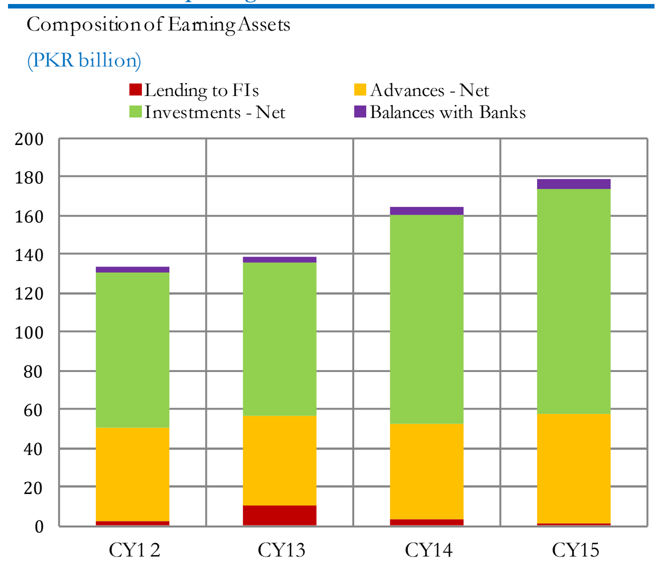
Development Financial Institutions (DFIs)

The DFIs continue to grow with a conservative pace in CY15[134] undermining the development role of the sector. The size of the industry remains limited to 8 DFIs with insignificant (3 percent) contribution to gross fixed capital formation.

The asset base of the DFIs has expanded by 8.7 percent in CY15; mainly driven by growth in advances and investment portfolio. Investments as compared to advances occupied significant share in total assets and remained the major source of earnings for the DFIs (**Figure 5.6)**.

Figure 5.6

Investments occupied significant share in Total Assets



Source: FSD,SBP

Advances grew handsomely but the share of SMEs squeezed further…

In CY15, advances (gross) increased by a notable 14.0 percent over the last year, significantly higher in comparison to growth of 8.1 percent in the banking sector. The main contributing factor in advances' growth during the year can be traced to a

134 For DFIs the calendar year (CY) is the same as the Financial Year (FY).

remarkable 13.6 percent growth in corporate sector lending. Private sector lending increased as the macro economic conditions improved. An analysis of advances' flow displays the same pattern of growth in fixed loans as observed in the banking sector (**Figure 5.7**).

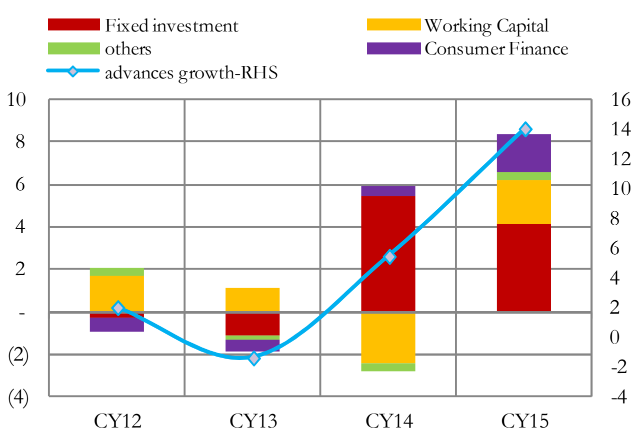
Under Consumer finance, flow of funds surged mainly in mortgage loans category. However, the growth was limited to only one DFI. SME sector shrank further with a net retirement of PKR 27 million. A prominent 75 percent decline was observed in the overall lending to Financial Institutions (FIs). Except one DFI, lending to FIs witnessed a downward trend.

Figure 5.7

Major share of funds flew to Fixed Investments

Advances Composition (Flows)

(PKR billion) (percent)



Source: FSD,SBP

Share of investments in total assets remains large…

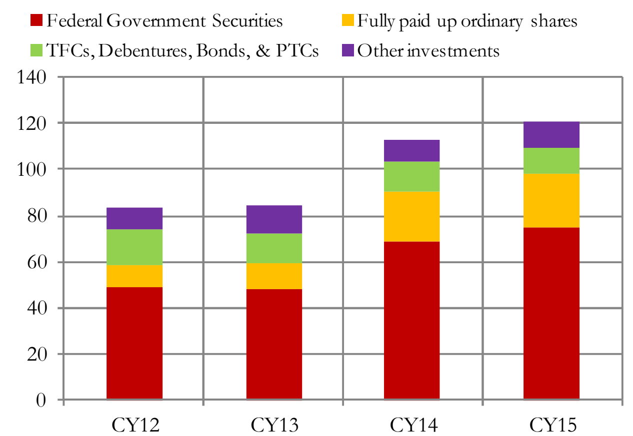
Investments, despite a decline in their share by 140 bps, occupy almost two-thirds share in total assets of the DFIs during 2015. A growth of 7 percent in investments is observed during the period owing to a notable increase of 9 percent in government securities (**Figure 5.8**). Investment in stock market also observed rising trend. Since CY13, equity investments have almost doubled in line with the capital market's remarkable performance.

Figure 5.8

Investment composition skewed towards Government Securities

Investment Portfolio of DFIs

(PKR billion)



Source: FSD,SBP

Investment composition skewed towards government securities…

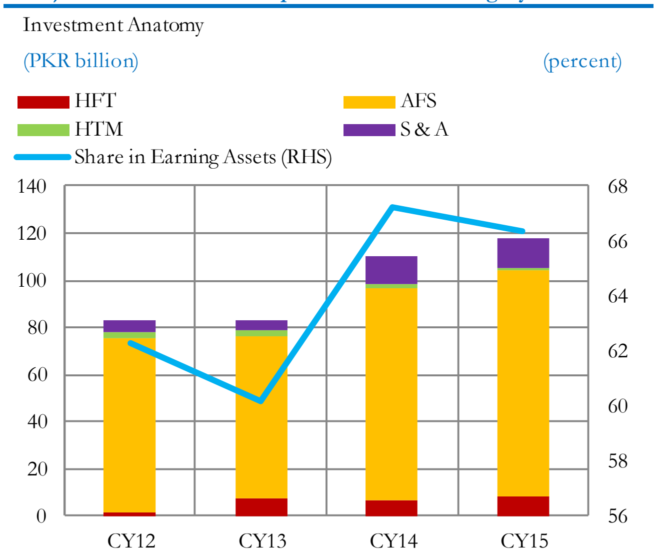
Investment composition is skewed towards government securities followed by equity instruments. In order to manage their liquidity and gain benefit from interest rate movements, DFIs kept their investment strategy flexible by parking major chunk of their investments under AFS category (**Figure 5.9**). As of CY15, DFIs hold 50 percent of PIBs and 17 percent of T-bills under AFS category.

Growth in deposits receded…

On the funding side, borrowings and equity remained the main sources of funding for the DFIs. Borrowings grew by 16 percent YoY largely on account of increase in call borrowings and loans from SBP. This increase in borrowings is mainly attributable to low cost of borrowings compared to that of deposits. Equity, which on average funds 41 percent of the total balance sheet footing, grew on the back of healthy growth in retained earnings.

Figure 5.9

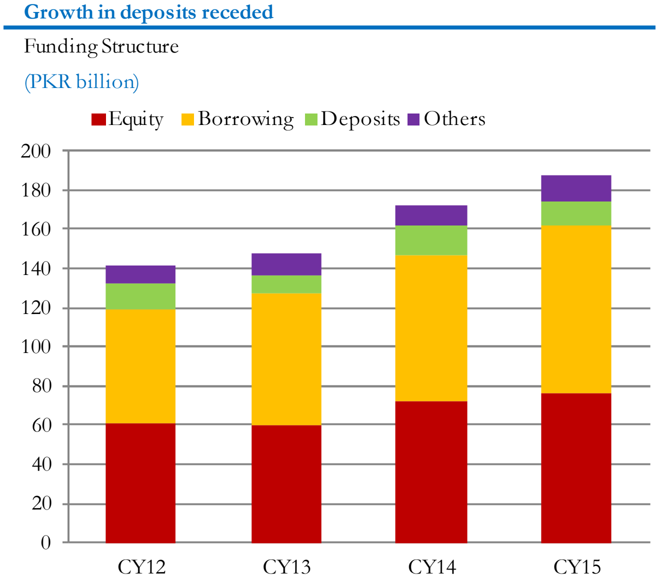
Major chunk of investments parked under AFS category



Source: FSD,SBP

Figure 5.10

Growth in deposits receded



Source: FSD,SBP

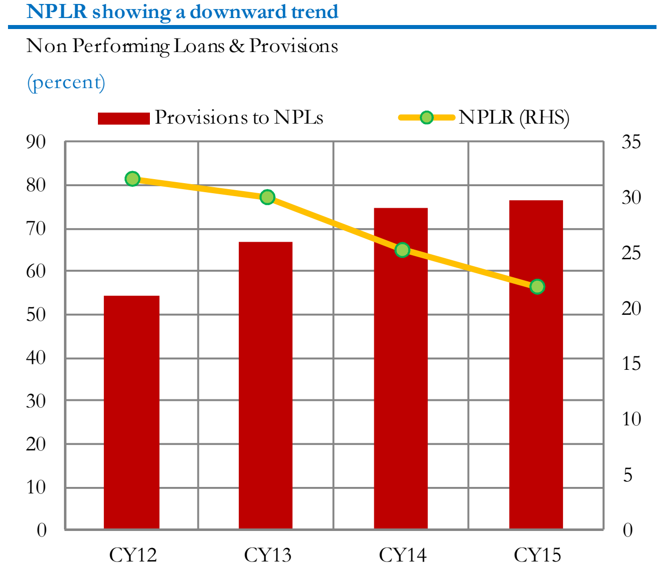
The share of deposits in total funding, on the other hand, has receded due to higher cost[135] (11 percent in CY15 compared to 9 percent in CY14) (**Figure 5.10**).

Assets quality of the DFIs shows improvements…

The infection ratio of DFIs has dipped due to marginal decline in NPLs stock and growth in advances, leading to improved asset quality (**Figure 5.11**). NPLs declined across the board except for two DFIs that showed an upward trend. More than 80 percent of the NPLs were parked under loss category having remote chances of recovery. Further, provision coverage ratio reached to a marginally higher level of 76.5 percent in CY15 in comparison to last year's level of 74.5 percent, demonstrating somewhat improved resilience of the sector.

Figure 5.11

NPLR showing a downward trend



Source: FSD,SBP

ROE and ROA of the sector dipped…

Operating performance of DFIs has been modest during CY15. The sector has posted pretax profit of PKR 8.8 billion, 1.1 percent higher over the last year. However, after tax profitability has

135 DFIs as per their mandate can only raise term deposits.

significantly declined relative to CY14 (a fall of 15 percent).

Though, the low interest rate environment has squeezed the return on advances, interest earned on large investment portfolio supported the overall net interest income which has also been complimented by a 16 percent growth in non-interest income. The major increase in non-interest income came from gains on sale of securities and dividend income.

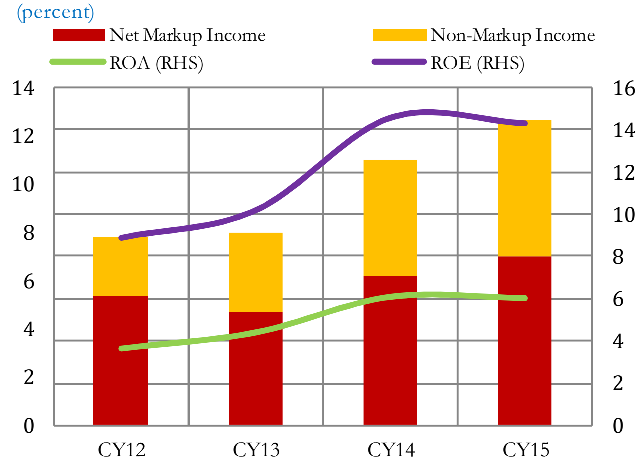
Nevertheless, ROA and ROE has dipped mostly due to increase in provisions and administrative expenses, and expanding asset base of largely low yielding assets (**Figure 5.12**).

Figure 5.12

ROE & ROA dipped

Performance of DFIs

(PKR billion)
(percent)



Source: FSD,SBP

Capital Adequacy Ratio (CAR) is declining…

Credit risk weighted assets have grown on the back of growth in advances. Operational risks weighted assets (ORWAs) also inched up due to higher gross income. Eligible total capital increased as well but proportionately less than the increase in RWAs; pulling the CAR downwards (**Figure 5.13**). However, the overall CAR of the industry at 43.6 percent is still at a level higher than the regulatory requirement evidencing strong solvency of the sector. All, but two, DFIs are compliant with minimum capital requirements.

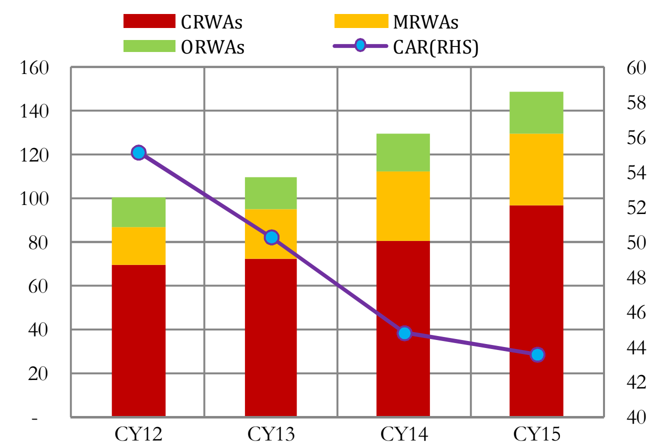
Positive economic outlook, energy sector reforms, improved law & order situation, developments on CPEC and low interest rate environment may lead to increased growth opportunities for this sector as well.

Figure 5.13

CRWAs inched up

Solvency Profile of DFIs

(PKR billion)



Source: FSD,SBP

Leasing Sector

With a miniscule share in the financial sector, leasing sector poses limited concerns for the stability of the overall financial sector. However, their positive contribution in spurring economic activities via provision of alternative financing source is well desired for the development of the financial markets. Also, the focus of the leasing business in Pakistan is, generally, on SME segment and consumer finance, with most of the disbursements for machinery, equipment and vehicle leasing, which makes it even more attractive for equitable economic growth purposes.

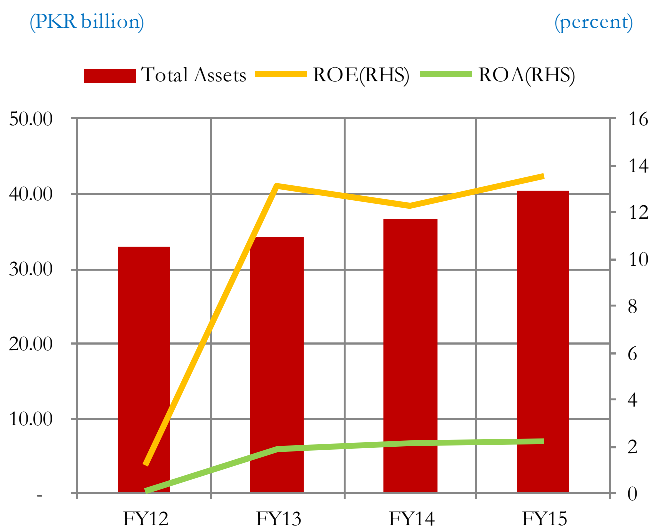
Steady growth funded by deposits and borrowing…

The leasing sector has registered a steady growth for the last couple of years. The sector added another 10 percent to its assets base during FY15. Most of it was funded by a reasonable increase in deposits and borrowings from financial institutions. The fresh funds were largely disbursed for financing core business of leasing. Despite increase in loan loss provisioning charge, the operating performance showed significant improvement as ROE increased by 130 bps to 13.5 percent (**Figure 5.14**).

Figure 5.14

Steady asset growth funded by deposits and borrowings

Asset Growth & Profitability Ratio



Source: Annual Audited accounts of Leasing Companies

The ownership structure of leasing industry shows that 6 of these companies are part of the local or foreign banking groups and are largely contributing to the growth and performance of the sector during the last few years. The sector is quite concentrated as the largest firm (asset-wise) in the sector accounts for 69 percent of the sector's assets and 82 percent of sector's lease income. Market news suggest merger of two leasing companies which will create a larger firm whose market share will further increase concentration risk.[136]

Credit and liquidity are major risks faced by the leasing companies. In terms of severity, liquidity remains a major impediment in the growth of this sector. As large number of these firms are dependent on bank funds to finance their business, their growth remains largely affected by availability of funding lines from the banking sector.

Changes in the regulatory framework…

Leasing sector is governed by NBFCs and NE (Non-Bank Finance Companies and Notified Entities) regulations 2008 which were amended in November 2015 **(See Box 5.1)**. One of the major changes in these regulations is in capital requirement for deposit raising leasing firms.

As a result capital standards for new leasing companies which can raise deposits has been set at PKR 1 billion while existing leasing companies with deposit raising status can operate with a capital base of PKR 500 million. Further non-deposit taking leasing firms can operate with a nominal capital base of PKR 50 million.

Changes in the regulatory environment will help to solve the long standing solvency issues plaguing the sector. Further it will add to overall financial stability as only strong players remain in the market.

Modarabas

The Modaraba sector, despite 30 years of its operations, is far from actualizing the true potential of its business model which encompasses diversity in operations and maximum dividend payouts to its investors.

In 2008, SECP introduced 12[137] model financing agreements both to bring the companies at a level-

[136] For details of merger please visit www.psx.com.pk

playing field with the conventional sector and to provide new products for the Islamic financial market. Capitalizing on the model agreements, the companies can undertake diverse activities including leasing (Ijarah), financing, trading, manufacturing, property development, project financing and equity investments. Yet the sector's assets and income remains concentrated in leasing and only a few players have attempted to venture into trading, manufacturing and other Shariah-compliant financing.

Although the bank sponsored modarabas drawing on the credibility of their parent companies are able to mobilize funds in their investment schemes while also getting concessional credits at times, the rest of the companies are facing funding constraints and financing expenses.

Further, the Modaraba Management Companies (MMC) akin to an Asset Management company, were expected to float different types of Modarabas exploiting their respective strengths but almost all of the MMCs remained confined to the first offering. Currently there are 33 licensed MMCs but only 24 are in operation.

The growing Islamic finance industry offers immense potential for profitable operations, but the business strategies of the sector's players and lack of innovation in product offerings continues to dampen the modaraba companies' progress.

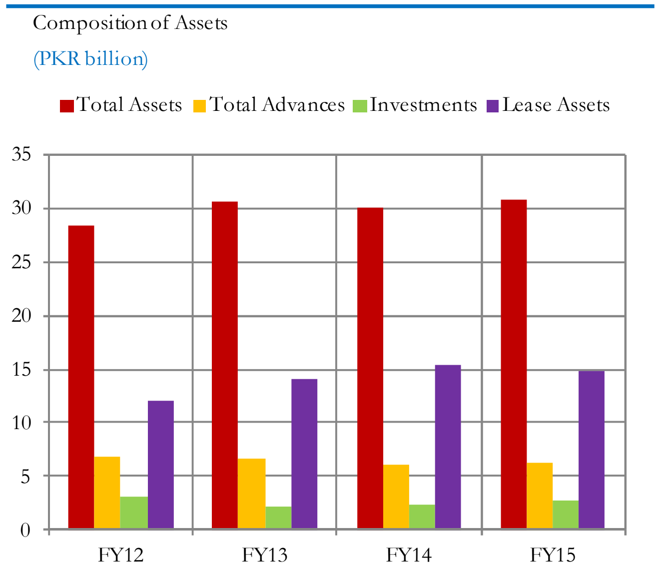
Moderate asset expansion amidst unchanged composition…

The 24-company sector's asset base, while expanding over the years at an average rate of 3 percent, has reached PKR 31 billion in FY15. It still accounts for a meager 4 percent of the non-banking financial sector's assets. The current asset growth was largely contributed by investments[138] which grew by 13 percent in FY15 on the back of vibrant equity market.

On the other hand, lease rental receivable -the core business of modarabas showed a nominal growth of 2 percent. Reliance on lease rental services is evident from the sector's asset profile whereby lease assets, while shrinking marginally, continued to make up a sizeable portion of total assets (48 percent in FY15 down from 51percent in FY14) (**Figure 5.15**).

Figure 5.15

Sector Assets remain concentrated in Lease Assets



Source: Audited financial statements of Modarabas

Modest inclination towards advances can be gleaned from the trend in financing under the various Shariah-compliant modes which grew by 2 percent in FY15. The growth, however, was concentrated in the bank sponsored modaraba companies which witnessed a 4 percent increase while the rest saw a decline of 5 percent.

Performance is concentrated in asset rich and bank controlled companies…

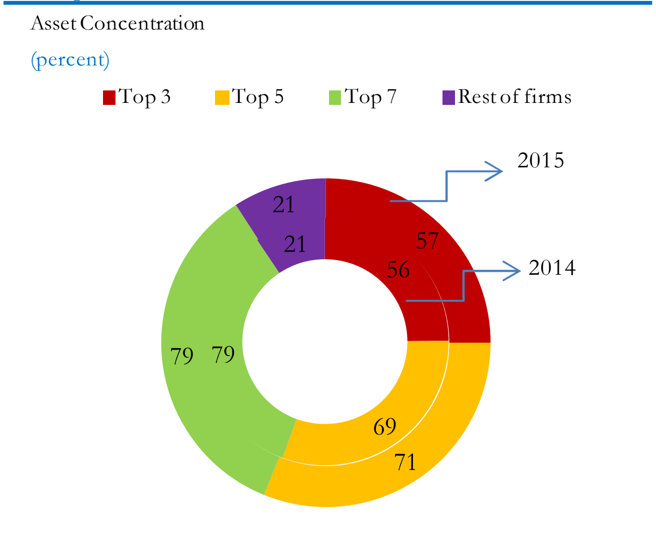
137 Ijara, Modaraba, Musharika, Diminishing Musharika, Musawamah, Istisna, Murabaha, Salam, Syndicate Modaraba, Syndicated Musharika, Islamic CFS Murabaha and Sukuk.

138 Investments include Listed /unlisted securities, Sukuk, certificate capital of other modarabas, subsidiaries/ associated companies and mutual funds.

Much of the sector's performance and assets remained concentrated in the top seven modarabas. These seven companies (asset-wise) represented 79 percent of the sector's assets, 70 percent of sector's equity and 86 percent of sector's income from operations in FY15 (**Figure 5.16**).

Figure 5.16

Sector Assets remain concentrated in Top Seven Modaraba Companies



Source: Audited financial statements of Modarabas

The modarabas under management control[139] of the banking sector seemed better positioned to take advantage of the business model offered by the sector as they made up 51 percent of total assets, 19 percent of equity and 34 percent of income from operations (**Table 5.6**).

Table 5.6

Modarabas under Management control of banks

	FY12	FY13	FY14	FY15
	percent			
Contribution in Sector Assets	58.0	55.0	53.0	51.0
Contribution in Sector Equity	18.0	16.0	17.0	19.0
Contribution in Core Income	28.0	48.0	32.0	34.0

Source: Audited financial statements of Modarabas.

Equity financed a major portion of the sector's assets…

Prudential regulations requiring transfer of 20-50 percent of after tax profits to a statutory reserve translated into an ever increasing contribution of equity in the sector's funding mix which surpassed 51 percent in FY15. In FY15, 33 percent of the sector's profits were transferred to statutory reserves. Financing, predominantly from the banking sector and other modaraba companies shrank to 12 percent while deposit mobilization, via non-interest bearing investment certificates, reached 21 percent (**Table 5.7**).

Table 5.7

Funding Mix of Existing Modarabas

	FY12	FY13	FY14	FY15
	percent			
Financing	17.0	14.9	16.4	12.2
Deposit Mobilization	23.2	25.6	20.8	21.3
Equity	44.0	42.9	47.9	51.7

Source: Audited financial statements of Modarabas.

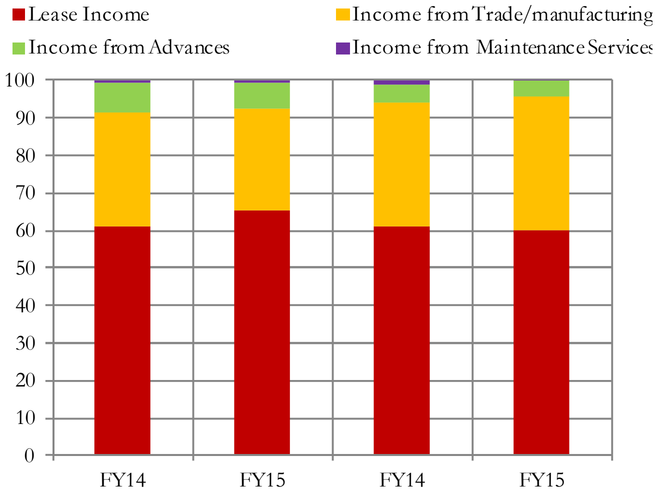
139 Via direct ownership of the Modaraba Management Company or shareholding by the bank's associated companies.

Figure 5.17

Lease Income continues to dominate Sector Earnings

Composition of Income from Operations

(percent)



Source: Audited financial statements of Modarabas

Lease income dominated sector's earnings…

The sector's income remained concentrated in lease rentals which accounted for 59 percent (down from 61 percent in FY14) of total income generated from operations in FY15. While income from trading/sales grew on average at 7 percent over FY12-15, more than 70 percent of that income was attributable to a single manufacturing modaraba (**Figure 5.17**).

Profitability declined marginally…

Profitability of the sector fraught with operating and financing costs, declined over the year by 4 percent to reach PKR 1.4 billion with four companies landing in red. 61 percent of the income from operations was expensed in operating costs while another 10 percent went towards payment of finance costs (**Table 5.8**).

Depreciation on Lease Assets and Modaraba Management Company (MMC) fee further dragged down the profitability as most of the modarabas continued to pay the MMC fee at the maximum prescribed threshold of 10 percent of annual profits.

Tax exemption benefits continued to drive payouts to certificate holders. Cash dividends ranging from 0.9 percent to 90 percent of paid-up-capital were paid out by 20 of the companies in FY15 but many of the companies offered rates which were still not competitive.

Table 5.8

Performance Indicators of Modarabas

(PKR in billions and ratios in percentage)

	FY12	FY13	FY14	FY15
Profit After Tax	1.2	2.0	1.4	1.3
Total Income	10.2	11.8	10.6	10.7
Operating and Finance Cost	6.3	7.1	6.7	6.9
ROA (After Tax)	4.3	6.4	4.7	4.4
ROE (After Tax)	9.8	15.0	9.8	8.5

Source: Audited financial statements of Modarabas.

SECP in March-2016 carried out a comprehensive financial review of the modaraba companies to initiate action against the ones with unsatisfactory track record of dividend payouts, excessive bookings of non-earning assets and imprudent risk management framework. In the process, SECP has identified 13 underperforming modarabas and has vowed to chalk out business plans for their performance improvement.

SECP invited stakeholder comments on proposed regulations…

The proposed draft of Modaraba Regulations-2015, much in-line with the sector's current funding status, seeks to confine issuance of certificates of investment to the financial services modarabas. The change, if approved, would likely result in increased secondary offerings of securities by non-financial modarabas or alternatively padding-up of reserves via profitable operations in an attempt to maintain funding level. The proposed regulations further seek to link deposit mobilization with minimum equity and proposed CAR methodology along with more stringent credit rating requirements envisaging stronger depositor protection.

The resilience that Islamic financial system components bring to the financial sector due to their real asset backed nature advocates for their stronger presence in our financial system. Lacking the ability to mobilize funds via investment schemes/deposits on the level of bank sponsored modarabas/Islamic banks which enjoy public confidence, the non-bank sponsored modaraba companies may venture into small-ticket businesses.

By offering short and medium term financing in areas like agriculture, livestock, tailor-made financing, small-scale businesses, the companies can better position themselves to cater to the unbanked segments of the economy promoting financial inclusion on the one hand and avoiding overwhelming competition on the other.

While the sector is devoid of posing a worthwhile threat to the stability of the country's financial system, the resource contribution by the banking sector, both as a financier and as an investor, points to a relatively vulnerable position of the sector itself in instances of operational threats to the banking sector.

Investment Finance Companies (IFCs)

Investment Finance companies licensed as such by the SECP can undertake a wide range of activities from the very basic fee-based investment advisory, FX trading and brokerage to the much intensive portfolio/ wealth management and corporate /consumer financing. The companies are meant to serve the investment and financing needs of a diverse clientele of financial institutions, general public, private sector corporations and high net worth individuals and can also venture into other NBFC categories such as commercial and retail leasing subject to additional minimum equity requirements as defined by the SECP.

The sector has seven[140] operative companies as of FY15 but the licenses for six of these companies are pending renewal by SECP which is in the process of devising a road-map for the NBFC sector along with a new set of regulations.

Repercussions of the liquidity crisis persisted while competitive environment threatened viability of operations...

The liquidity crunch after the stock market crisis of 2008 was especially intense for the investment finance companies because of their excessive reliance on the unsecured credit lines from banks and huge provision expense on their infected investments in stock market.

The repercussions of the crisis still persist as the sector is yet to post a profit. The companies continue to struggle with recoveries, accumulated losses and inability to raise financing. Lack of level-playing field and competition emanating from the presence of the much resourceful investment banking desks of commercial banks add to the adversity being faced by the sector as they continue to rely on their very competitors for their business funds.

…… wiping out sector assets……

The business of IFCs is stagnant. The companies have been operating on the side-lines focusing on settling outstanding liabilities via disposal of non-core/non-earning assets and maximization of recoveries from NPLs; thereby shrinking their balance sheets.

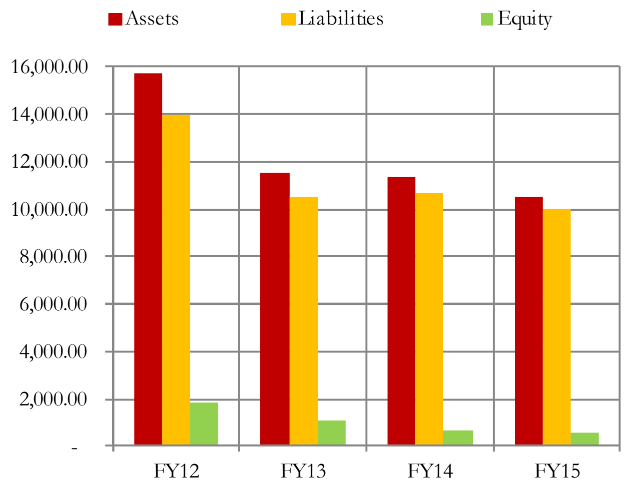
[140] LSE Financial Services, formerly the Lahore Stock Exchange, exchange has been licensed as an IFC.

Figure 5.18

Declining Balance Sheet Size of all but one company in the Sector

Balance Sheet Composition

(PKR million)



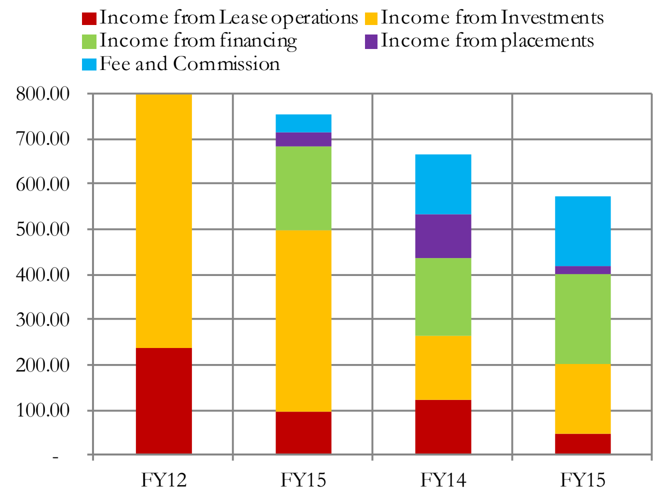
Source: Audited financial statements of Investment Finance Companies

Figure 5.19

Sector Earnings shift towards non-fund based sources

Composition of Income from Operations

(PKR million)



Source: Audited financial statements of Investment Finance Companies

The receding balance sheets of majority of players diluted the sector's asset base which reached PKR 10.5 billion in FY15 registering a 33 percent reduction over the four year period (FY12-15). Funding side (both liabilities and equity) followed suit, decreasing by 28 percent and 31 percent, respectively. All of the companies continue to report deferred tax assets which remained unutilized owing to their limited taxable income. Deferred tax assets accounted for 10 percent of the sector's asset base in FY-15 (**Figure 5.18**).

Mixed profitability results and tax losses overwhelm the sector's bottom line…

Most of the companies, due to non-availability of liquidity for fresh business, have been focusing on non-fund based activities to remain afloat. Non-fund based income (Fee and Commission) took the lead witnessing YoY growth of 17 percent in FY15 accommodating a 26 percent share in income (up from 4 percent in FY12). The contribution in total income from financing, investments and placements reduced from 78 percent to 62 percent over the period FY12-15 (**Figure 5.19**).

In FY15, five companies posted after-tax profits capitalizing on mark-up waivers on settlement of liabilities, reduction in financing costs brought on by a reduction in borrowings, net reversals in provisions (registered by 5 companies in FY15) and rationalization of administrative expenses (**Table 5.9**).

Table 5.9

Performance Indicators of Investment Finance Companies

	FY12	FY13	FY14	FY15
	(PKR billions)			
Income from Core Operations	1.46	0.76	0.67	0.57
Admin & Operating Cost	(0.67)	(0.56)	(0.48)	(0.46)
Finance Cost	(1.50)	(0.48)	(0.30)	(0.21)
Operating Profit	(0.71)	(0.28)	(0.99)	(0.72)
Equity	(1.69)	(0.78)	(0.13)	(0.16)

Source: Audited financial statements of Investment Finance Companies

Over the four year period (FY12 to FY15), funding (borrowings, COIs, CDs) went down by 31 percent which resulted in a reduction of 86 percent in the mark-up costs. During FY15, finance costs posted a 30 percent decline coming from a 12 percent reduction in funds; net provisions of PKR 156 million in FY14 turned into net reversals against provisions of PKR 96 million in FY15; while administrative and operating expenses decreased by 32 percent over the year.

While both the operating and financing costs have reduced over the years, the progressively declining income from operations remains insufficient to cover these costs. In FY15, operating expenses wiped out 77 percent of Income generated from operations and another 35 percent was expensed in finance costs (28 percent for mark-up on COIs and CDs and 7 percent for borrowing).

Reversals in provisions of PKR 96 million were enough to offset the operating loss of the sector which managed to achieve nominal profits before tax of PKR 45 million- the first positive figure since FY12. However, reversal of deferred tax asset of PKR 220 million by a single company overwhelmed the sector's after-tax performance landing it in red (negative PKR 163 million).

Re-emergence of positive yet insufficient cash flows from operations…

Cash flows from operations, a primary determinant of debt-servicing ability and one of the decisive factors in credit analysis, seems to be a constraining factor in the companies' ability to raise financing.

The sector is facing serious problems in terms of liquidity based on the cash flow generated from operations. Cash flows of PKR 239 million generated from operations in FY15 were only 25 percent of the maturing liabilities of PKR 942 million.

Inability of the core income to cover the maturing liabilities will present liquidity constraints over the coming year as well. The companies will continue to face the need to re-structure their present obligations or draw on funds from disposals of non-earning assets to meet impending commitments.

Non-compliance under NBFC regulations continues…

Unfavorable business environment over the years coupled with accumulated losses has eroded net worth of most of the companies; as a result, six of the companies remained non-compliant under the Non-Banking Finance Companies and Notified Entities Regulations 2008 regarding Minimum Equity Requirement. The non-compliance further extends to fund and non-fund based exposure limits which have been linked to equity.

SECP, under the new regulations has linked the Minimum Equity Requirement (MER) with deposit taking and has given a year to the existing deposit taking investment finance companies for compliance with the new MER or opt out of the deposit taking category while freezing the deposits at the existing level.

The fund and non-fund-based exposures have been revised downwards[141], further constraining the limits for IFCs which opt out of the non-deposit taking status. Deposit taking finance companies have further been required to maintain a Capital Adequacy Ratio of 8 percent for the first two years and 10 percent thereafter.

This while being challenging for those investing in unlisted equity, risky debt securities and unsecured financing (highest capital charge category of 150 percent) would provide for additional capital cushion adding to immunity from adverse business outcomes.

Should the expected outlook of the equity markets materialize, the companies capitalizing on the

[141] Fund and non-funds from 30 percent to 20 percent and fund-based from 20 percent to 15 percent of equity.

generated business opportunities for investment banking services may generate funds enough to cover at least their operational costs.

Box 5.1: Revamped Regulatory Framework for NBFCs

SECP introduced major amendments to the regulatory framework for NBFCs in November, 2015. The amendments seek to improve on the risk management practices of NBFCs, link Minimum Equity Requirements (MER) with the respective business activities of the NBFCs and enable SECP to regulate the non-bank micro finance institutions.

The amendments categorize NBFCs as lending NBFCs and Fund management NBFCs. Lending NBFC i.e. Leasing Companies, IFCs, HFCs, Discount Houses and Non-Bank Microfinance Companies. NBFCs have been further segregated into non-deposit taking and deposit-taking entities with distinct regulatory requirements. The definition of NBFC has been broadened to include Discount Houses and Non-Bank Micro Finance Companies (NBMFCs). With the addition of new entrants, NBFIs are expected to play an important role in mobilizing investments to the sectors that need special attention such as micro finance, SME financing, housing and infrastructure development.

The concept of small and mid-sized non-deposit taking NBFCs has been introduced with significantly reduced equity requirements. MER for non-deposit taking leasing companies and housing finance companies has been reduced to PKR 50 million from PKR 700 million and that of non-deposit taking investment finance services has been reduced from PKR 1,000 million to PKR 100 million. Moreover, housing finance companies, in addition to the consumer financing, have been permitted to undertake commercial housing finance activities.

Lending NBFCs can apply for permission to raise deposits after complying with the prescribed criteria related to MER, CAR (initially at 8 percent), credit rating etc. However, leasing companies, discount houses and house finance companies are required to invest 70 percent of its total assets in its licensed form of business.

Measures have also been adopted to support sustainable growth of fund management industry. In order to reduce the cost of setting up a company, Fund Management NBFCs have been allowed to undertake different Fund Management Services i.e. Asset Management, Investment Advisory, Private Equity & Venture Capital Fund Management Services and REIT Management Services under a single entity. In order to encourage private fund management, the eligibility criteria for Fund Management Company has been redefined and now a company other than a public limited company may also obtain license for private fund management. In addition, a new type of fund i.e. Private Fund has been introduced. Now, the fund management company may launch private funds with varied objectives of investing in wide range of financial assets including equity securities, debt securities etc.

For mutual fund industry, expense ratio has been capped according to the type of fund. Management fee has further been reduced to limit the maximum expenses that can be charged to a mutual fund to improve investors' return.

Box 5.2: Real Estate Investment Trusts (REITs) in Pakistan

Real Estate Investment Trust (REITs) is a mutual fund that invests in a pool of properties/mortgages bundled together and offered as a security in the form of unit investment trusts. These units can then be traded on stock markets. Each unit in a REIT represents a proportionate fraction of ownership in each of the underlying properties/mortgages providing its holders a simple way to invest in real estate without the cost or illiquidity associated with owning a property directly. There are two main types of REITs: equity REITs and mortgage REITs (mREITs). Equity REITs invest in real estate by acquiring properties and developing or renting them. Mortgage REITs invest in the debt required to finance real estate, including mortgage loans and Mortgage Backed Securities (MBS).

Global perspective

The global real estate securities market has seen a major transformation with the adoption of REITs and similar structures as countries sought to encourage broader public investment in commercial real estate. The market grew to approximately US $1.5 trillion in March 2016[142] with more than sixty six percent of investment in REITs.

REIT legislation was first introduced in 1960 in the United States, followed by the Netherlands (1969) and Australia (1971). In the early 1990s, faced with a downturn in the commercial real estate and the savings-and-loan crisis, private real estate companies began to adopt the REIT structure thereby accessing capital from public markets. As a result, more than 100 U.S. companies formed as REITs and became public between 1991 and 1997.

Encouraged by the positive impact REITs had on the investment landscape, real estate industry, capital markets and real economy, other countries began to implement similar legislation. From the late 1990s Asian governments started passing legislation allowing for establishment of REITs. The earliest Asian markets to adopt the structure were Japan and Singapore, later followed by Hong Kong, Malaysia, Thailand, Taiwan, and South Korea.

Benefits and Risks

REITs under a product offering that derives value from both the real estate and trading components is expected to simultaneously promote the development of the real estate and capital markets. A new product's trading while adding depth to the capital market will build professional capacities in the areas of valuation, fund management and trusteeship. The disclosure requirements of a REIT (which equate those of a public limited company) and the improved price discovery for rental and sale transactions of properties are further expected to bring the much needed transparency in the current murky real estate market.

Equity REITs are subject to the location-specific risks of their properties including any negative developments in the nearby locations which may depress REIT valuations. Phases of boom and bust, typical of the property market, may introduce further volatility in valuations.

In the mortgage REITs, the Global Financial Crisis has already demonstrated the potential hazards of leverage, maturity transformation and repo borrowings. These risks are typical of the mREIT model which borrows in the repo market to invest in the longer-term MBS-earning the yield differential. Despite that, the US mREIT market capitalization has grown significantly in recent years to reach US$ 52 billion. The policymakers seem to go soft on this asset class given the desirability of an active and liquid market for MBS and its favorable effects on the housing market development.

Regulatory environment in Pakistan

Globally, REITs are open-end structures. But in Pakistan, REITs have been initially introduced as closed

[142] FTSE EPRA/NAREIT Global & Global ex US Indices as at March 31, 2016.

end funds to avoid high redemptions thereby safe guarding against systemic risk.

The three types of REIT schemes introduced by SECP in Pakistan are the Developmental, Rental and Hybrid REITs. Developmental REIT schemes focus on developing acquired properties for Industrial, Commercial or Residential purposes through construction or refurbishment and then selling it for profit. Rental schemes invest in commercial or residential Real Estate to generate rental income. Hybrids are a combination of the two.

SECP initially notified the REIT Regulations in 2008 licensing two REIT Management Companies (RMCs), Arif Habib REIT Management Company Limited and AKD REIT Management Company Limited. However, sufficient interest was induced after the launch of fresh REIT regulations in 2015[143]. The specified parameters for REIT schemes under the previous regulations tended to encourage developmental REITs and large-sized rental REIT schemes. The new regulations tend to encompass the whole spectrum of schemes.

Entry barriers have been lowered whereby capital requirements for starting an RMC have been revised downwards from PKR 200 million to PKR 50 million. Limits on single investor ownership of fund units (IPOs capped at 5 percent and Pre-IPOs at 10 percent of fund units) has been done way with to facilitate admission of large-scale REIT projects. Concept of strategic investor has been introduced making RMC and the strategic investors the fall-back entities which are to hold the specified investments units in blocked accounts until the winding up of the scheme. The scheme's fund size has been linked with the listing regulations of the relevant exchange.

Utilization of customer advances has been capped to a percentage of construction cost as specified in the business plan and offering document. Unsecured borrowing for capital expenditures and to meet cost overruns has been permitted to the extent of 30 percent of land/real estate value. This resulting reliance on capital market for liquidity is expected to deepen capital markets and protect unit holder's right on the underlying property as it avoids excessive leveraging of a high-ticket business.

REITs investments have been encouraged further by providing tax benefits. As per finance bill 2015-16, the capital gains of a person who sold property to a REIT development scheme have been exempted from Income Tax till June 30, 2020. Further, income tax chargeable on dividend income from a REIT scheme set up by June 30, 2018 for the development of a housing sector has been reduced by 50 percent for the first three years.

State Bank of Pakistan also took an initiative to develop REIT market by relaxing its concentration limits for banks' exposure in equity market. Previously, banks were allowed to hold aggregate equity investment up to 30 percent of their own equity. However, for REITs investment, they can add another 10 percent exposure. This measure will help to develop the REIT market by creating demand from the banking sector.

Current status of REITs in Pakistan

Pakistan's first Real Estate Investment Trust fund was launched on June 12, 2015 which was oversubscribed; indicating huge interest of investors in indirect real estate market. Bringing together the strengths of the Arif Habib group and the Dolmen Group, the "Dolmen City REIT" floated 25 percent of its fund size of 22.237 billion. The Dolmen City REIT is close-end, listed, Shariah compliant Rental REIT offering investors to become unit holders of two components of the Dolmen City project, the Dolmen Mall Clifton and The Harbor Front. The fund management paid its first month's profit of PKR 169.612 million as dividends, yielding 9.6 percent return to its investors in only a month.

Outlook

Traded equity characteristics of the REIT structure may make them vulnerable to swings of the stock market.

[143] Currently four RMCs have been licensed under the new regulations- AKD, Arif Habib Dolmen, Orange and ISE Towers.

However, backing of a real asset as the fall-back value coupled with the structure's currently small share in the NBFI sector assets (3 percent) points towards its relative insignificance in terms of posing financial instability threats to the financial system.