3.4 Risks to the Development Finance Institutions

Operations of the DFIs are far from an ideal business model which should foster economic growth in emerging economies by promoting private investments. Most of the sector's asset base remains parked in government securities with only 37 percent lent to the private sector. This cautious activity profile translates into a strong solvency position and impressive financial soundness indicators (FSIs). However, in CY16, given relatively lesser government borrowings, credit to private sector has expanded with the advances posting a 21 percent increase. This is suggestive of increasing risks on the sector balance sheet. Accordingly, CRWAs have posted an increase of 19 percent. Further, increase in Repo lending by a factor of 11 is suggestive of increasing inter-connectedness within the financial sector.

Development Finance Institutions (DFIs) play a fundamental role in emerging markets as they aim to invest in sustainable and profitable businesses either directly (investments in private sector companies or provide lending), or through financial intermediaries. Being funded by bilateral and multilateral sovereigns, they can catalyze higher risk private sector investments while remaining financially viable in the long run. Such sought-after development-oriented activities of DFIs have rather been slack in the past in the country. But this may be changing with the improving macroeconomic conditions.

Table 3.4.1

Key Variables and Financial Soundness Indicators of DFIs

	CY12	CY13	CY14	CY15	CY16
	PKR billion				
Investments	79.1	79.5	108.3	115.3	108.9
Advances	46.0	45.3	48.6	56.8	68.6
Total Assets	140.4	149.1	176.1	190.5	208.8
Borrowings	58.2	67.3	74.4	86.5	98.4
Deposits	13.5	8.9	15.0	12.0	10.9
Equity	59.6	62.6	76.4	79.3	82.2
NPLs	18.2	17.1	15.1	15.0	13.9
	Percent				
CAR	54.82	51.42	44.85	43.62	40.78
NPLs to Advances	31.80	30.04	25.27	21.98	17.48
Net NPLs to Net Advances	14.68	12.25	7.93	6.21	4.51
ROA (After Tax)	(0.17)	8.77	4.48	3.36	3.56
ROE (After Tax)	(0.42)	7.49	10.64	7.92	8.66
Cost to Income Ratio	42.06	40.85	30.96	32.59	38.78
Liquid Assets to Short-term Liabilities	81.31	84.77	84.80	86.31	90.23
Advances to Deposits	340.40	505.90	323.92	471.61	627.65

Source: SBP

Strong growth in advances provided boost to assets base

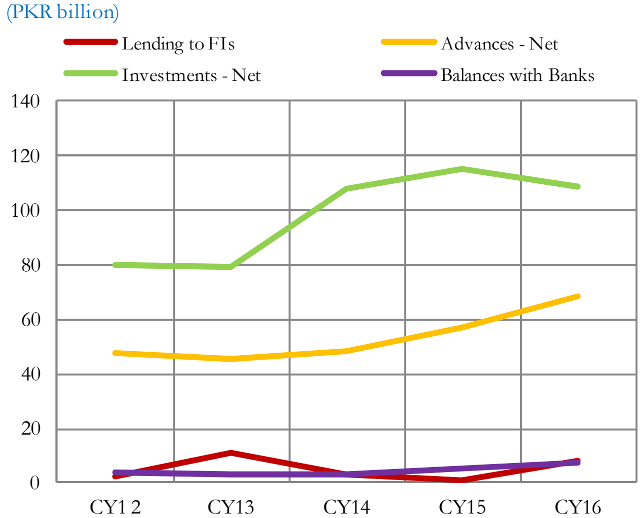
The asset base of the DFIs has expanded by 9.6 percent in CY16; mainly driven by growth in advances. Investments, as compared to advances, still holds roughly one half of the balance sheet of DFIs, however, its growth has receded in CY16 (**Table 3.4.1 & Figure 3.4.1**).

Figure 3.4.1

Investments occupied significant share in Total Assets

Composition of earning assets

(PKR billion)



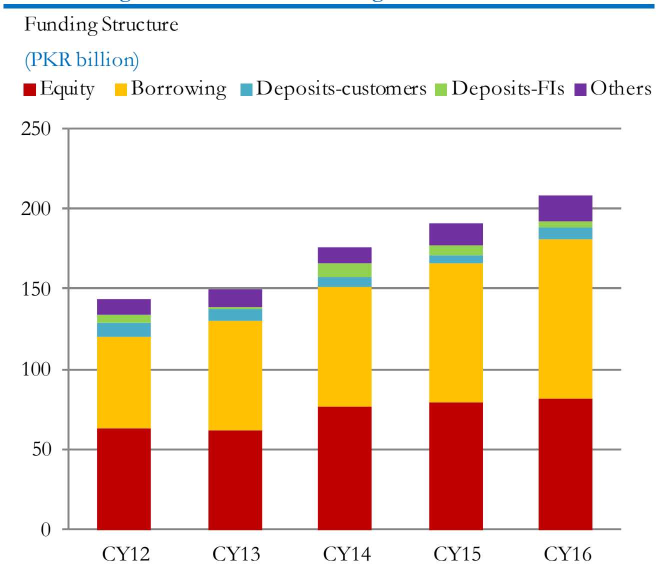
Source: FSD,SBP

Funding structure has remained heavily reliant on costly borrowings

Unlike banks, which rely on deposits as the main funding source, DFIs has remained reliant on equity and borrowings which jointly fund 86 percent of the assets of DFIs (**Figure 3.4.2**). Equity usually has remained the mainstay of the funding structure of DFIs; however, borrowing has seen a substantial jump, particularly clean borrowing, which has almost doubled in CY16.

Figure 3.4.2

Borrowing remained the main funding source



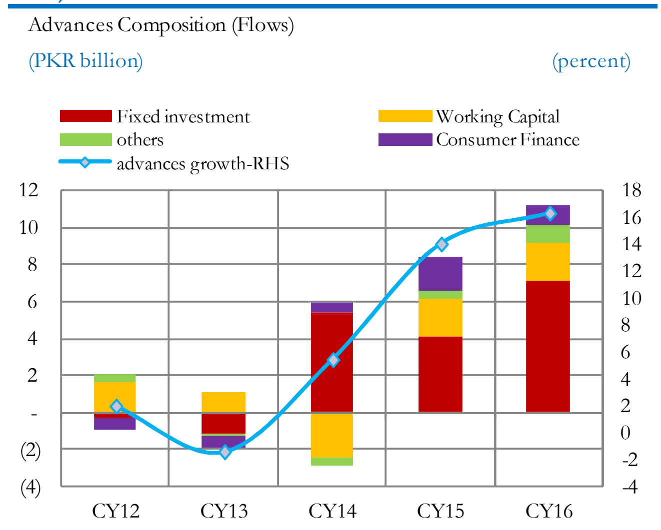
Source: FSD,SBP

This phenomenon of clean borrowing is quite in contrast to previous behavior of DFIs which are very active in secured borrowing market. This trend indicates strong money market activity by DFIs which is further substantiated by their active involvement in Repo lending to FIs in CY16 which is 11 times higher than previous year. The active role of DFIs in money market is indicative of their strategy to borrow short and lend long and earn the yield spread. However, such a strategy is very risky because any adverse movement in yield curve may lead to severe losses for DFIs.

Deposit[117] base of DFIs, largely comprising of Certificates of Investments (COIs) and financial institutions deposits, on the other hand, has declined in CY16. However, within deposits, customers deposits have picked up pace and have grown by 40 percent which can provide strong base for further expansion in DFIs' advances portfolio. Apparently, this deposit growth is result of accommodative regulatory policy which has allowed DFIs to issue COI of shorter tenors (one month and above).[118]

Figure 3.4.3

Major share of funds flew to Fixed Investments



Source: FSD,SBP

Advances have grown both for working capital and fixed capital formation

In CY16, advances (gross) have increased by a notable 16.3 percent over the last year, higher in comparison to growth of 12.8 percent in the banking sector. The main contributing factor in advances' growth during the year can be traced to a remarkable 17.9 percent growth in corporate sector lending for both working capital needs and fixed

117 DFIs as per their mandate cannot raise checking deposits (CASA deposits).
118 BPRD circular No. 2 of 2015

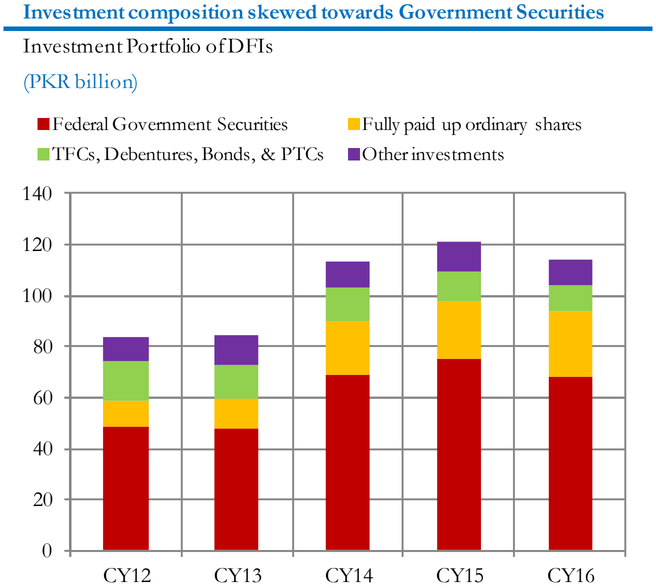
capital formation mainly in textile and electronics. Private sector lending has increased as the macro economic conditions have improved. An analysis of advances' flow shows same pattern of growth in fixed loans as observed in the banking sector (**Figure 3.4.3**).

Investment composition skewed towards government securities…

Contrary to their defined roles as development finance institutions, the business model followed by DFIs is more of investment banking. Their balance sheet composition comprises on average 50 percent of investment book. Investment composition is skewed towards government securities (60 percent share) followed by equity instruments and TFCs.

Figure 3.4.4

Investment composition skewed towards Government Securities



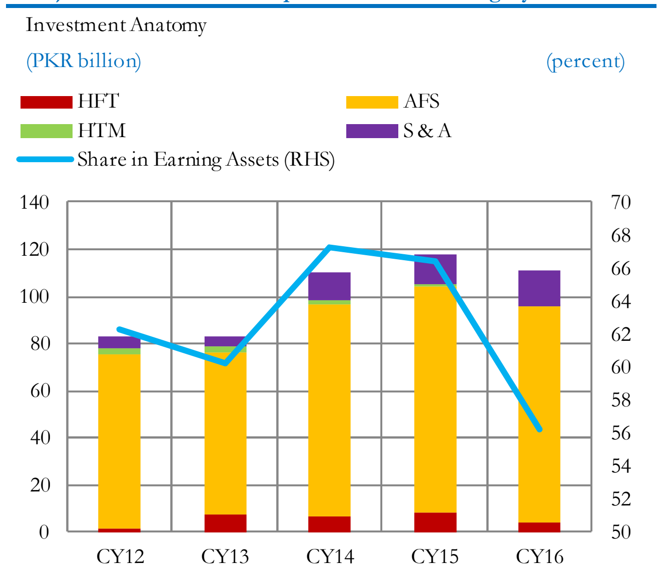
Source: FSD,SBP

Investments, despite a decline in their share by 135 bps, occupy 56 percent share in earning assets of the DFIs. Despite 10 percent additional exposure to stock market, investments have observed a dip of 5.5 percent largely on the back of 39 percent contraction in PIBs portfolio (**Figure 3.4.4**). This declining investment portfolio can have a strong bearing on the earnings performance of DFIs (both in terms of interest income and revaluation gains) in the long run.

Liquidity preference is also dominant in classification of investment portfolio by DFIs. In order to manage their liquidity and gain benefit from interest rate movements, DFIs have kept their investment strategy flexible by parking major chunk of their investments under AFS category (**Figure 3.4.5**). DFIs hold 83 percent of their investment portfolio, largely comprising of T-bills and PIBs, under AFS category.

Figure 3.4.5

Major chunk of investments parked under AFS category



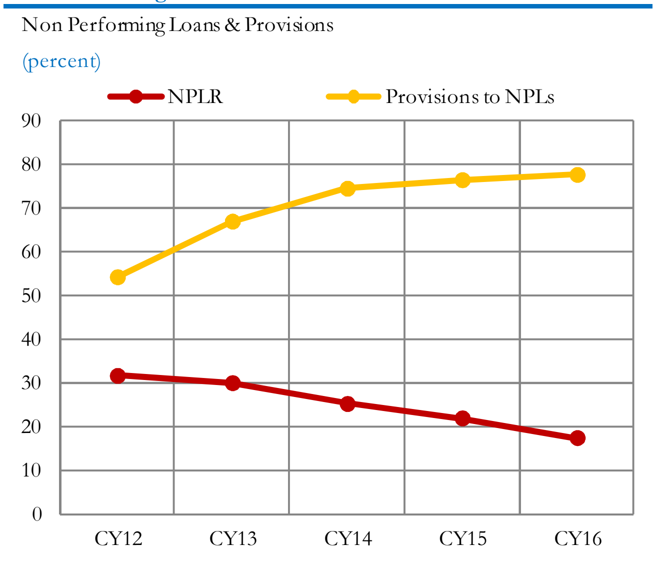
Source: FSD,SBP

Assets quality of the DFIs shows improvement…

The infection ratio of DFIs has dipped due to decline in NPLs stock and relatively higher growth in advances, leading to improved asset quality (**Figure 3.4.6**). Among DFIs, trend of NPLs decline is mixed. However, most of the NPLs have been parked under loss category with provision coverage ratio of 77.69 percent demonstrating improved resilience of the sector. With growing advances portfolio, DFIs need to be vigilant to arrest the flow of fresh NPLs in the system to maintain a healthy growth momentum.

Figure 3.4.6

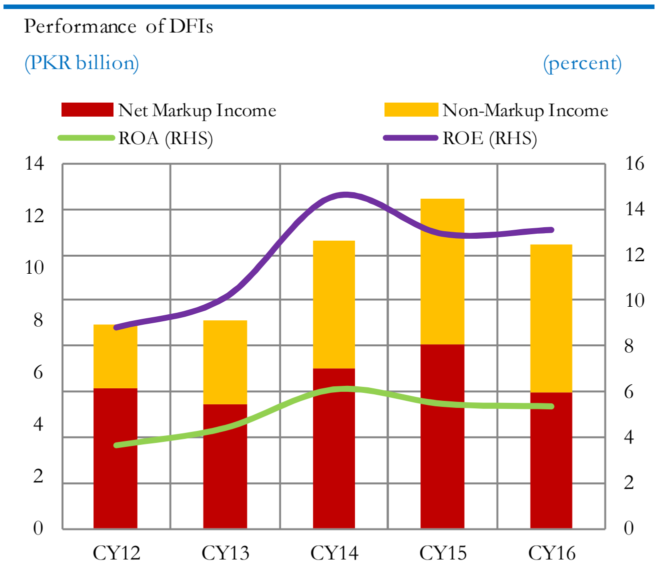
NPLR showing a downward trend



Source: FSD,SBP

Figure 3.4.7

Return indicators remained in comfortable zone



Source: FSD,SBP

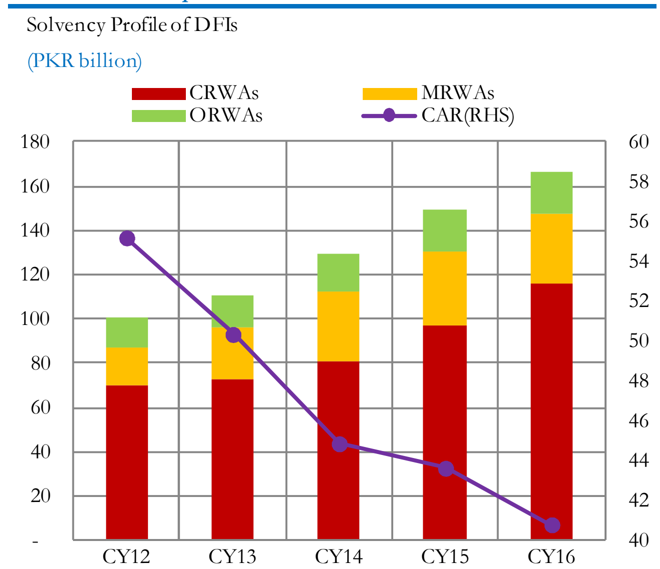
Operating performance improved…

In comparison with the banking sector, operating performance of DFIs has been strong during CY16. The sector has posted pretax profit of PKR 9.2 billion, 4.9 percent higher over the last year.

In contrast to revenue from investments in previous years, advances portfolio has provided boost to profitability of DFIs in CY16. This has further been complemented by provision reversals and increase in non-mark up income. Nevertheless, ROA has marginally dipped due to higher growth in average assets compared to rise in profits (**Figure 3.4.7**), while ROE has improved due to relatively slower growth in average equity levels.

Figure 3.4.8

CRWAs inched up



Source: FSD,SBP

CAR is declining but significantly higher than regulatory benchmark CAR…

The DFIs have maintained strong solvency profile over the years due to risk averse behavior. However, this trend has reversed in CY16 as evident from growth in credit risk weighted assets on the back of growth in advances. Eligible total capital has increased as well but proportionately lesser than the increase in RWAs, pulling the CAR downwards (**Figure 3.4.8**). Nevertheless, the overall CAR of the industry at 40.8 percent is well above the regulatory requirement evidencing strong solvency of the sector.

Growth prospects for DFIs seem bright, though prudence will be the key

DFIs financing activities have remained subdued when it comes to their real objective of development finance. They have been functioning more as an investment house by parking major portion of their assets in government securities. However, with ample cushion on their balance sheet and better demand prospects, it is appropriate time for DFIs to focus on lending. They may exploit long term financing projects in line with the developments on CPEC by joining hands in consortium type mode of financing. Nevertheless, the inherent riskiness of financing demands prudent approach, going forward.