4.1 Risk Analysis of Development Finance Institutions (DFIs)

DFIs have yet to achieve the performance maturity that triggers the next phase of fund deployment focusing on countercyclical financing. Reliance on financial institutions for funding confines their asset expansion and diminishes their possible role in scaling up lending during contractionary phase of credit cycle. However, net advances of DFIs, over the last three years, have observed double digit growth (16.5 percent on average). Integration of DFIs in national level planning of the government, enhanced engagement of stakeholders to broaden their scope of activities, and operational support from the regulators could enable them to measure up to their due role in financial intermediation from a developmental perspective. This effort would further reflect upon the national commitment of ensuring economic and financial stability in the country.

DFIs importance is fading in the overall financial sector…

Internationally, many of the DFIs have attained their objective of contributing to the developmental process and now their existence is being justified for their role in providing counter-cyclical financing.[170,171] The purpose of creation of DFIs in Pakistan, majority of whom are jointly owned by GoP and other sovereigns[172], was to contribute to economic development by channelizing funds to economically significant sectors, industrial and infrastructure projects, and to facilitate trade flows between Pakistan and other jurisdictions. However, even after lapse of decades[173], DFIs are still to assume the developmental role.

Pursuit of risk free returns overwhelms developmental objectives but bolster soundness indicators …

DFIs' assets of PKR 228.0 billion, as of end CY17, account for only 0.92 percent of total financial sector's assets **(See Overview)**. Advances have observed growth of 16.5 percent (over the last three years on average) graduating their share in total assets from 26.7 percent in CY14 to 33.6 percent in CY17. But the DFIs are more active in the capital and money market activities[174] as investments account for 53.6 percent of their assets. Although these investments (34.4 percent of investments in government securities) undermine the developmental finance objective of DFIs, they have supported the soundness indicators of DFIs. Return from investments (48.7 percent of total income in CY17) have bolstered the profitability indicators while utilization of assets in credit-risk free liquid securities has led to a CAR of 47.04 percent and the liquid assets to total assets ratio of 40.4 percent. The NPLR, seemingly higher at 17.2 percent, reflects the non-performing mortgage portfolio of one DFI active in house finance. Excluding this outlier, the sector's NPLR is low at 9.5 percent. (**Table 4.1.1**).

170 Global Symposium on Development Financial Institutions (http://www.worldbank.org/en/events/2017/09/19/global-dfi-symposium/aspx)
171 By countercyclical financing, we mean scaling up of lending operations when private institutions experience temporary difficulties in granting credit thus contributing to economic recovery efforts.
172 With the exception of one DFI (out of total 8) which is wholly owned by the Government of Pakistan.
173 The first of the currently existing DFIs was established in 1952, while the first joint-venture DFI was established in 1978 and the latest one was established in 2007.
174 One of the DFIs is also a licensed Primary Dealer of government securities. To maintain its license status the DFI must remain active in market making of government securities. In CY17, this DFI alone has accounted for 45.3 percent of the total investments of the sector in government securities funding them through borrowing from financial institutions (44.4 percent of the sector's borrowing).

Advances to strategic sectors remain insufficient

DFI's gross advances to private sector constitute only 1.72 percent of the advances of the banking sector. The inadequacy of their advances is also apparent from the fact that in CY17, they have made disbursements of PKR 4.0 billion to key sectors of the economy (such as textile, sugar, cement, agribusiness and energy) against PKR 397.2 billion by the banking sector.

Table 4.1.1

Key Variables and Financial Soundness Indicators of DFIs

	CY12	CY13	CY14	CY15	CY16	CY17
	PKR billion					
Investments	80.2	79.5	108.3	115.3	108.9	122.1
Advances	47.7	45.3	48.6	56.8	68.6	76.7
Total Assets	143.2	149.4	176.1	190.5	208.8	228.0
Borrowings	58.2	67.3	74.4	86.5	98.4	100.5
Deposits	13.5	8.9	15.0	12.0	10.9	17.1
Equity	62.6	62.3	76.4	79.3	82.2	99.5
NPLs	18.2	17.1	15.1	15.0	13.9	15.0
	Percent					
CAR	55.18	50.33	44.85	43.62	40.78	47.04
NPLs to Advances	31.69	30.04	25.27	21.98	17.48	17.15
Net NPLs to Net Advances	17.50	12.41	7.93	6.21	4.51	5.52
ROA (After Tax)	2.21	3.05	4.48	3.36	3.56	2.36
ROE (After Tax)	5.35	7.00	10.64	7.92	8.66	5.77
Cost to Income Ratio	40.20	40.25	30.96	32.59	38.78	37.28
Liquid Assets to Short-term Liabilities	81.31	84.77	84.80	86.31	90.23	90.90
Advances to Deposits	352.71	506.85	323.92	471.61	627.65	447.93

Source: SBP

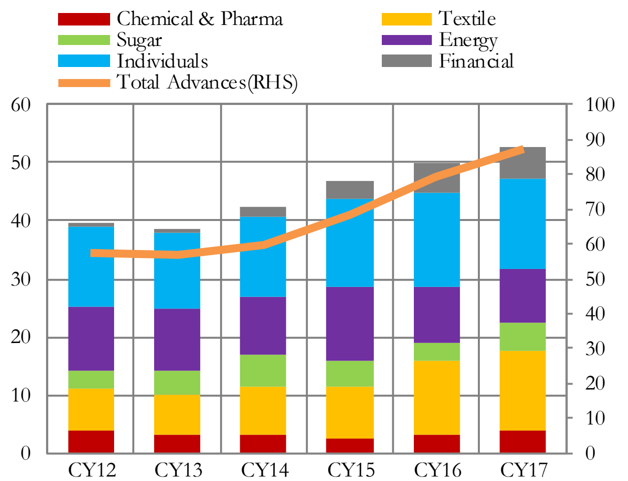
In terms of sectoral concentration, financing to individuals[175], textile and energy production /transmission dominates; but remains meager in comparison with flow of advances by banks[176]**(Figure 4.1. 1)**.

Figure 4.1.1

Insufficient advances to strategic sectors

Breakdown of advances by major sectors

(PKR billion)



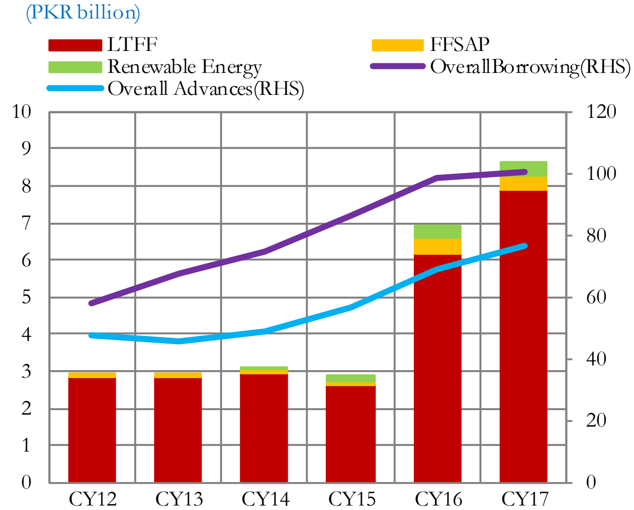
Source: SBP

Figure 4.1.2

Outstanding borrowing under SBP concessional credit is also small

Breakdown of borrowing under SBP major refinance schemes

(PKR billion)



Source: SBP

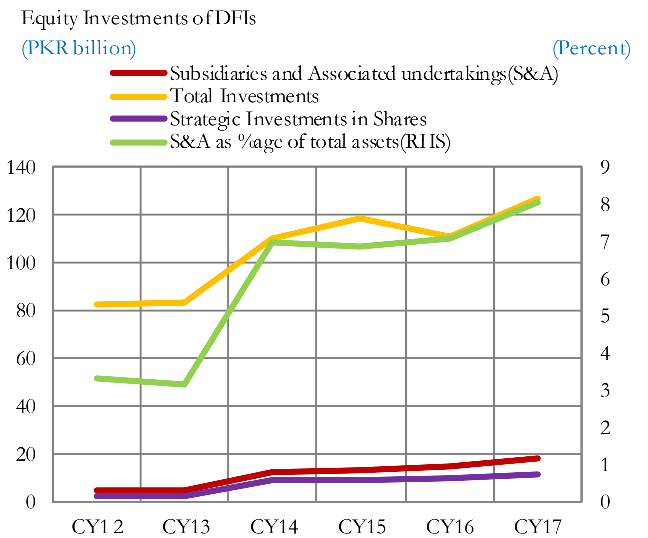
SBP has introduced various refinance schemes for sustainable and inclusive economic growth. All the institutions regulated by SBP can participate in the scheme for provision of finance to strategic

[175] These are only sourced in mortgage lending of one house finance based DFI, which accounts for almost 96.0 percent of total individual portfolio.

[176] Gross advances (CY17) by Banks: Individuals (PKR 618.9 billion), textile (PKR 989.9 billion), energy production/transmission (PKR 1,043.5 billion).

sector[177]. However, the extent of participation of DFIs in these refinance schemes is quite meager as the related liability accounts for only 8.6 percent of the overall borrowing. Hence, the current profile of DFIs is insignificant to build sufficient economic momentum that the DFIs aspire to achieve (**Figure 4.1.2**).

Figure 4.1.3
Investments in related companies are rising

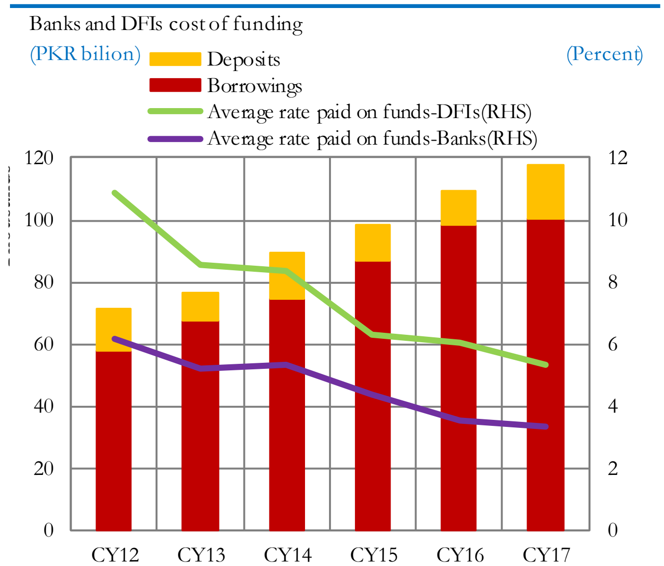


Source: SBP

Although sector's development through equity investments is a worthwhile channel, higher capital charge is a constraint…

Most DFIs have equity investments (through subsidiary/associate relationships or other investments in shares classified as strategic) in many sectors including commercial banks, microfinance banks, asset management companies, leasing, modarabas, real estate, insurance and power generation. Such investments are currently a small part of total assets and investments. Since equity investments can also be a worthwhile channel for supporting growth of significant sectors, stakeholders may consider supporting this avenue. Key stakeholders may consider capacity building programs and operational support to DFIs to enhance their scope of operations while regulators may support this channel through relaxations in limits on per-party exposures and capital charge[178] (**Figure 4.1.3**).

Figure 4.1.4
Costly sources of funds restrict asset expansion



Source: SBP

Lack of viable funding avenues continue to constrain funding…

Deposit base of DFIs, which mainly comprise of remunerative deposits[179] in the form of Certificates of Investments (COIs), represent only 6.7 percent of total assets. Consequently, DFIs heavily rely on borrowing from financial institutions to funds their assets (44.1 percent of total assets). Hence, higher

177 Four long-term refinancing schemes i.e. Long Term Financing Facility (LTFF) for import of machinery and purchase of locally manufactured plants; Modernization of SMEs; Financing Facility for Storage of Agriculture Produce (FFSAP); and Scheme for Financing Power Plants Using Renewable Energy are available for capacity development of the industrial sector.

178 Under the Basel requirements, risk weight of 1000 percent is to be charged for investment in the equity of commercial entities (which exceeds 10% of the issued common share capital of the issuing entity) or where the entity is an unconsolidated affiliate.

179 DFIs cannot raise checking deposits (BPRD circular No. 2 of 2015)

costs of remunerative deposits and dependence on borrowing raises funding costs for DFIs, which limit DFIs asset expansion. The average rate paid on funds mobilized by DFIs has been higher than the banking sector by 200 bps (**Figure 4.1.4**).

…. reliance on secured short-term borrowing further drive DFIs towards unsustainable asset growth

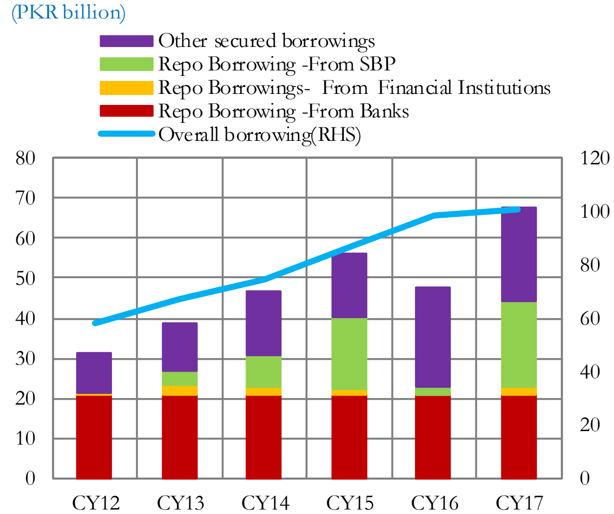
Although the participation of DFIs in government debt market is not a concern per se, the use of borrowings to fund these investments may be unsustainable. The availability of financial securities makes DFIs reliant on secured borrowing to fund asset expansion. Such a channel allows DFIs to get economical rates based on the credit/liquidity quality of underlying securities; these short-term borrowings do not help build a sustainable asset base. Maturity of securities and settlement of outstanding borrowings drive sharp changes in DFI's asset base. DFIs need to develop alternative funding sources for sustainable assets growth (**Figure 4.1.5** & **4.1.6**).

Figure 4.1.5

Reliance on secured borrowing discourage long-term advances

Breakdown of secured borrowings

(PKR billion)



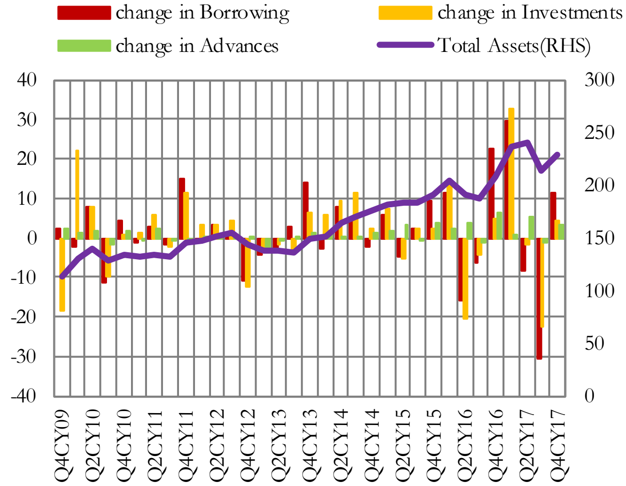
Source: SBP

Figure 4.1.6

Borrowings being utilized for investments-Quarterly flows

Passive intermediation model of DFIs

(PKR billion)



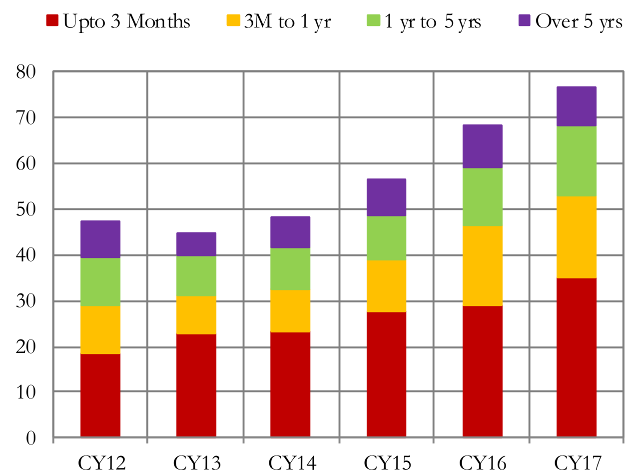
Source: SBP

Figure 4.1.7

Short-term advances dominate

Maturity composition of Advances

(PKR billion)



Source: SBP

…. which leads to increase in short-term lending….

DFI's reliance on short-term secured borrowing is shifting the lending portfolio towards the shorter end, downplaying the unique role of DFIs as providers of long-term growth financing to projects of national significance. In repo borrowing, maturity of the underlying securities must be greater than the term of the repo agreement. Given the inclination towards short-term securities, the borrowings secured through them are also short-term (**Figure 4.1.7**).

Some recalibration of policy is required to scale up DFIs' presence in the financial sector…

As one of the core objectives of the policy-makers is to achieve sufficient depth in the financial sector enabling it to sustain shocks, it is imperative that alternative lending institutions exist to plug the gaps and provide back up. Therefore, there is a need to establish a significant role of DFIs. On the policy front enhanced engagement with the DFIs, development of medium to long term plan for enhancing the scope of activities, discussions at bilateral level and encouraging participation of the private sector in shareholding of DFIs are some possible measures. Government may consider DFIs role in national level long-term development planning. In addition, DFIs may need to be supervised separate from commercial institutions.

The current solvency indicators- CAR at 47.04 and NPLR at 17.2 percent[180] in CY17 reveal sufficient cushion to scale up lending. With the required boost from the stakeholders, DFIs, as representative of governments, can play their role in providing countercyclical financing, if ever there is a need to safeguard financial stability.

[180] The NPLR is relatively higher than the banking sector (8.4 percent) due to mortgage lending by one house financing-based DFI, which accounts for almost 44 percent of the sector's NPLs.