4.2 Performance & Risk Analysis of Non-Bank Financial Institutions

CY18 witnessed an increase in market risk due to volatility in stock market, political uncertainty, rising interest rates and exchange rate depreciation. Though, the slowdown in growth of NBFI sector has been recorded, the availability of various investment options and addition of new firms helped to maintain the asset size of the sector besides adding diversity. Mutual funds, during CY18, have observed net outflow and compositional change. Investors, to safeguard their capital, have switched their investments from equity funds to money market funds. They have also appeared cautious as they took investment decisions by opting non-discretionary portfolio. On the other hand, the companies having financing mandate experienced growth in their assets, except the leasing sector. The assets of investment finance companies have increased on account of addition of two new companies. Further, two new modarabas, after a long time, have been registered and floated in the stock exchange. An increase in assets of NBMFCs has positively contributed to total assets of NBFI sector. In addition, the increasing share of IFCs, REITs, NBMFCs and modarabas may reduce the dependence of NBFI sector on performance of stock market.

Addition of new institutions add to diversity, though the tighter macrofinancial conditions have led to a slowdown in NBFIs asset growth …

The NBFI sector is continuously adding depth to the existing financial sector by catering to the diverse needs of the end users. The recent additions of REITs funds, Pakistan Microfinance investment Company and Private Equity Firms further expand the scope of NBFIs. This diversity helps minimize the adverse impact of any potential risk.

The total assets of the NBFIs, after witnessing healthy growth in previous years (18.17 percent on an average from FY14 to FY17 (**Table 4.2.1**), have slowed down during FY18.[182] The overall expansion in NBFIs' assets reflected an increase of only 3.41 percent in FY18 as compared to growth of 31.48 percent in FY17.[183]

Table 4.2.1: Asset profile of NBFIs

	FY14	FY15	FY16	FY17	CY17	FY-18	CY18
	PKR billion						
AMCs/IAs	30	32	37	41	37	39	36
Mutual Funds	452	492	546	710	654	679	642
Pension Funds	8	14	19	26	24	27	27
Portfolios	72	97	139	141	139	153	188
Total AUMs	532	603	705	877	817	859	857
RMCs	0	2	1	2	5	5	6
REITS	-	23	27	41	41	42	46
PE & VC Firms	-	-	-	-	0.2	0.2	0.2
PE Funds	-	-	-	-	1	5	6
Modarabas	30	31	37	44	48	53	54
Leasing Companies	36	40	42	43	45	10	10
IFCs	11	10	10	21	25	58	58
NBMFCs	-	-	-	61	70	97	110
Total Assets	639	741	859	1,130	1,089	1,169	1,184

Source: SECP

The slowdown is more visible in NBFIs pegged with equity market…

The overall slowdown in NBFIs assets can, primarily, be attributed to deteriorating economic conditions resulting in volatility in the equity market. The assets

182 Financial Year (FY) for NBFIs ends in June, but for the purpose of complete analysis of CY18 and to give due coverage to the changes experienced in the AMC segment, the Six months period from Jul-Dec, 2018 (or H2CY18) has also been added, wherever possible.

183 Though the net assets of NBFIs have expanded by 1.35 percent in H2CY18 against 3.61 percent in H2CY17, the growth is still on the lower side.

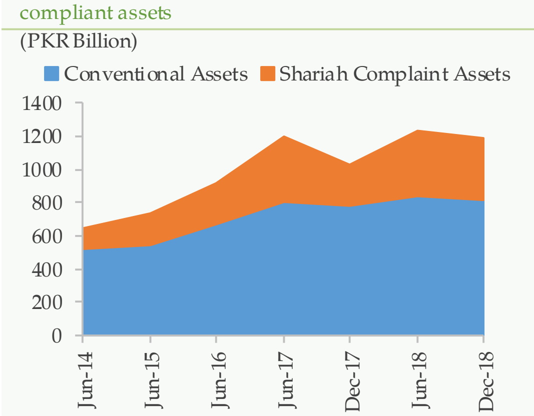
of Mutual Funds have decreased by 4.39 percent in FY18 compared to 29.99 percent increase in FY17. Accordingly, their share in total assets of NBFIs has dropped to 58.10 percent in FY18 compared to 62.84 percent in FY17. The assets of AUMs have also decreased by 2.09 percent in FY18 compared to an increase of 24.43 percent in FY17.

On the other hand, the assets of modarabas and NBMFCs have expanded by 20.10 percent and 58 percent, respectively, during FY18. The asset base of IFCs have also increased but mainly due to a conversion of one large leasing company into an investment finance company.

As is the case in banking, the Shariah compliant structures are gaining popularity in the NBF sector…

The Shariah compliant structures, which include Shariah compliant mutual funds, Shariah compliant pension funds, Shariah compliant modarabas and the only REIT in operation are attracting investors. The asset size of these structures in total NBFIs assets has increased from 17.86 percent in FY14 to 31.81 percent in FY18 (**Chart 4.2.1**).

Chart 4.2.1: Breakup of conventional & Shariah compliant assets



Source: SECP

Asset valuation of mutual funds decline in the aftermath of rising macroeconomic vulnerabilities…

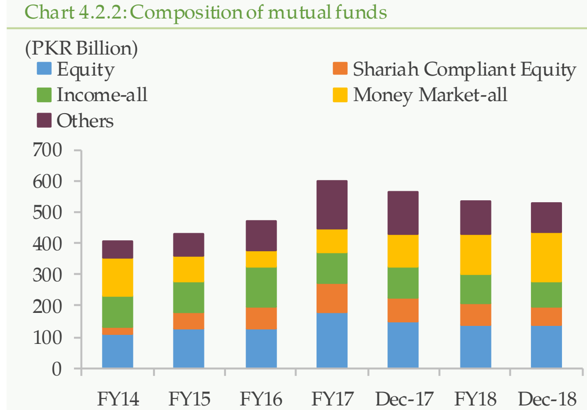
The value of mutual funds' assets has declined by 4.39 percent in FY18 compared to an increase of 29.99 percent in FY17. The assets have lost another 1.91 percent value by end December 2018. The net assets of both the conventional and Islamic equity funds have declined; by 23.49 percent and 19.07 percent, respectively. The bearish stock market sentiments arising out of tighter macrofinancial conditions, political transition and uncertainty about the future economic prospects have been instrumental in the performance of mutual funds and the behavior of their investors.

During CY18, the foreigners, banks and brokers have been net sellers of mutual funds, while insurance, individuals and companies have absorbed all the selling. The continuous risk aversion of mutual fund investors may lead to further asset devaluation.

…and the "flight to safety" motive prevails…

Investors, anticipating further volatility due to rising interest rate risk, have quickly switched from the equity funds to money market funds.[184] There has been a decline of 21.97 percent in FY18 in the equity mutual funds. Resultantly, the share of equity mutual funds in net assets of the mutual funds has dropped to 39.38 percent in FY18 from 45.34 percent in FY17 (**Chart 4.2.2**).

Chart 4.2.2: Composition of mutual funds



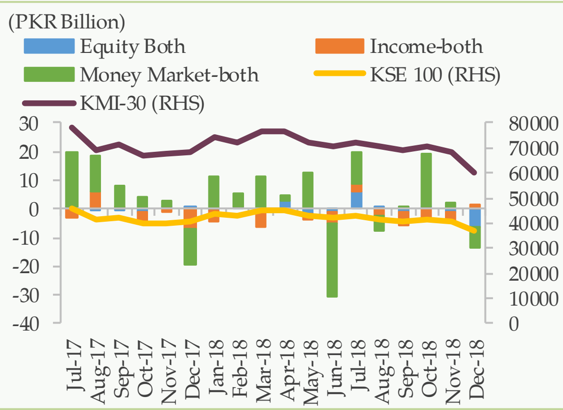
Source: MUFAP

[184] Equity fund has witnessed net outflow of PKR 7 billion in CY18, while net inflow in money market fund stands at PKR 39 billion. The income funds have also observed net outflow of PKR 26 billion.

On the other hand, the value of net assets of money market funds has increased by 67.34 percent in FY18 as compared to 40.14 percent in FY17 (47.18 percent in CY18) (**Chart 4.2.3**). Accordingly, the share of money market funds in the net assets of mutual funds has increased from 13.04 percent in FY17 to 24.30 percent in FY18 (29.86 percent at the end of CY18).

The increasing share of money market funds, in the prevailing macroeconomic environment, indicates low risk appetite of the investors and inclination towards capital preservation.

Chart 4.2.3: Net sales of top three mutual funds categories

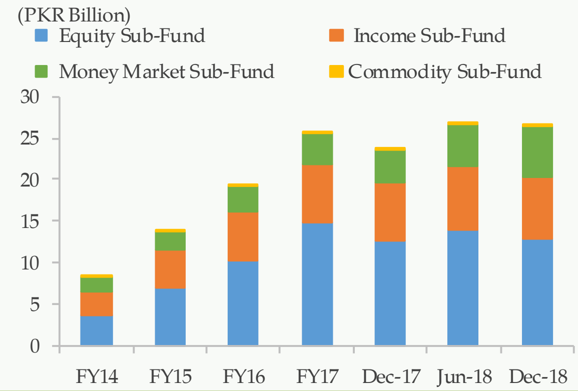


Source:MUFAP & PSX

Pension funds too have been affected by market volatility…

As was the case with mutual funds, risk aversion also prevails in pension funds (**Chart 4.2.4**). They have not only receded from the equity market, they have also divested away from government exposure. In terms of asset allocation, the pension funds have made placements in equity securities (44.97 percent in CY18 vs. 48.62 percent in CY17), government securities (9.05 percent in CY18 vs. 15.59 percent in CY17) and bank balances (34.61 percent in CY18 vs. 19.43 percent in CY17). As a result, the net asset value of pension funds could only increase by 4.11 percent in FY18 as compared to a growth of 33.41 percent in FY17.

Chart 4.2.4: Composition of pension fund assets



Source: SECP

The performance of the pension funds is dependent on the performance of sub-funds. The overall return of the pension fund has remained on the lower side (**Table 4.2.2**). The returns on the equity sub fund have been negative in FY18. However, during the same period, the money market sub fund and debt sub fund have seen positive returns. Despite the strong management regulatory framework for Voluntary Pension Scheme, high volatility in the stock market may expose the sector to the low returns, which may create socio-economic disturbance.

Table 4.2.2: NAV growth in islamic and conventional pension sub-funds

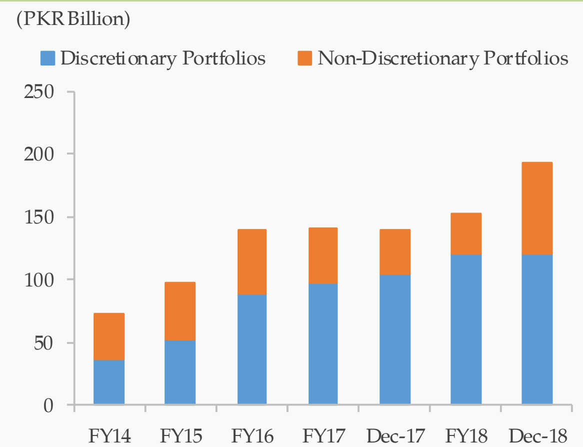
	NAV Growth (%)							
	FY16		FY17		FY18		H1FY19	
	Min	Max	Min	Max	Min	Max	Min	Max
Equity Sub Funds	1.22	20.33	-6.16	41.25	-16.26	-2.97	-14.66	-8.78
Debt Sub Funds	3.90	12.29	3.74	5.24	3.60	4.96	5.22	8.35
Money Market Funds	3.87	5.74	3.85	5.53	3.65	5.36	5.27	7.24
Commodity Sub Funds	10.05	13.77	-1.70	-1.70	1.17	4.88	1.08	1.98
Islamic Equity Sub Funds	4.13	19.05	-2.75	38.01	-20.95	-9.54	-15.70	-8.00
Islamic Debt Sub Funds	3.06	4.50	3.56	5.39	1.26	3.58	3.71	6.25
Islamic Money Market Funds	2.24	4.21	2.89	4.88	1.68	4.02	3.53	6.48
Islamic Commodity Sub Funds	-		-9.40	-9.40	12.10	12.10	11.80	11.80

Source: SECP

…and so is the case with high-networth individual Investors

Under the prevailing uncertainty in the market, high-networth individual investors appeared cautious about their investment strategy. They preferred non-discretionary portfolios[185] for investment during CY18. In the first half of the year, they relied on fund managers to manage their investment, while in the second half they took decision making into their own hands (Chart 4.2.5). This suggests a general lack of confidence shown by the high-networth individual investors in the ability of the fund-managers to make investment decisions in a volatile market. However, this emerging trend may increase "trading noise" in the market, as large investors are more prone to panic sales that may shorten investment-holding period. They may also be more "risk averse" investing in blue chip stocks, which may limit the flow of funds to the emerging sectors.

Chart 4.2.5: Portfolios classified by investment decision-making



Source: SECP

The survival of leasing companies is at stake…

The individual business of leasing is on the decline since last few years. As opposed to forty companies in the year 2000, only seven remain at the end of 2018. The entrance of commercial banks in the leasing business in early 2000s and tighter liquidity conditions, made the operating environment difficult.

Moreover, the adverse global financial shock of 2008, which resulted in a steep rise in domestic interest rate, led to an upsurge in borrowing costs and further shortage of liquidity. Resultantly, the companies had to utilize their rental recoveries to pay off their borrowings, restricting new business operations. There was an upsurge in NPLs, which forced the leasing companies to concentrate on managing their infected portfolio rather than expanding their business. As a result, the leasing companies either had to windup or explore other avenues for survival.

In CY18, the largest and profitable leasing company has broaden its scope by converting itself into an Investment Finance Company.[186] Resultantly, the assets of the leasing sector have reduced by 76.80 percent from PKR 45 billion in CY17 to PKR 10 billion in CY18. Its share in total NBFI sector assets has also dropped to 0.84 percent at the end of CY18.

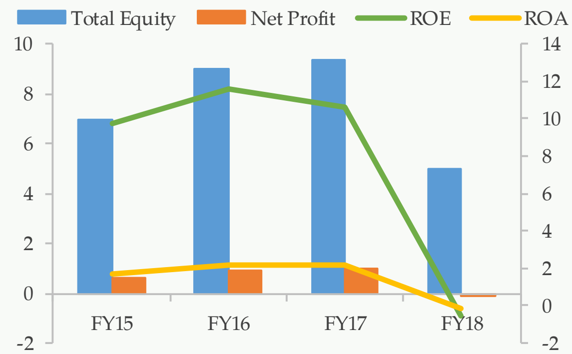
Further, the sector is facing poor asset quality. The infection ratio is 73.22 percent and only 76.19 percent of the bad loans have been provided for. Moreover, the sector is no longer profitable; the after tax ROA and ROE stands at negative 0.53 percent and negative 0.13 percent, respectively (Chart 4.2.6).

[185] Portfolios are investments of eligible investors (person offering a minimum of PKR 3 million investment) managed by Investment Advisors. Under "Discretionary Portfolios", investment decisions are made and executed by the Investment Advisor on behalf of clients. While under a "Non-Discretionary Portfolio", investment decisions are made as per the written instructions of the clients.

[186] The company comprised 80.83 percent of total assets, 92.40 percent of deposits and 64.39 percent of the total equity of the leasing sector.

Chart 4.2.6: Profitability of leasing sector

(PKR Billion)



Source: Accounts of respective leasing company

The NBMFCs are adding depth to the NBFI sector…

The non-bank microfinance companies (NBMFCs) gained momentum during the year and registered an increase of 56.71 percent, which contributed 43.41 percent in overall growth of NBFIs. The rapid growth in NBMFCs is primarily due to availability of market based liquidity from Pakistan Microfinance Investment Company (PMIC). [187] The purpose of PMIC is to mobilize funding from both donors and commercial lenders i.e. development agencies, financiers, commercial banks and capital markets and lend it further to NBMFCs.[188] Keeping in view the critical role being played by PMIC in the growth of NBMF sector, the health of PMIC becomes paramount. The PMIC may increase the interconnectedness between the banks and the NBF sector, as it has started channelizing liquidity. As the microfinance borrowers are deemed more risky, any asset quality concerns of NBMFCs may have repercussions for the banking sector.

…and so are the modarabas

The growth momentum in the assets of modarabas have continued during FY18. The assets have increased by 20.10 percent as compared to 20.63 percent in FY17. The two new modarabas, after a long time, having the equity of PKR 1.05 billion were floated and listed on the stock exchange. With this addition, the number of modarabas has reached to 27.

Despite this expansion, the concentration in the sector remains high. The top 4 modarabas constitute 73.91 percent of the total assets of the sector. Moreover, there is still room to improve the performance of the modaraba companies. Their potential can be achieved by creating the awareness about the universal applicability of the concept for undertaking multiple activities like financing, manufacturing and trading, some of which may not be handled by Islamic banks.

Assets of REITs have also increased due to revaluation of the underlying property…

There are four REIT management companies, registered with SECP, having accumulated asset value of PKR 5.67 billion at the end of CY18. However, there is only one REIT scheme (the rental REIT) with a fund size of PKR 22 billion and asset size of PKR 46 billion (**Table 4.2.3**). The expansion in assets of PKR 4 billion during CY18, is backed by unrealized valuation gains from the underlying property.

Table 4.2.3: Impact of change in fairvalue of underlying property on assets expansion

	Jun-16	Dec-16	Jun-17	Dec-17	Jun-18	Dec-18
	PKR Billion					
Total Assets	40.89	40.86	42.40	41.73	43.00	45.90
Chane in fair value of property	15.42	1.03	0.15	1.13	1.15	2.87

Source: Financial statements of REIT

Currently, the rental REIT has an occupancy level of 97.00 percent, which reduces the opportunity cost for the company (rental losses due to vacancy).[189]

[187] Pakistan Poverty Alleviation Fund, Karandaaz Pakistan (KRN) and KfW development Bank together created PMIC.

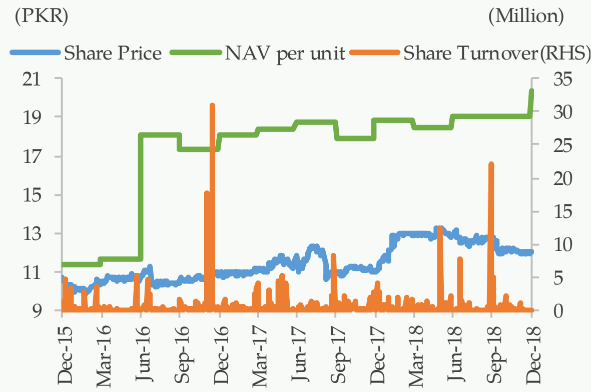
[188] As of December 2017, the PMIC had made loans of PKR 11.49 billion to 26 companies. This has increased to 16.67 billion (36 companies) in June 2018.

[189] Source: Un-audited half yearly report of a REIT

Despite higher occupancy levels, the contribution to income from rentals has declined to 37.14 percent in CY18 from 60.15 percent in CY17. The major portion of income has contributed by net profit because of increase in unrealized valuation gains from the underlying property. Being the rental REIT, the income from rent should be the major source of income.

Moreover, it appears that the investors, in line with the acceptable valuation procedures, have given more weightage to the actual gains from operations rather than unrealized gain from property valuation. The REIT unit has traded at an average discount of 33 percent from its NAV **(Chart 4.2.7)**.[190]

Chart 4.2.7: REIT share's closing price, turnover & NAV per unit



Source: Accounts of REIT & PSX

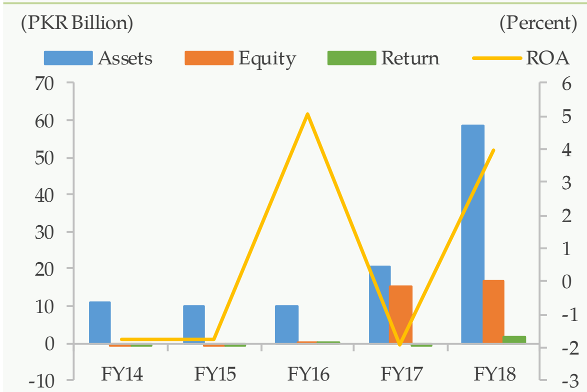
Going forward, the business of REIT is expected to improve due to the favorable regulatory changes, introduced by SECP in December 2018, such as allowing REITs to borrow.[191] This will provide impetus for the growth and enhance REIT's attractiveness.

Moreover, the government is also taking measures to promote investment in REIT. The rate of tax on dividend received by corporate unitholders of a REIT has been reduced to 15 percent from 25 percent, vide Finance Act, 2018. The tax rate applicable to dividend received by an individual unit holder from a rental REIT has also been reduced to 7.5 percent. Moreover, in case of developmental REITs the tax on dividend received by a unitholder has also been reduced. The steps taken to promote developmental REITs would also help the government agenda to eliminate the shortage of housing units in the country.

The addition of two new companies change the dynamics of the IFC sector…

The number of investment companies remained same during the year. However, one company ceased to exist due to its merger with a brokerage house and one leasing company has been converted into an investment finance company. Therefore, the assets of IFCs have increased by 181.69 percent during FY18 **(Chart 4.2.8)**. Moreover, two companies contain 83 percent share in total assets of IFC as of December 2018. Both the companies are recent addition to the IFC sector.

Chart 4.2.8: Asset profile and profitability of IFCs



Source: Annual financial statements of IFCs

Further, with the inception of new company in CY17, the advances of IFCs have increased by 11 times from PKR 1 billion in CY16 to PKR 13 billion in CY17. Further, the conversion of a leasing company

[190] REIT unit has traded at an average price of PKR 12.51, with a maximum of PKR 13.70 and a minimum of PKR 10.86. While, the average NAV has been around PKR 18.83, with a maximum of PKR 20.32 and minimum of PKR 18.44.

[191] SECP SRO1473(I)/2018-Notification for REIT's Amendments dated 5/12/2018 available at: https://www.secp.gov.pk/laws/notifications/

into investment finance company, the leasing assets of the IFCs have increased by more than 12 times from PKR 1.3 billion in CY17 to PKR 18 billion during CY18. Moreover, the advances and leasing assets of IFC sector have increased by more than 16 times from CY16 to CY18.

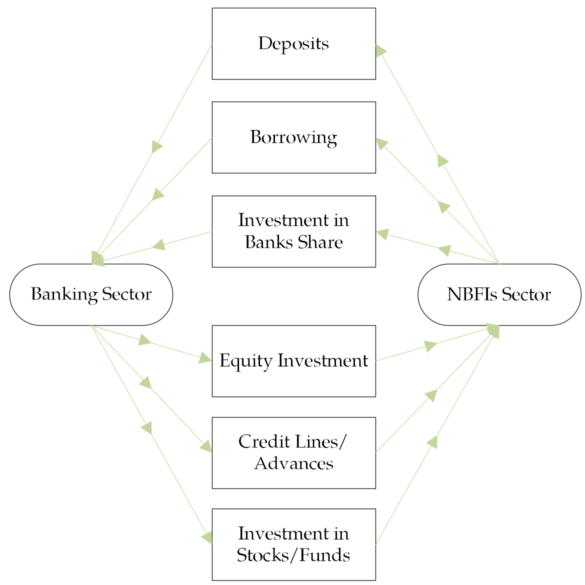
As of December 2018, the non-performing assets to total assets have declined to 8.20 percent in CY18 compared to 18.28 percent in CY17 (62.24 percent in CY16). Further, excluding the recently added IFCs, the infection ratio of the remaining companies stands at 34.32 percent out of which 64.78 percent has been provided for.

The new companies also had a beneficial impact on the profitability of the sector. They have pulled out the sector from losses. The after tax losses of PKR 294 million in FY17 have been converted into a profit of PKR 1.6 billion in FY18. Accordingly, the after tax ROA and ROE has increased from negative 1.9 percent and negative 3.8 percent in FY17 to 4.0 percent and 19.8 percent in CY18, respectively.[192]

The risks rising from interconnectedness of the bank and non-bank sectors remain low…

There are various channels of interconnectedness between the banking and NBFI sectors. Both the sectors are mainly connected through equity investments, borrowing/lending, investments and deposits **(Chart 4.2.9)**.

Chart 4.2.9: Channels of interconnectedness



Currently, 22 AMCs and IAs are operative out of which 11 are owned by Banks/DFIs. These 11 AMCs have floated 215 funds, which constitute around 85 percent of the total funds. Further, banks owned AMCs have a share of 75.41 percent in the overall assets of the segment (73.07 percent in CY17) **(Table 4.2.4)**. Banks have increased their direct investment in mutual funds. However, the exposure of banks in Mutual funds is not significant.

On the other hand, the exposure of mutual funds on the banking sector has increased through investments in deposits, COD/TDR/COI and money at call/Placement with the banks **(Table 4.2.4)**.

[192] In FY16, the ROA of IFCs improved noticeably due to recognition of additional tax asset of PKR 480.8 million in respect of unabsorbed tax depreciation and carry forward unused tax losses.

Table 4.2.4. :NBFIs flow of funds & exposure to the banking sector

	Total Value (i)	Banks share (ii)	Banks share in Total* (iii= ii/i)	Total Value (i)	Banks share (ii)	Banks share in Total* (iii= ii/i)	Total Value (iv)	Banks share (v)	Banks share in Total* (vi= v/iv)
	Jun-17			Dec-17			Dec-18		
	PKR billion		Percent	PKR billion		Percent	PKR billion		Percent
1. Equity of AMCs/ IAs	24.0	12.0	50.00	23.7	11.9	50.22	23.7	12.9	54.42
2. Assets Under Management of AMCs/ IAs	876.9	637.9	72.74	817.3	597.3	73.07	856.6	645.9	75.41
3. Mutual Funds size	710.2	32.4	4.56	654.2	30.0	4.58	641.7	47.1	7.34
4. Mutual Fund exposure in Financial Institutions	229.5	221.5	96.51	254.2	230.6	90.70	277.8	257.1	92.54
5. Mutual Funds exposure in top 20 equity securities	122.9	3.8	3.08	91.8	3.8	4.18	84.7	6.2	7.27
6. Mutual Funds exposure in top 10 debt securities	11.7	7.9	67.91	15.0	9.0	59.74	16.7	8.0	47.55
7. Top 20 holders of mutual fund units	68.9	21.1	30.58	68.7	13.1	19.10	68.8	11.2	16.25

Source: SECP

*Banks share for the respective head means:

1.Equity of Bank-owned AMCs /IAs

2.Mutual/Pension Funds and Portfolios being managed by bank-owned AMCs /IAs

3.Banks' investments in mutual fund units

4.Mutual Funds' investments in deposits, COD/TDR/COI and money at call/placements with banks

5.Mutual Fund investments in ordinary shares of banks

6.Mutual Funds investments in TFCs/Commercial Paper/Sukuk etc. issued by banks

7.Banks(investment value) in the top 20 holders of mutual fund units

However, the slowdown in the NBFI sector has also affected their credit needs. Accordingly, the exposure of banks on NBFI sector in terms of credit lines has reduced during CY18 (**Table 4.2.5**). Another reason for decline in credit lines from banks is the withdrawal of liquidity requirements for mutual funds. SECP, to support mutual funds, has withdrawn the requirement for asset management companies to arrange credit lines from banks/DFIs equivalent to 10 percent of net assets of each fund.[193]

Table 4.2.5: Lending to AMCs by banking sector

	PKR Million	
	Fund Limit	Outstanding
Dec-17	5,993	1,362
Jun-18	5,712	1,491
Dec-18	1,153	1,000

Source: SBP

Keeping in view the relative size of deposits, investments and borrowing by NBFIs from banking sector, NBFIs do not pose any systemic risk to banking as well as financial system. However, they carry high reputational risk to overall financial system.

Going forward, the development of financial markets may enhance the complexity of the financial system and so will the interconnectedness among financial institutions. SBP and SECP cognizant of their responsibilities to ensure the stability of the overall financial system and safeguard the interest of customer has taken several measures. One of them is the formation of Council of Regulators, which periodically reviews the performance of the financial system and assesses the risks arising thereof. Moreover, work is underway to establish the National Financial Stability Council (NFSC), which besides the two regulators also includes the concerned ministry.

[193] Direction no. 37 of 2017 dated December 29, 2017 available at: https://www.secp.gov.pk/document/circular-no-37-2017-withdrawal-of-liquidity-requirements-for-mutual-funds/?wpdmdl=30212