5.1. Development Finance Institutions (DFIs)

The performance of DFIs, considering their risk averse behavior and a challenging environment, remained steady during CY19. There was strong asset expansion primarily driven by investments in government securities, which had positive impact on their earnings. However, the strategy of funding assets through short-term borrowing may not be sustainable in the long-term. Lack of longer tenor affordable funding remained a major challenge for DFIs in expanding their advances portfolio. Conversely, the availability of refinancing for housing finance made it possible for DFI(s) to increase their housing finance portfolio. There is a need to align the DFIs operations with their mandates of financing projects, housing, SMEs etc., in order to make them economically viable.

Investments drive expansion in assets…

Despite tight macrofinancial conditions, DFIs' assets observed strong expansion of 58.12 percent during CY19, mainly driven by 96.47 percent expansion in investments, **(Table 5.1.1)**. Accordingly, share of investments in total assets increased to 63.71 percent in CY19 (51.27 percent in CY18).

Table 5.1.1: Key Variables & Financial Soundness Indicators of DFIs

	CY15	CY16	CY17	CY18	CY19
			PKR billion		
Investments (net)	115.3	108.9	122.1	122.3	240.2
Advances (net)	56.8	68.6	76.7	82.3	91.9
Total Assets	190.5	208.8	228.0	238.5	377.1
Borrowings	86.5	98.4	100.5	111.4	229.0
Deposits	12.0	10.9	17.1	11.6	12.0
Equity	79.3	82.2	99.5	106.2	117.0
NPLs	15.0	13.9	15.0	14.7	15.0
			Percent		
CAR	43.62	40.78	47.04	46.95	44.95
NPLs to Advances	21.98	17.48	17.15	15.83	14.53
Net NPLs to Net Advances	6.21	4.51	5.52	5.29	4.17
ROA (After Tax)	3.36	3.56	2.36	2.25	2.68
ROE (After Tax)	7.92	8.66	5.77	4.89	7.16
Cost to Income Ratio	32.59	38.78	37.28	40.08	32.38
Liquid Assets to Short-term Liabilities	86.31	90.23	90.90	86.95	97.60
Advances to Deposits	471.61	627.65	447.93	707.08	763.81

Source: SBP

Although investment driven growth in DFIs improved soundness and profitability, it was mostly funded through short-term borrowings from banks and was misaligned with their economic model of providing long-term project financing. Further, financing assets through short-term borrowing may not be a sustainable proposition in the long run.

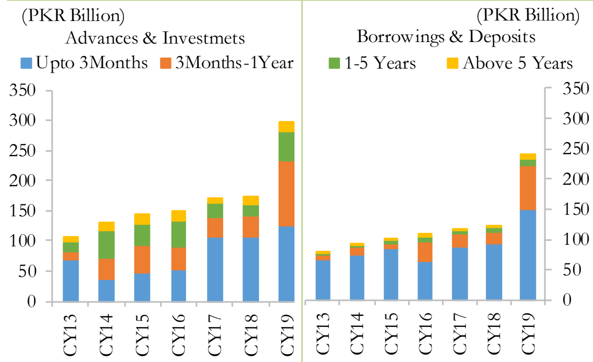
…though advances also accelerate but as a consequence of refinancing of existing portfolio

Advances growth accelerated to 11.63 percent during CY19 against 7.39 percent in CY18. However, share of advances in total assets declined mainly due to substantial increase in investments. Moreover, the growth was not broad-based as one DFI—involved in refinancing of existing housing finance portfolio—contributed 68.18 percent in the advances growth, as it extended refinance facilities to other DFIs and banks. This refinancing enabled the primary mortgage lenders to fix their end user rates for at least the next 3 years.

Reliance on short-term funding dictated DFIs behavior towards short-term investment and advances…

Contrary to the objective of providing long-term financing and building long-term assets, more than 78.35 percent of DFIs advances and investments had maturity up to 1 year and only 6.02 percent of the total advances and investments had maturity above 5 years as of end Decemeber-2019 **(Chart 5.1.1)**. Further, 92.39 percent of the funding had maturity of less than a year. Such a sizable reliance on short-term funding to support asset growth create maturity mismatches. The size of liabilities, for instance, maturing in three months was around 1.5 times of the assets maturing in the same period.

Chart 5.1.1: DFIs' reliance on short-term funding created maturity mismatch

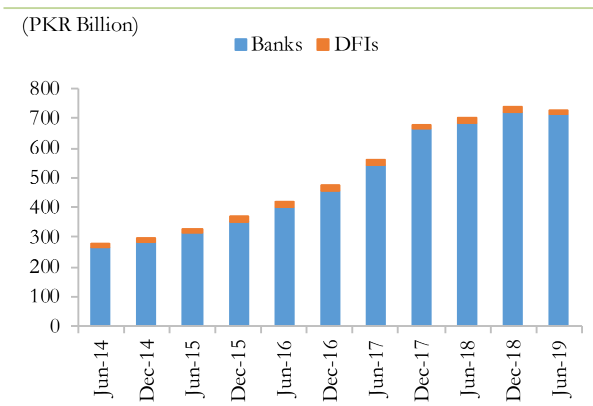


Source: SBP

Worryingly, DFIs' share in Infrastructure Project Financing remained negligible…

In a competitive environment where DFIs' share in Infrastructure Project Financing (**IPF**) was already low, their share further reduced to 1.90 percent in FY19 from 4.89 percent in FY14 **(Chart 5.1.2)**. As of June 2019, the highest participation of DFIs financing was in 'social, cultural & commercial infrastructure' (6.12 percent) followed by 'Renewable Energy (**RE**) Power' (3.01 percent) and 'Telecommunication'[248] projects (3.01 percent).

Chart 5.1.2: Banks continue to dominate IPF

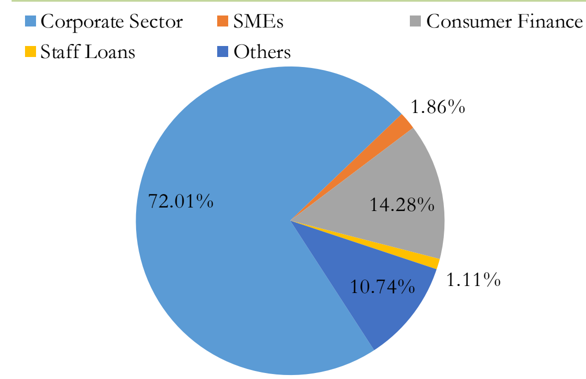


Source: SBP

Corporate sector remained the dominant borrower, despite some deceleration in financing…

The advances to the corporates decelerated to 2.63 percent in CY19 compared to 4.39 percent growth in CY18. Consequently, corporate sector's share in total DFIs advances reduced by 6.03 percentage points to 72.01 percent during CY19 **(Chart 5.1.3)**. Within the corporate sector, around 80 percent of the financing was for long-term purposes[249].

Chart 5.1.3: Corporate sector remained the largest borrower



Source: SBP

SMEs financing decelerated, while housing finance portfolio expanded during CY19…

SMEs financing also decelerated to 7.95 percent in CY19 against robust growth of 59.16 percent in the previous year. The reasons behind marked slowdown in SMEs financing included feeble demand conditions, impact of PKR depreciation and rise in duties on import of raw material, monetary tightening as well as DFIs risk averse lending behavior. On the contrary, the housing finance portfolio increased by 2.65 percent in CY19 as compared to 1.14 percent decline in CY18. The prime reason for increase in house financing was availability of credit line on fixed

[248] As per Prudential Regulations for Infrastructure Project Financing (**IPF**), Telecommunication projects are defined as 'A Telecommunication Local Services, Long Distance and Towers'

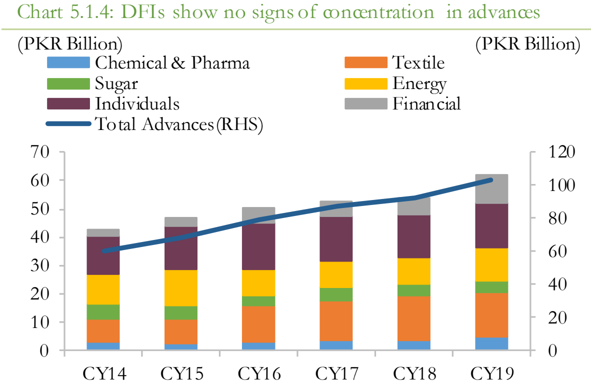
[249] DFIs collateralized these advances through hypothecation of plant and machinery, which provided the due comfort to them to repossess the collateral in case of default of a borrower.

rate for three years from a DFI with a mandate of mortgage refinancing.

Concentration risk in advances remained low…

The advances to financial sector, other than interbank lending, surged by 79.11 percent in the wake of refinancing for housing finance provided by a DFI to other banks and DFIs. On the other hand, there was some deceleration in textile sector loans (4.62 percent in CY19 vs 10.05 percent in CY18), while advances to sugar sector declined by 11.64 percent (4.99 percent decline in CY18). Despite deceleration in textile related advances, it remained the largest borrower with 15.54 percent share in total advances followed by individuals (15.26 percent share) and then energy sector (11.30 percent share) **(Chart 5.1.4)**. Thus, advances portfolio of DFIs remained well diversified with limited signs of concentration.

Chart 5.1.4: DFIs show no signs of concentration in advances

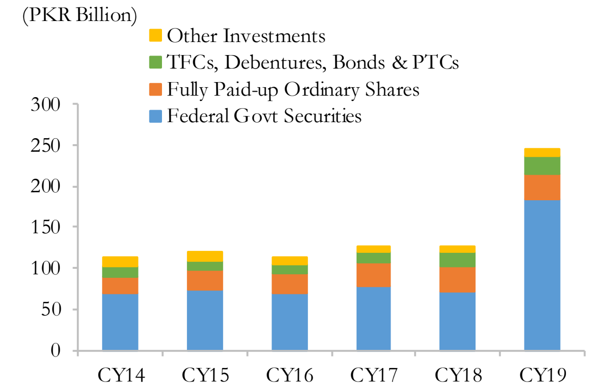


Source: SBP

Risk free investments remained a priority…

In the wake of increased policy rate, investments in government securities remained lucrative for DFIs. Overall investments boosted by 96.47 percent in CY19 compared to negligible rise in CY18 **(Chart 5.1.5)**. More than 90 percent rise was contributed by investment in federal government securities. Further, to reap the maximum benefit from interest rate dynamics, more than 82 percent of the securities were placed in available for sale category.

Chart 5.1.5: Govt. Securities continue to dominate Investment portfolio



Source: SBP

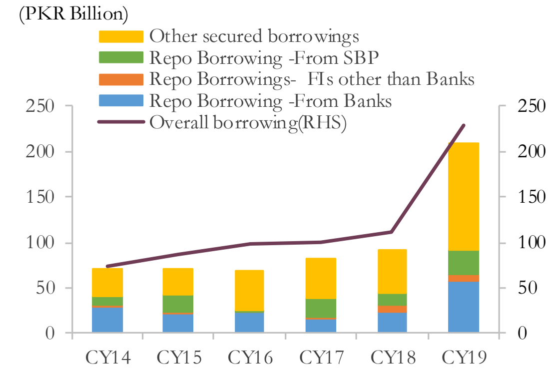
Review of existing regulatory framework could redefine the DFIs role…

Most DFIs invested in their subsidiaries/ associates operating in sectors including commercial banks, microfinance banks, asset management companies, leasing, investment banks, real estate, modarabas, insurance and power generation through equity participation. Due to regulatory limits, these investments, however, remained small part of the DFIs portfolio. A little tweaking in existing regulatory framework could allow DFIs to effectively invest through equity participation in the economically viable projects and support the enterprises operating at infancy stage.

On the liability side, borrowings remained the key source of funding besides equity…

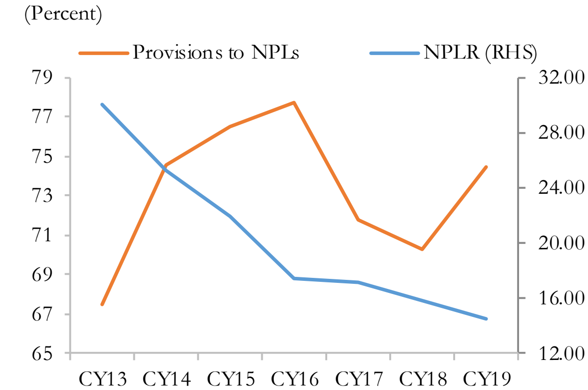
Borrowings funded more than 60 percent of the assets in CY19. Borrowings increased by 105 percent, which financed 99.66 percent rise in investments (net). It manifested that DFIs capitalized upon the opportunity of earning higher yields on government paper by relying on short-term borrowings. However, this modus operandi of expanding assets through short-term borrowings may not be a sustainable strategy in the long-term **(Chart 5.1.6)**.

Chart 5.1.6: DFIs borrowing surged in CY19



Source: SBP

Chart 5.1.7: Asset quality improved



Source: SBP

Equity remained the only source of long-term financing…

Over the years, the DFIs have been unable to raise long-term liquidity due to either lack of efforts or strategy. Further, shallow capital markets, make it expensive to raise funds by issuing bonds or TFCs. Therefore, DFIs mainly resorted to short-term borrowings to fulfill their liquidity needs during CY19. In this scenario, Equity remained the major source of long-term financing. Total equity of the DFIs observed a rise of 10.16 percent during CY19 reaching at PKR 117 billion. Increase in share capital and revaluation surplus largely facilitated this growth.

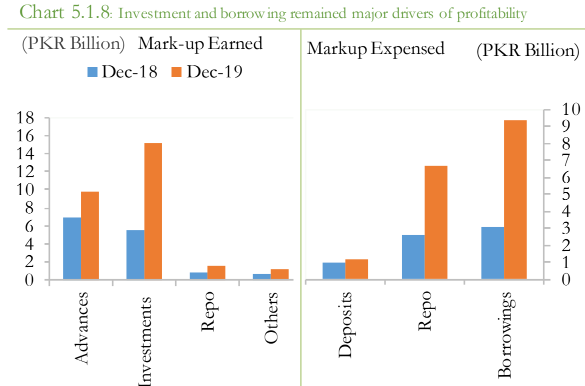
Asset quality continued to improve…

DFIs infection ratio declined to 14.53 percent in CY19 from 15.83 percent in CY18 **(Chart 5.1.7)**, largely because of reasonable growth in gross advances (11.24 percent), even though NPLs stock increased (2.07 percent) in CY19. Further, strict monitoring of the borrowers made DFIs able to identify problem loans timely and undertake remedial measures. Most of the delinquent loans i.e. 74.41 percent were provided for at the end of CY19. DFIs, with their cautious lending approach and strict credit standards, were successful in containing their credit risk, despite substantial rise in interest rates.

Profitability surged owing to increase in income on investments…

DFIs earnings jumped by over 50 percent in CY19 primarily at the back of sharp rise in interest income on investments. Income on advances also improved due to favorable interest rate dynamics **(Chart 5.1.8)**. Besides the surge in net mark-up income, increased dividend income and relatively lower administrative expenses were also among the drivers of profitability. The Return on Asset improved to 2.68 percent in CY19 (2.05 percent in CY18) and Return on Equity to 7.16 percent in CY19 (4.44 percent in CY18).

Chart 5.1.8: Investment and borrowing remained major drivers of profitability

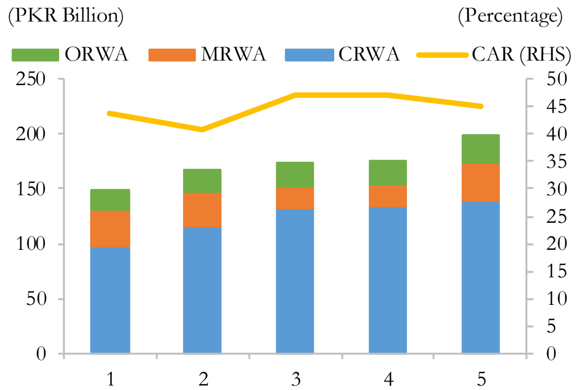


Source: SBP

DFIs remained solvent…

The DFIs remained resilient with the Capital Adequacy Ratio (**CAR**) at 44.95 percent in CY19—higher than the minimum capital requirement of 12.50 percent (**Chart 5.1.9**). CAR did observe marginal decline over CY18, due to increase in general market risk emanating from huge investments in government securities that exposed the DFIs to interest rate risks.

Chart 5.1.9: Solvency profile of DFIs



Source: SBP

DFIs role need to be reconsidered…

DFIs are vital to channelize the cross-country banking experiences and boost bilateral trade between Pakistan and sponsoring countries. In order to improve the participation of DFIs in the financial arena, the stakeholders need to revisit their role and strive to align their organizational as well as financial structure to suite their stated objectives. Some regulatory leeway may be awarded to DFIs to achieve their goal of investing in troubled yet profitable ventures and emerging businesses through equity participation. DFIs may also take initiatives to find ways to a) finance government's public sector development programs (**PSDP**) except through investment in government securities and b) become a sort of hub for financing public private partnership (**PPP**) based projects. Moreover, all the stakeholders need to work towards providing an enabling environment for DFIs to raise long-term funding through secondary as well as primary markets, and actively participate in long term projects, particularly, IPF.