10 PERFORMANCE REVIEW OF NON-BANK FINANCIAL INSTITUTIONS

10.1 Overview

The group of Non-Bank Financial Institutions (NBFIs) includes the Non-Bank Finance Companies (NBFCs), Mutual Funds, Modarabas and Development Finance Institutions (DFIs). During FY07,[1] assets of the NBFIs registered a YoY growth of 22.7 percent, in comparison with growth of 17.4 percent in FY06, to reach Rs 567.0 billion. The number of operative entities in FY07 was 209,[2] which subsequently increased to 237 in FY08, in comparison with 188 in FY06. The size of the total assets of the sector relative to GDP at 5.9 percent, and total financial sector assets at 8.0 percent (end-FY08), is small, as is the proportion of its deposits in the total deposits of the financial sector at 1.1 percent. Notably, while NBFCs, Mutual Funds and Modarabas are regulated by the Securities and Exchange Commission of Pakistan (SECP), DFIs are regulated by the State Bank of Pakistan (SBP): together, the NBFCs, Modarabas and DFIs are termed as NBFIs.

In November FY08, the SECP implemented some necessary measures to revamp the regulatory framework for the Non-Banking Finance Companies (NBFCs), the concept of which was introduced in 2002 when the regulatory responsibility of these financial institutions was shifted to SECP from SBP. Keeping in view the dynamics of the broad financial sector in which the NBFCs operate, SECP amended the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003, in addition to issuing the Non-Banking Finance Companies and Notified Regulations, 2007.[3] While the amended rules are based on SECP's experience with the NBFC sector since 2002, in addition to extensive consultation with various stakeholders, the new NBFC Regulations incorporate SECP's enhanced powers as laid out in the Finance Act, 2007. The new regulations specify the requisite parameters for the formation of various types of NBFCs, and address all operational aspects and issues for NBFCs and their notified entities. Notably, all the previously issued Prudential Regulations for NBFCs have been merged into these Regulations. In August FY09, SECP issued a revised version of the 2007 Regulations in the form of the (Draft) Non-Banking Finance Companies and Notified Entities Regulations, 2008, to clarify certain legal interpretations of the 2007 Regulations and address market related operational issues. These regulations have now been finalized and issued. Consequently, the new regulatory framework now consists of: the NBFCs Rules 2003 (amended) and Non-Banking Finance Companies and Notified Entities Regulations, 2008.

As discussed in detail in FSR 2006,[4] the NBFC model has had limited success in shaping the growth opportunities for non-bank financial services, and the performance of the various sub-sectors has been undermined by the increasingly challenging operating environment in the broader financial sector, of which the NBFCs form a small component. As pointed out in last year's financial stability assessment, some urgent remedial measures were needed to enhance market outreach, promote product innovation, increase capitalization and restructure the under-developed segments, to ensure sustained growth of the NBFCs as a whole.

The new NBFCs Regulations 2008 (**Box 10.1**) serve to address these concerns to a large extent. In particular, the enhancement in the minimum capital requirements for each type of business allowed under the NBFC umbrella was a much needed measure, as the low capital base of NBFCs

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[1] The analysis of NBFCs and Modarabas is based on Annual Audited Statements as of June 30, 2007, whereas DFIs data is of end-December 2007. Since annual audited data is received with a lag of several months, it is not possible to give an analysis of the consolidated position as on June 30, 2008 in this report. However, where possible, statistics on numbers of companies and licenses issued etc have been updated upto June 30, 2008, in line with the information received from SECP.

[2] This number counts all the mutual funds as separate entities.

[3] Issued on November 21, 2007.

[4] Financial Stability Review, 2006, State Bank of Pakistan.

and modaraba management companies has been a major challenge in mobilizing low cost funding, while effectively ensuring low barriers to entry. Consequently, the NBFC sector has suffered from widespread fragmentation in the form of a large number of small and weak entities, with limited market share. The increase in minimum capital requirements will not only strengthen the resilience of the sector once the new requirements are implemented in a phased manner by 2010, it has also given impetus for further consolidation, by encouraging small institutions to join hands and operate on a stronger footing.

Box 10.1: Non-Banking Finance Companies and Notified Entities Regulations, 2008

The Securities and Exchange Commission of Pakistan has issued the NBFCs and Notified Entities Regulations, 2008. These Regulations aim at industry facilitation, risk management and safeguarding the interest of shareholders. The NBFC Regulations issued in 2007 stand repealed and replaced by these Regulations.

The time for compliance with various regulatory requirements has been extended, enabling the industry to reposition itself adequately to meet the demands of the changing circumstances.

Salient features of the Regulations are as follow:

1. The requirement for listing at the stock exchange for entities engaged in deposit taking has been extended up to June 30th, 2009.
2. The time schedule to comply with the minimum equity requirement has been extended by one year.
3. The time period for aligning portfolios by Asset Management Companies has been extended until June 30th, 2009.
4. Annual fees on mutual funds have been reduced depending on the category of a fund.
5. Procedure for cancellation of registration and revocation of the Open End Scheme or Closed End Scheme by the AMC has been improved.
6. To address the issue of discount on closed-end mutual funds, certificate holders have been empowered to decide conversion into open end or revocation of the funds.
7. The application of provisioning criteria on non-performing assets has been extended for a period of two years.
8. Per-party and per-sector exposure limits have been specified for different types of schemes and CIS has been barred from investing in securities of its Asset Management Company.

Source: SECP Press Release- November 24, 2008

Another major cause of concern for NBFCs' commercial viability stems from their limited sources for resource mobilization. The extensive reliance on credit lines from banks and other financial institutions has continued to pose problems for NBFCs in terms of the high cost of funding, in addition to being a potential source of systemic risk in case these credit lines dry up in an environment of a liquidity crunch, as seen most recently in October FY09.[5] While some NBFCs are allowed to raise retail deposits in the form of Certificates of Investments (CoIs), the amount so raised is generally not sufficient for them to finance their business activities and expand their operations. As a result, NBFCs continue to operate at a disadvantage in comparison with the banking sector which has access to relatively low cost funds.

The 2008 Regulations addresses this issue by allowing NBFCs offering leasing, housing finance and investment finance services to raise deposits from COIs with tenors of 30 days and above, as opposed to the previous restriction on the minimum tenor of deposits to be of 3 months. In a similar vein, the resource mobilization capacity of Modarabas has also been enhanced with the introduction of the Model Financing Agreements and the conceptual framework for the issuance of sukuks for Modarabas by the Religious Board.

[5] Special section on "Liquidity Pressures in the Banking System" in Chapter 3, "Stability of the Banking System" in this edition of the FSR.

Keeping in view these impediments to the growth of the sector, and the regulatory framework implemented in November FY08, subsequently upgraded in November FY09, this chapter provides an assessment of the performance of and key challenges for the non-bank financial sector and each of the financial services grouped therein. Section 2 provides an overview of the operating structure and framework of non-bank financial institutions (NBFIs). Section 3 provides a performance review of the sector during FY07, alongwith a detailed review of the performance of each sub-sector, followed by the conclusion in Section 4.

10.2 Operating Framework

A public limited company engaged in the business of asset management, investment finance, leasing, housing finance, venture capital investment, discounting and investment advisory, or a combination of these services, is categorized as an NBFC. For each financial service that an NBFC provides, it needs a separate license from the SECP. Prior to the issuance of the 2008 Regulations, any business entity which complied with the progressively tiered capital requirements for each type of business (adding up to Rs. 835 million for all types of NBFC licenses) could undertake all businesses allowed under the NBFC framework. The new regulatory framework, however, has created necessary firewalls between investment advisory and asset management services on one hand, and leasing, housing finance, discounting and investment finance services on the other. This essentially means that companies which undertake the business of asset management and investment advisory cannot at the same time offer leasing, discounting, housing finance, investment finance services or venture capital investment, simply by complying with the minimum capital requirements. In a way, this measure is a contravention of the universal banking model of financial services provided under the NBFC framework, but is essentially intended to minimize the functional overlapping that often leads to conflict of interest within the NBFCs sector. An additional requirement in the new regulations is that an NBFC engaged in a combination of leasing, investment finance and housing finance services, needs to invest at least 20 percent of its assets in each such form of business.[6]

Table 10.1: Minimum Equity Requirement for NBFCs

million Rupees

Form of Business	MCR for fresh license	Time Line for Existing NBFCs as of 30th June			
		2007/08	Existing (2009)	2010	2011
-IFS* and Discounting	1000	300	500	700	1000
-Leasing	700	200	350	500	700
-Asset Management Services	200	30	100	150	200
-Investment Advisory Services	30	30	30	30	30
-Housing Finance Services	700	100	300	500	700
-Venture Capital Investment	-	50	-	-	-
	-	200	-	-	-

Note:- Investment Finance Services

Source: Non-Banking Finance Companies and Notified Entities Regulations, 2008

10.2.1 Regulatory Framework

The previous and new minimum capital requirements (MCR) for each type of NBFC as laid out in the NBFC Regulations 2008, is given in **Table 10.1**. While new entrants are required to comply with the new MCR requirements when starting operations, existing institutions have been given time upto June 30, 2011 to comply with these requirements. The increased MCR will ensure that only sound and profitable entities continue to operate in the sector, and small and weak entities either exit or merge their operations with others in order to remain in business.

[6] Non-Banking Finance Companies and Notified Entities Regulations 2008, dated November 21, 2008.

Another important change in the regulations is the amendment in the criteria for the classification of non-performing loans as detailed in **Table 10.2**, applicable until July 1, 2010, where the classification criteria has been made more stringent by the elimination of the OAEM category, with direct classification into sub-standard loans after an overdue period of 90 days. New requirements, applicable from July 1, 2011 distinguish between short, medium and long-term financing facilities, alongwith increased provisioning requirements.[7]

Table 10.2: Classification and Provisioning for Non-Performing Assets of NBFCs

Classification	**As per Prudential Regulation for NBFCs issued in January 2004**			**As per NBFCs and Notified Entities Regulation, November 2008**		
	Determinant Overdue by:	Treatment of Income	Provisions to be Made	Determinant	Treatment of Income	Provisions to be Made
OAEM						
-Short Term	90 days	Unrealized mark-up/interest/profit to be put in Suspense Account and not to be credited to Income Account except when realized in cash.	Not Required			
-Medium and Long Term	90 days*	As Above	Not Required			
Substandard						
-Short Term	180 days or more	As Above	20%	90 days or more	Unrealized mark-up/interest/profit to be put in Suspense Account and not to be credited to Income Account except when realized in cash.	25%
-Medium and Long Term	1 Year or more	As Above	20%			
Doubtful						
-Short Term	1 Year or more	As Above	50%.	180 days or more	As Above	50%
-Medium and Long Term	2 years or more	As Above	50%.			
Loss						
-Short Term	2 years or more	As Above	100%	1 Year or more	As Above	100%
-Medium and Long Term	3 years or more	As Above	100%			

*Its determinant was revised to 180 days through SECP's Circular No. 23, dated June 25, 2004.

Source: SECP

The SECP has also taken steps to strengthen its supervision and enforcement capacity. For this purpose, a new inspection wing was established in 2007 at SECP's Karachi office.[8] Inspections conducted during 2007 pointed to issues such as weak internal controls and research capacity, and minimum board involvement in the highly centralized decision making among various NBFCs.

10.2.2 Ownership Structure

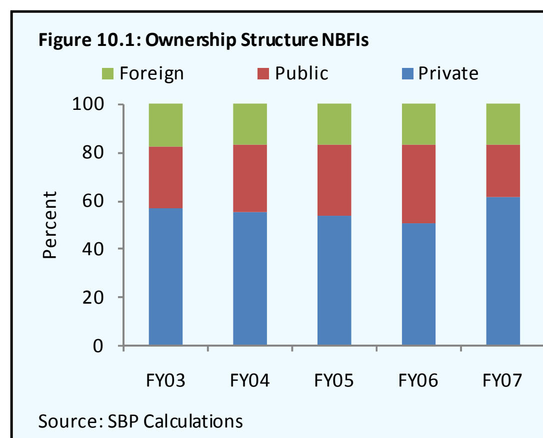
The ownership structure of NBFIs continued to evolve during FY07 as the asset share of the domestic private NBFIs (excluding foreign-owned companies)[9] reached 61.6 percent by end FY07,

[7] Schedule XI (Regulation 25), NBFCs and Notified Entities Regulations, 2008, SECP.
[8] Annual Report 2007, SECP.
[9] It may be noted that foreign ownership in the NBFIs sector is only in the shape of joint ventures in the form of Development Finance Institutions between the Government of Pakistan and governments of countries such as Oman, Brunei, Kuwait, Libya, China and Iran.

compared to 50.5 percent in the previous year (**Figure 10.1**). On the other hand, the asset share of public sector NBFIs declined to 21.6 percent, compared to 32.4 percent in FY06. It may be noted that the existing proportion of public ownership is only due to the National Investment Trust (NIT), which is the largest open-end mutual fund, and the House Building Finance Corporation (HBFC), which is a DFI. In terms of market share, NIT has an asset share of 31.5 percent as of end FY07, while HBFC enjoys near monopoly among housing finance companies, with an asset share of 99.1 percent in the total asset of these companies.

The private sector dominance of NBFIs is in line with the market-based liberalization reforms in the financial sector. Visible changes in the ownership structure of NBFIs in FY07 are primarily attributed to: (1) emergence of a new DFI as a joint venture between the Governments of Pakistan and Brunei;[10] and (2) increasing number of mutual funds, which serve to enhance the share of private sector entities. This increase in the share of the private sector has taken place despite the merger of a private sector DFI with a commercial bank: this transaction translated into a re-classification of assets from private sector NBFIs to the private sector commercial banks.

Figure 10.1: Ownership Structure NBFIs

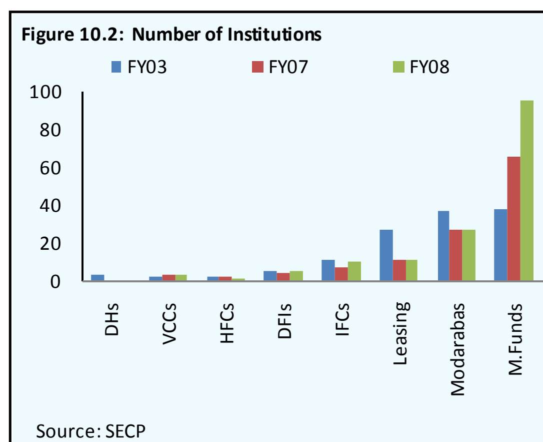


Source: SBP Calculations

10.3 Performance Review

Over the last few years, the primary focus of the NBFCs' reform process has been to strengthen the financial health of these entities, while reducing fragmentation by consolidating, and in some cases, weeding out weak institutions. As a result, several mergers and acquisitions transactions have been consummated in the sector during FY03-08 (**Table 10.3**), due to which the number of operating institutions has declined in almost every category, except Mutual funds (**Figure 10.2**). The composition of the NBFIs sector as of end-FY08 is presented in **Table 10.4**. As SECP allows NBFCs to hold multiple licenses, 75 NBFCs hold 89 licenses for providing various financial services as permissible under the NBFCs rules.

Figure 10.2: Number of Institutions



Source: SECP

The mutual funds sector, which has shown a consistently remarkable performance in the last couple of years, has grown more progressively than the other financial institutions among NBFCs. During FY08, SECP granted 19 new licenses and 29 registrations to the NBFCs sector, of which 29 registrations were granted for the mutual funds business alone, while of the remaining 19 licenses, 17 were granted for investment advisory and asset management and 2 for leasing.

During FY07, total assets of the NBFIs sector registered a relatively higher growth of 22.7 percent to reach Rs 567.0 billion, compared to the YoY growth of 17.4 percent in FY06. This growth in total assets largely came from Mutual Funds, which showed an exceptional growth of 77.0

[10] Another joint venture between Pakistan and Iran emerged in the form of the Pak Iran Joint Investment Company Ltd during CY08.

Table 10.3: Mergers in the NBFIs from FY03 to FY08

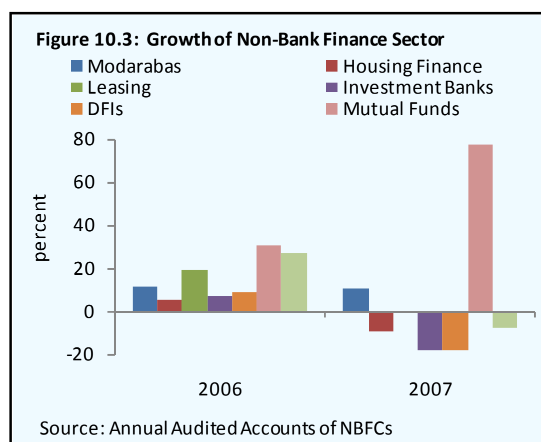
	Name of NBFC/ Modaraba	Name of Company/Modaraba Merged with	Date of
1	Crescent Investment Bank Limited	Mashreq Bank Pakistan Limited	9-07-2003
2	Industrial Capital Modaraba	First Dawood Investment Bank Limited	12-05-2004
3	First General Leasing Modaraba	First Dawood Investment Bank Limited	12-05-2004
4	Trust Investment Bank Limited	Trust Commercial Bank Limited	30-04-2004
5	Fidelity Investment Bank Limited	Trust Commercial Bank Limited	30-04-2004
6	Pacific Leasing Limited	First Standard Investment Bank Limited	18-06-2004
7	Paramount Leasing Limited	First Standard Investment Bank Limited	18-06-2004
8	First Leasing Corporation Limited	First Standard Investment Bank Limited	18-06-2004
9	First Hajveri Modaraba	First Fidelity Leasing Modaraba	22-10-2004
10	First National Modaraba	First Paramount Modaraba	11-09-2004
11	Ibrahim Leasing Limited	Allied Bank Limited	31-05-2005
12	Second Tri-Star Modaraba	First Tri-Star Modaraba	24-02-2006
13	Modaraba Al-Tijarah	Modaraba Al-Mali	6-12-2006
14	First Allied Bank Modaraba	Allied Bank Limited	7-12-2006
15	Atlas Investment Bank Limited	Atlas Bank Limited	26-07-2006
16	Jahangir Siddiqui Investment Bank Limited	JS Bank Limited	30-12-2006
17	Guardian Modaraba Limited	B.R.R. International Modaraba	25-05-2007
18	Crescent Standard Investment Bank Limited	Innovative Housing Finance Limited	20-07-2007
19	International housing Finance Limited	KASB Bank Limited	22-11-2007
20	Pakistan industrial & Credit Investment Corp. Ltd.	NIB Bank Limited	1-01-2008
21	Universal Leasing Corporation Limited	Al-Zamin Leasing Corporation Limited	6-06-2008

Source: SECP & KSE

percent compared with 30.1 percent in the previous year, whereas all other sub-sectors, except for modarabas, depicted negative growth during the period (**Figure 10.3).** Notably, the Mutual Funds Industry has been growing consistently since FY02. In FY09, however, both Equity and Income Funds have faced a more challenging operating environment, as discussed in the **Special section on Profile of Mutual Funds** at the end of this chapter.

The declining asset growth among a majority of NBFIs has led to a corresponding deterioration in their relative asset share in total NBFIs assets. Mutual Funds, the best performing sector during FY07, strengthened its position further in the total assets of NBFIs with a share of 55.3 percent (around twice its average share of 25.5 percent during FY02-06), compared to 38.3 percent in FY06. DFIs registered the largest reduction of 8.5 percentage points, followed by Investment Finance companies (**Table 10.5**).The detailed performance review of each component is covered later in this section.

Figure 10.3: Growth of Non-Bank Finance Sector



Source: Annual Audited Accounts of NBFCs

Table 10.4: Composition of the NBFIs during FY08

NBFIs	No. of Entities	No. of Licenses
DFIs	6	
NBFCs	75	
-Investment Finance		11
-Leasing		18
-Housing Finance		4
-Venture Capital Investment		4
-Discounting		1
-Investment Advisory and Asset management		51
Mutual Funds	95	
Modaraba Management Companies	40	
Modarabas	27	

Source: SECP

Table 10.5: Assets of NBFIs
growth rates and share in percent

	FY03	FY04	FY05	FY06	FY07
Assets (billion Rupees)	259.3	318.1	393.7	462.3	567
Growth rate	21.8	22.7	23.8	17.4	22.7
Share in Assets					
Mutual Funds	22.1	32.4	34.6	38.3	55.3
DFIs*	30.4	29.8	27.4	25.3	16.8
Leasing Companies	18.1	14.1	13.6	13.8	11.3
Investment Finance Companies	13.9	11.2	13	11.8	7.9
Modarabas	6.2	5.7	5.5	5.2	4.6
Housing Finance*	8.3	6.1	4.7	4.3	3.1
Venture Capital Companies	0.1	0.3	0.3	0.7	0.7
Discounting	0.8	0.4	0.4	0.4	0.2

*Assets of HBFC, a DFI engaged in providing housing finance, have been clubbed under 'Housing Finance' for a more appropriate comparison.
Source: Annual Audited Accounts

In terms of asset composition, the share of advances in the total assets of NBFIs (excluding mutual funds and venture capital) declined to 48.6 percent as compared to the relatively high share of 51.0 percent in FY06 **(Table 10.6)**.

Table 10.6. Key Performance Indicators of NBFIs*
percent (except in case of ratio)

	FY 03	FY 04	FY 05	FY 06	FY 07
Advances to Assets Ratio	42.9	46.9	51.8	51.2	48.6
Investments to Assets Ratio	36.6	33.3	30.5	27.1	28.7
Earning Assets to Total Assets	83.9	84.9	85.6	84.5	85.2
Debt to Equity Ratio	2.6	2.5	2.8	2.9	2.3
Borrowings to Liability Ratio	54.7	55.0	49.0	55.1	62.3
Deposits to Liability Ratio	31.1	33.4	40.9	37.0	29.3
Return on Advances and Investments	11.4	9.0	8.8	10.6	10.6
Cost of Deposits and Borrowings	6.1	3.9	5.7	7.6	8.0
Average Spread	5.3	5.0	3.1	3.0	2.7
Net Interest Margin	6.6	5.9	4.1	4.3	4.5
Income to Expense Ratio	156.6	159.4	144.3	122.4	106.8
Return on Average Assets (after tax)	4.3	3.5	2.7	1.6	1.3
Return on Average Equity (after tax)	17.7	13.5	10.4	7.0	4.9

*: excluding Mutual Funds and Venture Capital.
Source: Annual Audited Accounts

Decline in this ratio was primarily due to various mergers and the exit of several companies from the NBFIs sector, coupled with the meager performance of the existing entities during FY07. DFIs registered the largest decline of 44.8 percent in their advances, mainly due to the merger of PICIC with NIB Bank. Similarly, growth in the advances of Investment Finance Companies (IFCs) registered a decline of 17.6 percent**.** In comparison with DFIs and IFCs, the YoY growth in the advances of modarabas and leasing companies registered a marginal rise of 0.3 percent and 4.1 percent respectively over the period of analysis.

Despite the negative YoY growth of 4.5 percent in the NBFIs' investment portfolio (excluding mutual funds and venture capital), the share of investments in overall assets has increased by 1.6 percentage points during FY07, to reach 28.7 percent. In case of earning assets, the NBFIs sector collectively registered a negative growth of 10.5 percent. However, due to the negative asset growth in a majority of companies in FY07, the earning assets to total assets ratio improved slightly to 85.2 percent during FY07 compared to 84.5 percent in the previous year.

During FY07, in an environment of rising interest rates and weak resource mobilization, the debt to equity ratio (gearing) of NBFIs declined to 2.3 times, in comparison with 3.0 times in the previous year. The impact of the prevalent high interest rates in the economy is also reflected in the rising average cost of borrowings and deposits, which have risen to 8.0 percent from 7.6 percent in FY06. As shown in **Table 10.6,** NBFIs have traditionally relied more on borrowings rather than deposit mobilization, and this reliance increased further during FY07, when the borrowing to liability ratio increased to 62.3 percent compared to 55.1 percent in FY06. On the other hand, the deposits to liability ratio exhibited a decline over the same period. This change in the liability mix is primarily attributed to the merger of a deposit-taking IFC and a DFI with two different commercial banks.

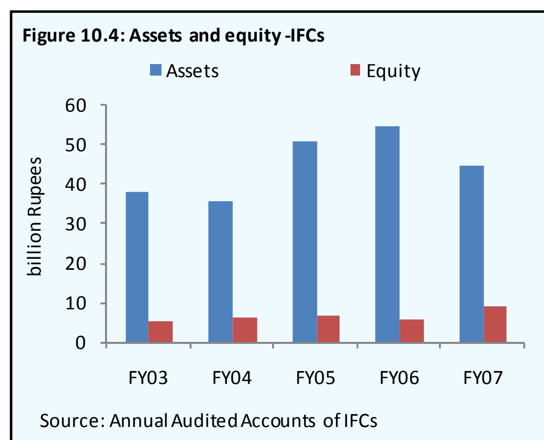
With the rising interest rates, the average spread of NBFIs (other than mutual funds and venture capital), has narrowed further to 2.7 percent from 3.0 percent in FY06, whereas the net interest margin, with a marginal rise of 22 bps, stood at 4.5 percent in FY07. The impact of the declining spread is also visible from indicators of profitability. Specifically, profitability indicators have deteriorated further due to high financial charges and stiff competition from the banking sector. As a result, return on average assets (RoA) and return on average equity (RoE) of NBFIs was 1.3 percent and 4.9 percent respectively, having declined markedly from their peak levels of 4.3 percent and 17.7 percent respectively, in FY03. This is in sharp contrast to the performance of the banking sector, with an RoA of 1.5 percent and RoE of 15.5 percent for the year CY07.

Given the trends in key performance indicators of overall NBFIs, a detailed discussion of the performance and challenges for each financial service group among NBFIs is provided in the following sections.

10.3.1 Investment Finance Companies

Traditionally, Investment banks provide strategic advisory services on takeover bids and mergers & acquisition, in addition to mobilizing long term funds for the implementation of Greenfield projects, in addition to equity and bond trading in capital markets. In Pakistan, Investment Finance Companies (IFCs) licensed by the SECP, are allowed to provide investment banking or investment finance services. Along with stand-alone IFCs, commercial banks and brokerage firms are also actively engaged in providing these services. In recent years, a number of IFCs have merged their operations with commercial banks due to the challenges faced in sustaining investment finance services on a stand-alone basis in an increasingly competitive business environment.

Figure 10.4: Assets and equity -IFCs



Source: Annual Audited Accounts of IFCs

By end FY07, there were 8 operative IFCs with a share of 7.9 percent in the aggregate assets of the NBFIs. In absolute terms, the asset and equity base of these IFCs was Rs 44.6 billion and Rs 9.0 billion, respectively (**Figure 10.4**). During the year, IFC's assets decreased by Rs 9.9 billion (YoY decrease of 18.2 percent), while their equity base increased by Rs 3.1 billion (52.6 percent) over the previous year. The boost in equity of the IFCs is mainly due to: (i) the exit of Crescent Standard Investment Bank Ltd (CSIBL), which incurred substantial losses and consequently had a huge negative equity of Rs 1.7 billion in FY06; and (ii) the entry of KASB Capital Limited as an IFC with an equity base of Rs 3.1 billion in FY07.

In FY07, the gearing ratio of the operative IFCs was 3.7, in comparison with 4.9 during FY06. This ratio indicates that the sector is relatively modestly geared, especially since this level is the lowest in the last five years. **Table 10.7** shows that with the persistent rise in interest rates, the average spread of IFCs has declined from its highest level of 5.8 percent in FY05 to only 2.0 percent in FY07. Net interest margin shows a similar declining pattern, reducing from 6.0 percent to 3.3 percent over the same period. Higher financial charges on borrowing during FY07 caused a significant jump in the expenses which led to a lower income to expense ratio of 109.0 percent in FY07 as compared to 136.5 percent in FY06.

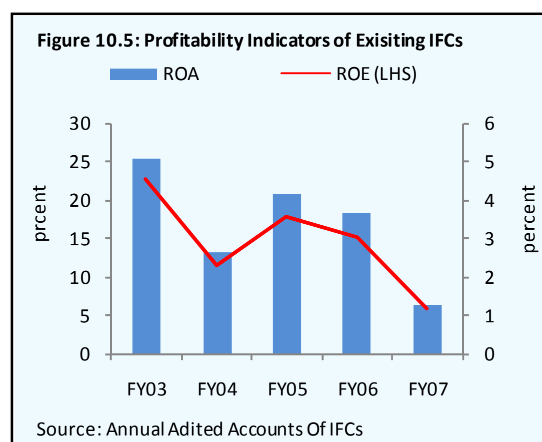
Table 10.7: Key Performance Indicators of Existing Investment Finance Companies
percent (except in case of ratio)

	FY03	FY04	FY05	FY06	FY07
Lease Finance to Total Assets	18.5	20.2	28	26.5	22.9
Investments to Total Assets	45.0	33.5	26.7	22.6	29.0
Placements to Total Assets	11.2	23	14.7	23.2	17.8
Term Finance to Total Assets	17.9	13.9	12.4	14.7	18.7
Earning Assets to Total Assets	92.6	90.7	81.8	87	88.4
Debt to Equity Ratio	4.4	4.6	4.5	4.9	3.7
Average Spread	4.2	4.1	5.8	4.0	2.0
Net Interest Margin	5.4	4.7	6.0	4.8	3.3
Income to Expense Ratio	155.7	159.4	166.1	136.5	109
Return on Average Assets (After Tax)	4.5	2.3	3.6	3	1.2
Return on Average Equity (After Tax)	25.3	13.3	20.8	18.3	6.4

Source: Annual Audited Accounts of IFCs

Profitability indicators of the IFCs deteriorated further in FY07, largely on account of rising interest rates which translated into higher financial charges. Specifically, the ROA declined to 1.2 percent during FY07 from 3.0 percent in FY06, whereas the ROE fell to 6.4 percent in FY07 from 18.3 percent in FY06 (**Figure 10.5**). Competition from banks has forced these companies to diversify their business activities, especially over the last three years (FY05-08). As mentioned earlier, a number of IFCs have merged their operations with commercial banks, and most of the existing investment finance companies hold multiple licenses: specifically, 6 out of the 11 operative IFCs as of end-June FY08 also hold additional licenses for offering leasing, brokerage and housing finance services (**Table 10.8**).

Figure 10.5: Profitability Indicators of Exisiting IFCs



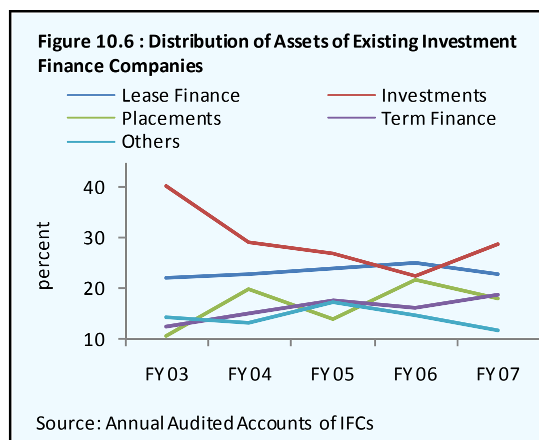
Source: Annual Adited Accounts Of IFCs

Table 10.8: License Structure of Existing IFCs - FY08

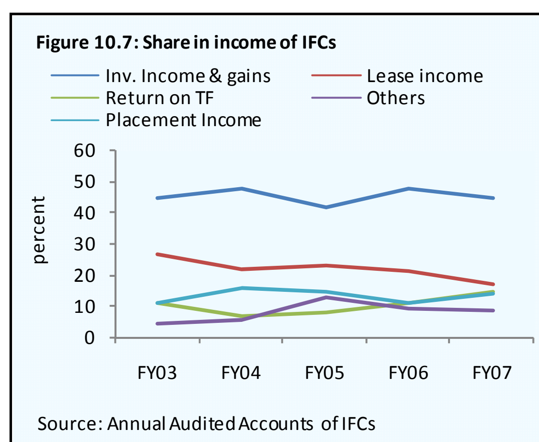
	Name	IFS	Brokerage activity	Leasing	Housing Finance
1	Security Investment Bank	√	-	-	-
2	Trust Investment Bank	√	√	√	-
3	Dawood Investment Bank	√	-	√	√
4	IGI Investment Bank	√	-	√	-
5	FCIB Investment Bank	√	-	-	-
6	Orix Investment Bank	√	√	-	-
7	Escort Investment Bank	√	-	√	√
8	KASB Capital Limited	√	-	-	-
9	Invest Capital Investment Bank Ltd	√	-	-	-
10	J.S. Investments Limited	√	-	-	-
11	Innovative Investment Bank Limited	√	-	√	√

Note : The number of licensed entities has increased by 3 in FY08
Source: SECP

The visible change in the asset mix of IFCs over the past year also highlights the shift in business activities. The share of investments in total assets has increased to 29.0 percent in FY07, from 22.6 percent in FY06. Lease finance decreased to 22.9 percent by end-FY07, compared with 26.5 percent in FY03 (**Figure 10.6**).



The asset mix of these financial institutions is closely linked to their income composition. **Figure 10.7** shows that around 50.0 percent of IFC's income originates from returns and valuation gains (surpluses/losses) on their respective investment portfolio. Despite the rising share of lease finance in total advances, the share of income from lease financing has steadily declined from 27.0 percent in FY03 to only 16.9 percent in FY07. This steady decline is largely attributed to the growing role of commercial banks in providing similar facilities in the form of consumer finance, and the consequent inability of the IFCs to pass on the impact of the rising interest rates to the borrowers.



Another important source of income of IFCs is the returns on funds placed with other financial institutions. In FY07 the share of income from this source was 14.0 percent of the total income compared with 11.0 percent in FY06.

The above changes in both the asset mix and income composition of the operational IFCs are largely attributed to the stiff competition from commercial banks that have an edge over IFCs in many aspects. Due to the lack of a level playing field, IFCs have not been able to capture and maintain a sustained market share in recent years.

10.3.2 Leasing

In a developing country like Pakistan, leasing companies play an important role in capital formation by providing a hybrid form of a debt cum investment option. Leasing companies meet the short to medium term funding requirements of businesses and provide a flexible, tax efficient and economic mode of raising funds.

The asset base of leasing companies reached Rs 64.0 billion by end FY07, compared with Rs 40.9 billion in FY00: indicating annual average growth of 6.6 percent. The aggregate data for NBFIs suggests that leasing companies have not succeeded in maintaining their asset share in line with overall NBFIs assets, which registered annual average growth of 13.1 percent over the same period. This is also visible from the share of leasing companies' assets in overall assets of the NBFIs, which has steadily declined to 11.3 percent by end FY07, from its peak level of 18.1 percent in FY03. This relatively weak asset growth is largely attributed to: (1) intense competition from commercial banks, investment finance companies, Modarabas and DFIs; (2) relatively higher

cost of funding in the wake of rising interest rates since FY05; and (3) decrease in total assets due to consolidation in the leasing sector. Substantial decline in the number of operating companies (from 31 in FY03 to 12 by end FY07) also highlights the extent of consolidation in the sector.

The trend of mergers and acquisitions in the leasing sector is expected to continue in the near future as the financial viability of a number of leasing companies is under pressure due to an increasingly competitive environment and declining spreads. SECP's new regulations for minimum capital requirements will also play a crucial role in this regard. **Table 10.9** indicates that only 2 leasing companies, i.e. Orix Leasing Pakistan Limited and Askari Leasing Limited are well capitalized, with an equity base of Rs 2.4 billion and Rs 1.1 billion respectively as of end-June FY07. 3 companies are adequately capitalized, with equity in the range of Rs 0.5 billion to Rs 1.0 billion. The remaining 7 companies have a lower equity base, one of which is acutely short of the existing minimum capital requirement of Rs 350.0 million as of end-June FY08.[11]

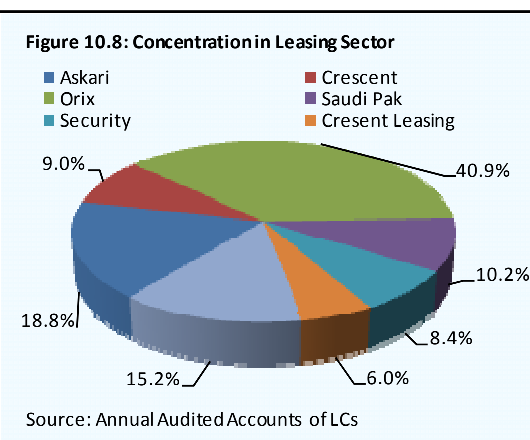
Table 10.9: Equity of Leasing Companies

Equity	Number of Companies
Over Rs 2.0 billion	1
Between Rs 1.0 – 2.0 billion	1
Between Rs 0.5 – 1.0 billion	3
Between Rs 0.2 – 0.5 billion	6
Less than R. 0.2 billion	1

Source: SECP

The asset distribution of leasing companies indicates that the two largest companies hold 59.7 percent of the assets, with the largest company's share at 40.9 percent (**Figure 10.8**). The distribution also indicates the presence of some small and financially weak leasing companies, which can hardly play an active role in the development of leasing activities in the economy.

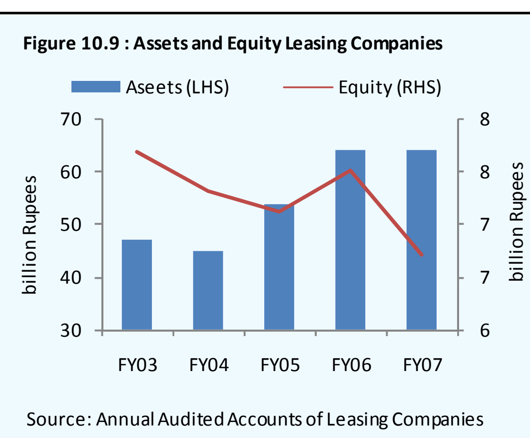
Figure 10.8: Concentration in Leasing Sector



Source: Annual Audited Accounts of LCs

In terms of key financial performance indicators, the total assets of the leasing sector remained almost unchanged at Rs 64.0 billion and the total equity decreased from Rs 7.5 billion in FY06 to Rs 6.7 billion during FY07 (**Figure 10.9**). This was largely due to the stiff competition from commercial banks that provide similar facilities at more competitive rates, lack of low cost funds in a rising interest rate environment, and the concentration of the leasing business in few cities.

Figure 10.9 : Assets and Equity Leasing Companies



Source: Annual Audited Accounts of Leasing Companies

Encouragingly, the composition of assets of the operative leasing companies shows that lease finance constitutes a major portion: in FY07, the share of lease finance in total asset was 81.9 percent compared with 78.2 percent in FY06, reflecting a dedicated focus of the leasing companies on their core business (**Table 10.10**). In contrast, the investment holdings of leasing companies declined to 6.2 percent in FY07, compared with 7.0 percent in FY06 and 10.9

[11] The minimum capital requirement for leasing business has been increased to Rs 700.0 million, to be implemented in a phased manner by end June 2010.

percent in FY04. Combination of lease finance, investments and placements with other financial institutions together form the earning assets of leasing companies which were 90.1 percent of total assets in FY07. For the last five years (FY03-FY07), the earning assets on average were 89.0 percent of the total assets, which is a positive sign despite the decline in growth during FY07.

Table 10.10: Key Performance Indicators of Existing Leasing Companies

Percent (except in case of ratio)

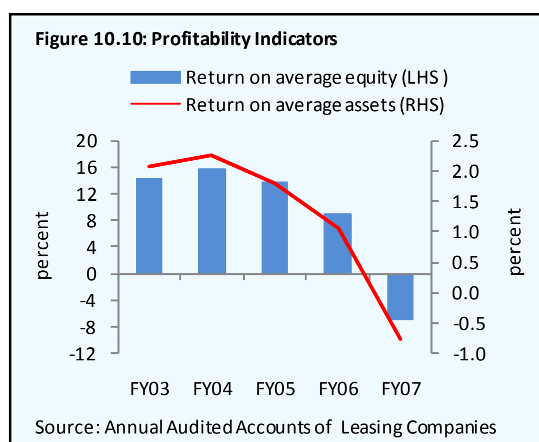
	FY03	FY04	FY05	FY06	FY07
Lease Finance to Total Assets	74.9	77.3	77.5	78.9	81.9
Investments to Total Assets	8.8	10.9	9.9	7.0	6.2
Earning Assets to Total Assets	86.4	89.8	90.1	88.5	90.1
Growth Rate of Lease Finance	55.1	19.7	29.0	24.6	5.0
Debt to Equity Ratio	5.2	5.4	6.5	6.9	7.6
Average Spread	4.9	4.9	3.5	2.3	1.8
Net Interest Margin	6.1	5.7	4.1	3.1	2.8
Income to Expense Ratio	122.1	129.1	124.5	112.7	94.0
Return on Average Assets (After Tax)	2.1	2.3	1.8	1.1	-0.8
Return on Average Equity (After Tax)	14.4	15.7	13.7	8.9	-7.0

Source: Annual Audited Accounts of Leasing Companies

The debt to equity ratio for FY07 was 7.6, indicating increased gearing in the leasing sector, in comparison with 6.9 at end FY06. The impact of high interest rates was also visible from the consistent reduction in the average spread and net interest margin. Specifically, the average spread has narrowed from 4.9 percent in FY04 to only 1.8 percent during FY07. The NIM has also declined to 2.8 percent during FY07 compared with 6.1 percent in FY03. The reduced margins are largely attributed to the heavy reliance of leasing companies on borrowings from financial institutions at floating rates, which is a costly mode of funding in an increasing interest rate environment. On the asset side, competition from commercial banks with a lower cost of funds has curtailed the ability of leasing companies to increase interest rates on lease finance to compensate for the increased cost of funding.

The impact of squeezed margins of leasing companies is also visible in the profitability indicators, which showed losses of Rs 486.9 million in FY07, compared with an aggregate profit of Rs 606.1 million in FY06. This situation is also reflected in the negative return on assets (ROA) of 0.8 percent during FY07 compared with ROA of 1.1 percent in FY06, and the peak level of 2.3 percent in FY04. The return on equity (ROE) follows a similar trend, as it declined to -7.0 percent in FY07 from a high of 15.7 in FY04 (**Figure 10.10**). Of the 12 operative leasing companies, 4 have reported negative profits for FY07, largely due to provisioning against potential lease and investment losses.

Figure 10.10: Profitability Indicators



Source: Annual Audited Accounts of Leasing Companies

The above financial indicators clearly highlight the weak performance of the leasing sector, and raises concerns about the future viability of leasing companies, especially the small and weak entities. Interest rate risk has particularly manifested itself in the case of Natover Lease and Refinance Limited – a company with an equity base of Rs 525.8 million in FY06, and only Rs 56.9 million in FY07. The sharp erosion in equity took place on account of: (i) a hike in the provisions

which increased from Rs. 6.0 million in FY06 to Rs 383.3 million in FY07; (ii) bulk of leases financed at a fixed rate of interest; and (iii) decrease in investment income from Rs 60.0 million in FY06 to Rs 32.0 million in FY07. Due to its precarious financial condition, the company was categorized as financially sick by the SECP on March 31, FY08. Trading in its shares was also suspended consequently. SECP has since then invited expressions of interest (EoIs) from interested parties for the rehabilitation of the company.[12]

Given the competitive environment in the financial sector, leasing companies need to diversify their businesses activities and establish their own funding base. The operating environment also faces emergent challenges from the weakening macroeconomic environment. As of end-FY08, three leasing companies have obtained multiple licenses under the NBFC Rules to undertake investment finance and housing finance services in addition to leasing. These companies also face the challenge of diversifying their business into new unexplored market segments. The newly implemented NBFC Rules allow leasing companies to undertake leasing of commercial buildings, shops and warehouses, and resource mobilization in the form of COIs with a minimum tenor of 30 days, at a floating rate. Both these measures are likely to facilitate the growth of the sector and help the sector in overcoming the challenges it faces.

Diversifying the product range is a strategic challenge for leasing companies in order to become competitive in a rapidly expanding financial sector. One of the potential markets for leasing companies is micro and rural leasing. The existing leasing companies can potentially expand their businesses to capture this segment of the market. Four leasing companies have already started to offer targeted services in this particular area.

10.3.3 Venture Capital Investment

Venture Capital (VC) business in Pakistan is still at an evolutionary stage. In FY07, only four VC companies were operating in the country with a combined asset base of Rs 4.1 billion: less than 1.0 percent of overall NBFIs assets.

VC companies provide financing specifically targeted for emerging businesses, start-up and innovative firms that need capital for product development and growth. Currently, the financing facilities of these companies have a limited base, and the concentration of their businesses is in the telecom sector. However, plenty of other opportunities exist for these companies in sectors such as engineering, health, environment, agriculture and energy.

As stated earlier, there are only four listed VC companies namely TRG Pakistan Limited, AMZ Ventures, TMT Ventures, and Pakistan Private Equity Management Ltd (PPEML). The principal activity of TRG Pakistan Limited is to directly and/or indirectly acquire, manage and/or maintain the business of telephone answering services, call centers, and other business process outsourcing (BPO) companies. The principal activity of AMZ Ventures is to invest in rapidly growing companies, purchase equity securities, assist in the development of new products or services, or to act as a management company for the management of venture capital funds, whereas TMT Ventures is Pakistan's pioneering venture capital company that has been financing start-up operations in the technology, media and telecom sectors since 2001.

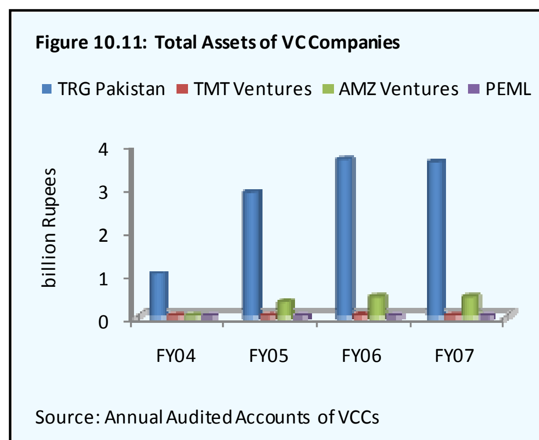
In terms of financial performance, the asset base of VC companies saw a YoY decline of 1.7 percent during FY07 to reach Rs 4.1 billion, compared with growth of 29.1 percent in FY06. Company-wise data indicates that the assets of TRG Pakistan Limited - the largest VCC Company with an 88.5 percent share - and TMT Ventures exhibited a decline of 1.8 percent and 41.9

[12] Press Release dated March 31, 2008, SECP.

percent respectively, whereas assets of AMZ Ventures registered a marginal increase of 0.2 percent **(Figure 10.11).**

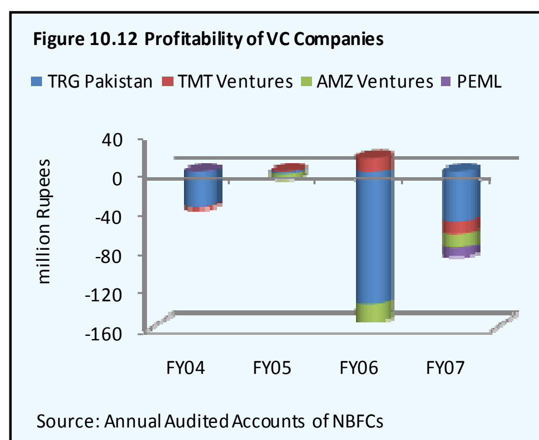
VC companies have sustained losses since FY04, which has negative implications for the long term sustainability of the VC business (**Figure 10.12**). Due to higher financial costs, all VCC companies have registered combined losses of around Rs 87.9 million during FY07, as compared to relatively higher losses of Rs 139.3 million in FY06, which were due to the higher financial charges of Rs. 135.9 million incurred by TRG Pakistan. These expenses subsequently reduced to Rs.51.0 million in FY07.

Figure 10.11: Total Assets of VC Companies



Source: Annual Audited Accounts of VCCs

Figure 10.12 Profitability of VC Companies



Source: Annual Audited Accounts of NBFCs

Venture capital business has grown significantly around the world. Despite the fact that the government of Pakistan has given certain incentives to foreign and local investors in the form of tax breaks and smooth 'exit' options, this sector continues to lag behind in producing tangible results. However, in recognition of the scope and potential of promoting VC in Pakistan, SECP has recently finalized a framework for the promotion and development of venture capital businesses (**Box 10.2**).[13] Furthermore, SECP has also joined hands with the Competitive Support Fund (CFS) and Pakistan Business Council (PBC) for their assistance in promoting venture capital in Pakistan and bringing in international professional expertise to this business. Going forward, it is expected that the implementation of the said framework will revitalize this sector which will help eliminate the impediments in its growth.

10.3.4 Discounting

The primary function of discount houses is to provide liquidity to the financial sector by providing a secondary market for debt securities issued by the government, the corporate sector and other financial institutions. As an NBFC, the capacity and outreach of stand-alone discounting businesses has remained insignificant in comparison with other non-bank financial institutions.

During the last 20 years, only 4 companies were registered as stand-alone discount houses in Pakistan. Three of them have already ceased their discounting business and NBP Capital Limited (NBPCL), a wholly owned subsidiary of National Bank of Pakistan (NBP), was the only discount house operating during FY07. The principal function of this company is to provide discounting/trade of negotiable instruments and business of leasing as licensed under the Non-Banking Companies Rules, 2003. However, contrary to its main function, discounting business has a small contribution in its total assets, and has declined over time **(Figure 10.13).** In the light of amendments in NBFCs Rules and the new Regulation issued by SECP in November 2008, NBP

[13]Private Equity & Venture Capital Fund Regulations 2008, dated August 19, 2008, SECP.

Box 10.2: Private Equity & Venture Capital Funds (PE&VCF)

SECP notified the regulatory framework for the registration and regulation of PE&VC Funds in Pakistan on August 20, 2008. These regulations are the result of a comprehensive consultative process that started about two years back and includes extensive market dialogue with domestic as well as international stakeholders.

Private equity can play a vital role in the economy by providing growth capital to the local corporate sector, particularly SMEs, besides patronizing entrepreneurship and fuelling the privatization process. Private equity will unlock the hidden value of private companies by providing capital and managerial skills for growth and expansion.

To foster the growth of these investment vehicles in Pakistan, significant incentives have already been provided by the Federal Government on the fiscal side in the Finance Act 2008. These include tax-free status for the funds upto 2014, and reduced capital gains tax rate of 10 percent as against 35 percent on the sale of assets and shares of a private company to a PE&VC Fund. It is expected that the conducive regulatory framework combined with the tax incentives provided by the government for PE&VCF will attract large amounts of foreign direct investment in the country.

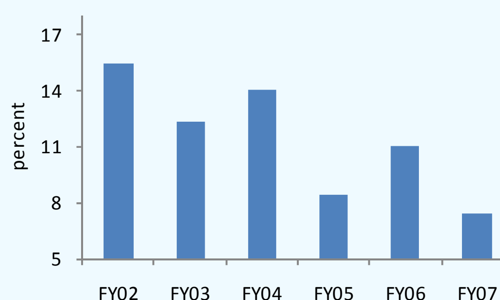
The PE&VCF will be an unlisted closed-end unit-trust fund open only to high-net worth individuals and institutions. The fund will provide equity for seed/start-up capital, expansion, buyouts, primarily to private companies. However, it can also potentially venture into privatization deals. The management company or the FMC will be an NBFC licensed by the SECP to undertake the PE&VC Fund Management Services with a paid-up capital requirement of Rs 30.0 million. The promoters, directors and key executives of the FMC will have to comply with the fit and proper criteria made part of these regulations by the SECP. The minimum fund size has been fixed at Rs 250.0 million, whereas the number of investors has been fixed at 5, with a minimum subscription amount of Rs 10.0 million per investor that can only be raised through private placement. The fund would not be allowed to list and would have a maximum fixed life of 15 years.

The PE&VC Funds established outside Pakistan have been offered the benefit of registering with the SECP to avail the tax advantages. Foreign funds not raising money locally will be subject to minimal regulation, while those raising money locally are subject to same level of regulation as are the local funds.

Source : SECP

has decided to convert NBPCL into a leasing company, so that leasing is now the core business activity of the company. Other business activities such as discounting, investment in capital and money markets, are intended to serve as additional tools of revenue generation. However, the company has also decided to retain the discounting license, as the fate of existing discounting licenses is not clear in the new NBFC Regulations.

Figure 10.13 : Share of Discounted Instruments in total Assets



Source: Annual Audited Accounts of NBPCL

During FY07, the business volume of NBPCL has been adversely affected given the high cost of funding. As a result, growth in total assets registered a YoY decline of 22.7 percent to reach Rs 1.4 billion by end FY07, from Rs 1.8 billion in FY06. However, despite the decline in assets, NBPCL managed to earn profits (after tax) of Rs 35.7 million in FY07, compared with Rs 55.9 million in FY06.

Asset composition of NBPCL reflects the new strategy of the company, as investments in securities and leasing operations account for 47.8 percent and 37.0 percent of total assets at end FY07. The share of discounted instruments in the total asset base is decreasing and has reduced to 7.4 percent from 11.0 percent in FY06.

In line with the asset composition, income earned from investments in securities constitutes the largest share of 47.2 percent in the total income of NBPCL during FY07 compared with 52.8 percent in FY06. Over the same period, the shares of income from leasing operations and discounting activities were 35.6 percent and 12.5 percent respectively (**Figure 10.14**).

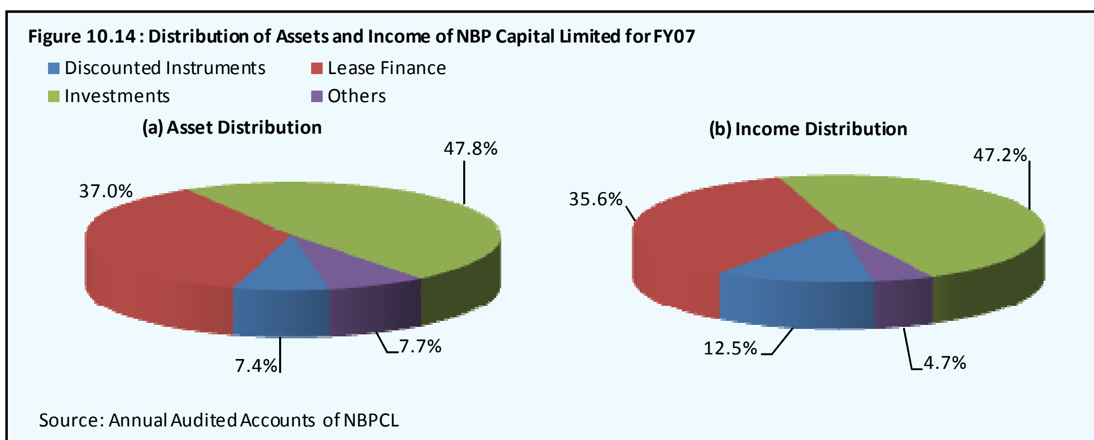


Figure 10.14 : Distribution of Assets and Income of NBP Capital Limited for FY07

Source: Annual Audited Accounts of NBPCL

Discount houses have been facing stiff competition from commercial banks which are financially strong and hold a dominant position in offering discounting services. There are no specific provisions given by SECP in the 2008 Regulations for the promotion of discounting business. These various issues and developments raise concerns about the survival of the discounting business under the umbrella of NBFCs. The sustainability of this business requires revisiting the role of discount houses in promoting a secondary market for government and corporate debt instruments.

10.3.5 Modarabas

Since the introduction of dedicated Islamic financial institutions in parallel with conventional financial institutions, Islamic financial services have witnessed phenomenal growth around the globe. In Pakistan, Islamic financial services are offered by Islamic banks, Islamic banking branches of conventional banks, modaraba companies and shariah-compliant mutual funds.

The concept of modarabas was introduced in 1980 through the Modaraba Companies and Modaraba (Floatation & Control) Ordinance. Since the inception of modaraba companies, various policy initiatives have been introduced for the promotion and growth of this sector in the country.[14] Upto FY06, the modaraba sector's operations were based on three financing agreements namely Musharika, Murabaha and leasing (Ijara), which were approved by the Religious Board in the early 90's, and since then neither any modification was made in these agreements nor was any new financing agreement introduced by the Religious Board. However, during FY07, SECP introduced necessary amendments in the previous model agreements and issued notification of 11 new model financing agreements as approved by the Religious Board for Modarabas. The Religious Board has also approved the conceptual framework for the issuance of sukuks by modaraba companies, in addition to approving issuance of "Modaraba sukuks" to corporate as well as individual investors by Modarabas, a measure intended to cater to the short-term resource mobilization for Modarabas. These sukuks will be specifically for tenors ranging from 90 to 365 days.[15] The Registrar (Modarabas) will issue guidelines for issuance of Modaraba sukuks separately. These policy initiatives are designed to revitalize the sector through better

[14] Financial Stability Review 2006, State Bank of Pakistan.
[15] Circular No. 6, dated May 8, 2008, Specialized Companies Division (Modaraba wing), SECP.

resources mobilization and attracting more business opportunities for the future development and growth of this sector

During FY07, there were 27 operational modarabas as compared to 29 in FY06. However, the modaraba sector is heavily concentrated, as the top 5 modarabas hold 66.8 percent of total assets of the sector **(Table 10.11)**. Similar concentration is also visible from their equity base, as the top two modarabas namely First Habib Modaraba and BRR Guardian Modaraba, contribute 37.0 percent of the total equity of this sector. Besides these two, there are only 4 modarabas with an equity base between Rs 0.5 billion and Rs 1.0 billion. The equity base of the remaining 21 modarabas is less than Rs 0.5 billion and as many as 6 modarabas have equity of less than Rs 0.1 billion.

Table 10.11: Concentration in Modaraba Sector

percent

	Assets			Equity		
	FY06	FY07	FY08	FY06	FY07	FY08
Top 3	32.3	37.7	48.7	29.6	33.6	44.8
Top 5	50.5	56.8	66.8	42.6	44.9	56.0
Top10	69.1	77.2	86.1	59.7	61.9	76.0

Notwithstanding, an important development in the sector in FY07 was the strong YoY growth of 24.0 percent in the equity base of the modaraba companies, compared with the average growth of 11.0 percent during the last 5 years. This increase was largely attributable to the policy decision taken by the Registrar Modarabas in July FY07, to raise the upper limit of the profits required to be taken into statutory reserves, from 30.0 percent to 50.0 percent, which has served to strengthen the equity base. The relatively slow growth in the past is attributed to the tax exemption given to the modarabas in case of 90.0 percent distribution of the profits. This incentive had instead become an obstruction in strengthening the capital base as most of the modarabas management companies were inclined to distribute their profits to certificate holders to avail this opportunity.

During FY07, several modarabas have either been merged or have winded up their operations. During the period under review, Fayzan Manufacturing Modaraba wrapped up its business, whereas Modaraba Al-Tijarah merged with Modaraba Al-Mali, Guardian Modaraba merged with B.R.R. International Modaraba to form B.R.R. Guardian Modaraba, and First Allied Bank Modaraba has merged into Allied Bank Limited. This process of mergers of small modarabas with bigger entities would help this sector in improving its equity base, where consequently financially sound and stronger modarabas would be in a better position to compete effectively in offering shariah-compliant financial services in a competitive environment.

During FY07, aggregate assets of the operative Modarabas surged to Rs 26.3 billion, with YoY growth of 22.2 percent, compared to 16.7 percent in the preceding year. During FY02-06, lease finance constituted on average about 50.0 percent of the total assets of modaraba companies. However, the share of lease finance has witnessed visible decline over the last two years to reach 41.6 percent by end FY07, compared to 53.1 percent in FY05 **(Table 10.12).** The second largest component in the total assets of Modarabas is investments in the equity market. The share of these investments has been gradually rising since FY05, and has reached 19.5 percent in FY07 from 16.7 percent in FY05. In addition to leasing and investment activities, the modaraba sector also provides financing facilities under modaraba and musharika arrangements, which constitute 15.5 percent of total assets as of end FY07.

On the financing side, the debt to equity ratio shows that modarabas have not relied extensively on debt for financing their asset growth, and that the leverage ratio has declined during FY07 to reach 1.2. This is because the Modaraba sector is allowed to mobilize funds by issuing Certificate

of Investment (CoI) and musharika-based term finance certificates, which reduces their dependence on borrowings in comparison with the NBFCs.

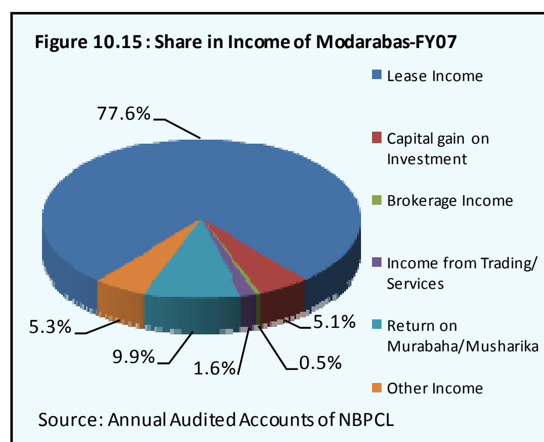
Table 10.12: Key Performance Indicators of Existing Modarabas
percent (except in case of ratio)

	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07
Total Assets (Billion Rupees)	12.3	12.4	14.8	18.5	21.6	26.3
Growth Rate of Assets	5.1	1.1	19.0	25.1	16.7	22.2
Lease Finance to Total Assets	49.8	54.3	51.6	53.1	51.0	41.6
Investments to Assets Ratio	15.6	11.5	17.2	16.7	17.5	19.5
Murabaha/Musharika to Total Assets	16.2	17.7	13.4	14.1	15.5	15.5
Earning Assets to Total Assets	81.6	83.6	82.1	83.9	84.0	76.6
Debt to Equity Ratio	0.8	0.7	0.9	1.0	1.3	1.2
Income to Expense Ratio	124.7	130.9	138.3	125.1	113.6	116.1
Return on Average Assets	5.6	7.1	6.1	4.1	2.3	3.2
Return on Average Equity	12.0	14.4	12.6	9.0	5.4	7.5

Source: Annual Audited Accounts of Leasing Companies

In line with the over 20.0 percent YoY increase in assets, the income of the modaraba sector also recorded an increase of 26.7 percent during FY07, compared to 14.5 percent in the previous year. Further break-up of income shows that revenue from modaraba/ musharika and lease financing contributed 87.5 percent of total income for FY07 (**Figure 10.15)**. Similarly, income from capital gains on investments in the stock market and from trading activities contributed around 5.1 percent and 1.6 percent respectively, whereas, other income sources like dividends and brokerage functions contributed less than 1.0 percent to the total income during FY07.

Figure 10.15 : Share in Income of Modarabas-FY07



Source: Annual Audited Accounts of NBPCL

On the expenditure side, rise in interest rates due to the ongoing monetary tightening has increased the financial charges for modarabas, which grew sharply by 50.0 percent to reach Rs.1.3 billion during FY07. As a result, their share in total expenses has grown to 28.0 percent from 23.0 percent in FY06. Over the same period, expenses related to depreciation/amortization costs have increased by 13.3 percent. However, the share of these expenses in total expenses has declined to 57.0 percent during FY07 against 62.0 percent in FY06.

The relatively lower depreciation/amortization costs coupled with the improved income of the modaraba sector have pushed the income to expense ratio to 116.1 percent in FY07 from 113.6 percent during FY06. The improved profitability is also evident from the increase in return on assets (ROA) of 3.2 percent and return on equity (ROE) of 7.5 percent during FY07.

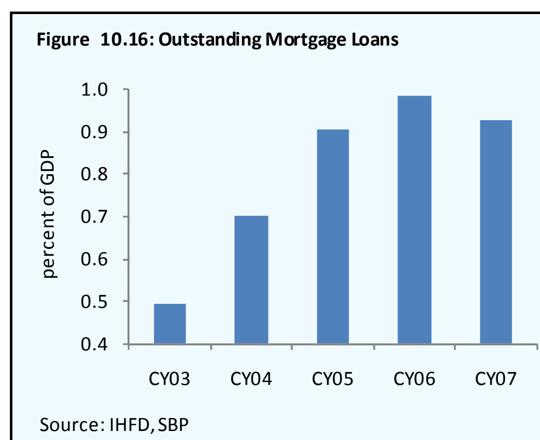
Although the financial performance of the modaraba sector has improved during FY07 compared to FY06, the benefits of the introduction of the new measures by the Religious Board and the SECP are yet to reflect in the performance of the modaraba companies. It is expected that the newly introduced modes of financing would not only enhance product diversification but would also help in mobilizing resources to compete and to attract other business opportunities for the future development and growth of this sector. These new policy initiatives also aim to provide a

level playing field to the modaraba companies viz-a-viz Islamic banks. Ultimately, these developments are likely to support the business expansion of Islamic financial services through the platform of modaraba companies.

10.3.6 Housing Finance

Developments in the housing sector have strong implications for the overall economic activities, due to their direct and indirect impact on almost 40 industries. For instance, the labor-intensive nature of activities in the construction sector creates significant employment opportunities and helps in promoting growth activities. In Pakistan, despite positive developments in mortgage financing during FY03-06, the housing sector carries a large and persistent deficit of 6 million housing units,[16] and housing finance services offered by financial institutions are still at an evolutionary stage due to both demand and supply side factors. The outstanding housing loans to GDP ratio steadily increased from 0.49 percent in FY03 to its peak level of 0.98 percent in FY06, before recording a marginal decline in FY07 (**Figure 10.16**). The demand for housing finance during FY03-06 was largely attributed to macroeconomic stability, rising per capita income due to strong GDP growth, historical growth in foreign remittances and access to mortgage finance facilities by the banking sector. However, the size of the housing finance market is still very small in Pakistan, in comparison with other countries, i.e. 2.5 percent in India, 5.0 percent in Colombia, 14.0 percent in Chile, and 65.0 percent in USA. With this backdrop, this section is dedicated to reviewing the performance of housing finance companies during CY07.[17]

Figure 10.16: Outstanding Mortgage Loans



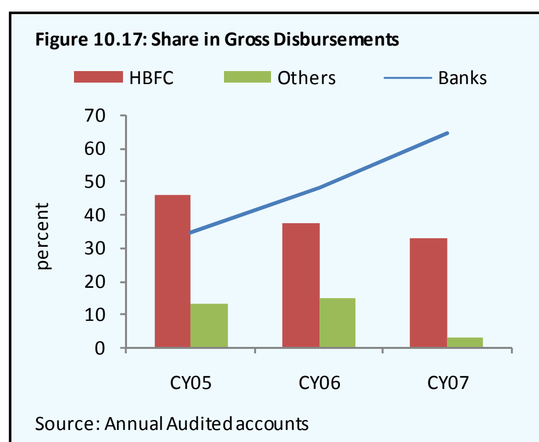
Source: IHFD, SBP

In Pakistan, Housing Building Finance Corporation Limited (HBFC), banks, and NBFCs holding the requisite license for offering housing finance facilities, are the main providers of mortgage loans. The accumulated gross disbursements for housing finance reached Rs 126.4 billion by end-CY07, as compared with Rs 103.2 billion as of end-CY06. In terms of YoY growth, an increase of 22.5 percent in gross disbursements during CY07 was lower than the 30.4 percent growth over the previous year. This decline in gross loans was primarily attributed to: (1) increased level of interest rates due to monetary tightening; (2) visible rise in the cost of construction and land; and (3) rising inflation, which impacts the demand for loans by reducing savings in the economy. Besides these issues, structural weaknesses such as the difficulties associated with establishing clear land titles, lack of long term funding sources for financial institutions to reduce the asset-liability mismatch that arises particularly in case of long-term loans as in case of housing, and inadequate incentives to lend to lower income households, continue to persist.

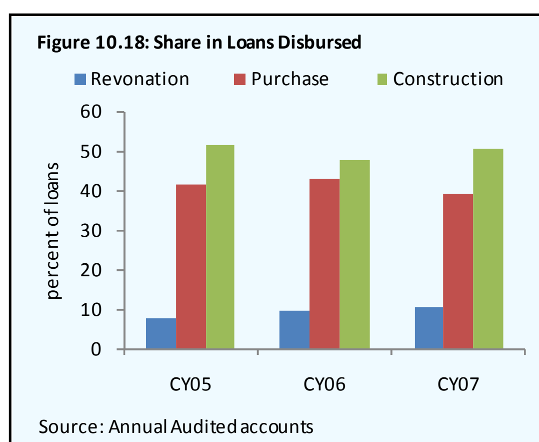
The institutional break up of gross disbursements indicates that banks have emerged as the major provider of housing finance loans, with a share of 64.5 percent as of end-CY07, compared with 37.4 percent in CY05 (**Figure 10.17**). The data also shows that HBFC, the oldest housing finance institution established in 1952, maintained its dominance in providing housing finance loans until 2005. Both HBFC and NBFCs offering housing finance facilities, have lost their market share over the last couple of years to the banking system which has access to low cost funds in the form of retail deposits, and better outreach due to the strong branch network.

[16] As estimated by the Karachi Chamber of Commerce and Industry (KCCI).
[17] The Annual Audited accounts of the House Building Finance Corporation (HBFC) are prepared on a Calendar Year (CY) basis.

Although the banking sector has emerged as the biggest provider of housing finance loans, HBFC still accounts for over 93.0 percent of the 480,569 loans disbursed as of end-CY07 in terms of volume, whereas the banking sector accounts for only 6.3 percent of the total loans disbursed. This, along with the two-thirds share of the banking sector in the loans disbursed, indicates that the banking sector is targeting the middle to upper end of the housing market, while HBFC's clientele consists of the lower end of the market. A similar inference can also be made from the average housing loan size of Rs 2.7 million of the banking sector, compared with only Rs 92,600 for HBFC.

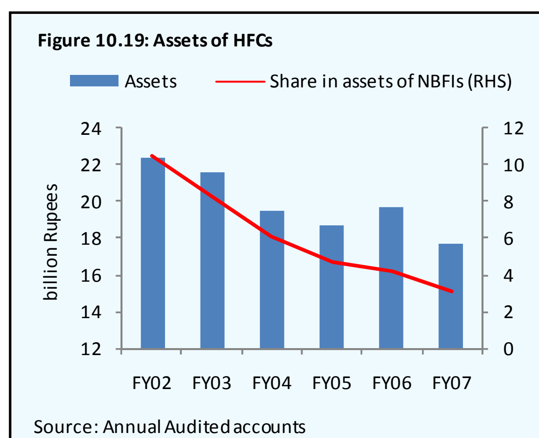


In terms of loan categories, housing loans are provided for three main types of activities including construction, outright purchases and for renovations. Disaggregated data of total housing loans disbursed up to end-CY07 indicates that almost half of the loans (50.7 percent) are disbursed for construction of private property, followed by loans for the outright purchase of houses (**Figure 10.18**). Loans for renovation of houses have increased considerably in recent years as their share in the total loans disbursed has risen from 7.5 percent at end-CY05, to 10.4 percent by end-CY07.



This clearly shows that banks, despite being a late entrant into housing finance services, have emerged as the biggest provider of housing loans, while HBFC and others have gradually lost their market share. In so far the overall performance of these institutions is concerned, the key financial indicators of HBFC and other NBFCs offering housing finance facilities are analyzed herewith.

At present, Asian Housing Finance Limited (AHFL) is the only entity operating as a housing finance company under the umbrella of NBFCs, while HBFC operates as a DFI under the supervision of the SBP. During FY07, the aggregate assets of HBFC and AHFL registered a YoY decline of 9.9 percent to reach Rs.17.7 billion as compared to the growth of 5.6 percent during FY06. As a result, the share of HFCs in overall NBFIs has dipped to 3.1 percent only, compared to 10.5 percent as of end FY02 (**Figure 10.19**). The loss of market share is primarily attributed to the negative asset growth of HBFC, and the exit of other HFCs from the sector. In FY07, both HBFC and the only stand-alone NBFC i.e. AHFL offering



housing finance, witnessed YoY decline in assets of 4.7 percent and 9.8 percent respectively. The negative growth of HBFC was primarily attributed to the re-classification of non-performing loans according to more stringent criteria. This is clearly visible from the negative 6.5 percent growth in HBFC's housing loans while gross disbursements increased by 7.3 percent during FY07, and a huge provisioning of Rs.1.9 billion made against its non-performing loans (NPLs), compared to only Rs.310 million in FY06. On the other hand, during FY07, AHFL's share was 0.9 percent in the overall assets of HFCs, with HBFC accounting for the remaining 99.1 percent.

The impact of recognized NPLs is also visible from the decline in the earning assets to total asset ratio, which decreased to 79.4 percent by end-FY07, compared with 86.7 percent in FY06 (**Table 10.13**). The gearing ratio of HBFC together with AHFL reached 3.1 times in FY07 against 2.7 in FY06. Higher financial leverage indicates a continuous reliance on borrowings to finance new housing loans during the year. HBFC alone holds the largest chunk of aggregate borrowings (99.8 percent) at concessional rates, largely from the SBP and the government. The benefit of low cost borrowing is clearly visibly from the high average spread and net interest margin. Subsidized borrowing alongwith increasing interest rates has contributing to the rising spreads. However, the benefit of these huge margins is not visible in the bottom line, i.e. ROA and ROE. Huge provisioning of Rs.1.9 billion by HBFC against its non-performing loans and increased operating expenses has pushed the bottom line into red. The substantial decline in the income to expense ratio is also attributed to these factors. Specifically, the income to expense ratio during FY07 reached 46.8 percent – lowest since FY00, against the average of 128.0 percent over FY02-FY06.

Table 10.13: Aggregate Performance Indicators of HBFCL and NBFCs providing Housing Finance

percent (except in case of ratio)

	FY03	FY04	FY05	FY06	FY07
Housing Finance to Total Assets	51.6	61.5	65.4	63.8	61.2
Investments to Total Assets	20.2	9.4	19.0	22.6	18.2
Earning Assets to Total Assets	71.8	70.9	84.5	86.7	79.4
Growth Rate of Housing Finance	5.3	7.8	1.8	3.0	-16.5
Debt to Equity Ratio	2.9	3.1	2.8	2.7	3.1
Average Spread	7.5	6.9	8.3	8.6	11.8
Net Interest Margin	7.5	6.9	8.4	8.8	11.9
Income to Expense Ratio	142.6	57.4	110.6	176.6	46.8
Return on Average Assets (After Tax)	0.9	-3.3	-1.5	0.7	-0.4
Return on Average Equity (After Tax)	4.0	-14.7	-6.8	3.2	-2.0

Source: Annual Audited Accounts and SBP Calculations

In a bid to convert HBFC into a commercial mortgage lender, the DFI was incorporated as "HBFC Limited" under the Banking Companies Ordinance 1984 in July, FY08. Upto FY07, HBFC's paid-up capital of Rs 3.0 billion was jointly shared by the Federal government (62.5 percent) and SBP (37.5 percent). HBFC is in the process of raising its paid-up capital to Rs 6.0 billion in line with SBP's minimum capital requirement for banks and DFIs. At present, its paid up capital is Rs 3.5 billion, of which 53.6 percent is held by the government and the remaining 46.4 is contributed by the SBP.

Besides HBFCL, AHFL is also facing difficulties in mobilizing long term funds to finance its operations. Until FY07, the major source of funding for AHFL was its equity base. Specifically, 84.4 percent of AHFL assets as of end FY07 were funded by the equity of the company. This clearly indicates that the company has yet to establish its own funding source. Specifically, the deposits mobilized by the company constituted only Rs 13.0 million, of which Rs 12.6 million was payable within the year.

Another area of concern for AHFL is its low equity, which has declined to Rs 133.6 during FY07 from Rs145.9 million in FY06, mainly on account of the net loss reported during the year. According to the new SECP Regulations 2008, minimum equity requirement for existing housing finance services is to be increased in a phased manner to Rs 700.0 million by end June 2010, which might pose a challenge for the company.

10.3.7 Development Finance Institutions

Development Finance Institutions (DFIs) were established in the 1950s and 1960s as a part of an overall economic strategy of targeted intervention in key sectors of the economy. The Pakistan Industrial Credit and Investment Corporation (PICIC) was the first DFI established in 1957 to mobilize funds from International Financial Institutions and the private sector for the financing of medium to long term industrial projects. In general, DFIs were expected to play the multiple roles of catalytic financier, knowledge broker and development partner, in addition to mobilizing resources from both the public and private sectors. However, with the changing financial landscape in the wake of the reform process initiated in the 1990s, DFIs have charted their own path in response to the evolving business environment.

At present, all the DFIs operating in Pakistan are bilateral joint ventures with friendly countries. CY07 was a noteworthy year for DFIs, as three new joint investment companies were established with the collabaration of the Governments of Iran, Brunei, and China, while PICIC was merged into a local private bank.

In terms of financial indicators, the assets of DFIs declined by 18.5 percent to reach Rs 95.3 billion by end-CY07, compared to the growth of 8.5 perent observed during CY06 (**Table 10.14**).[18] This decline is entirely attributed to the exit of PICIC from the sector, due to which its assets shifted from the DFIs to the banking system. Excluding PICIC, DFIs' assets grew by 20.7 percent during CY07 on account of both the increasing investment portfolio of the exisitng DFIs and the entry of new DFIs.

Table 10.14: DFIs at a Glance

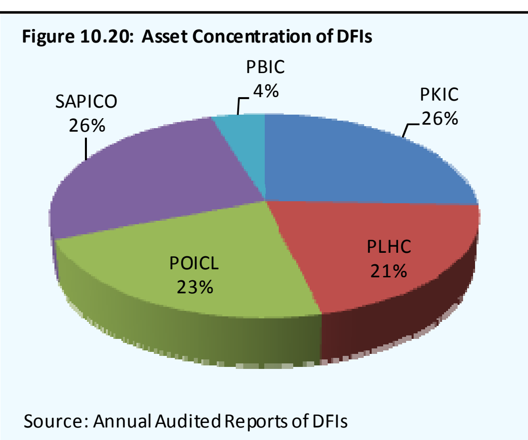
billion Rupees

	2005	2006	2007
Assets	107.8	116.9	95.3
Lending to FIs	8.3	17.0	18.9
Investments	43.1	37.9	37.5
Advances	42.1	41.7	23.0
Liabilities	73.8	79.6	54.6
Borrowing from FIs	35.0	50.0	44.5
Deposits/COIs	35.2	26.1	7.6
Equity	34.0	37.4	40.7

Source: Annual Audited Accounts of DFIs

Asset distribution among the DFIs indicates a low degree of concentration. Specifically, with the exception of a new entrant that commenced its business during CY07, the asset shares of the remaning four DFIs range from 20.6 percent to 26.3 percent (**Figure 10.20**). However, these asset shares are likely to witness visible changes during CY08 due to the entry of two new DFIs in the sector. Data for H1-CY08 data lends credence to this assertion, as the share of the largest DFI has increased to 28.3 percent of total assets compared to the asset share of only 5.5 percent of the smallest DFI.

Figure 10.20: Asset Concentration of DFIs



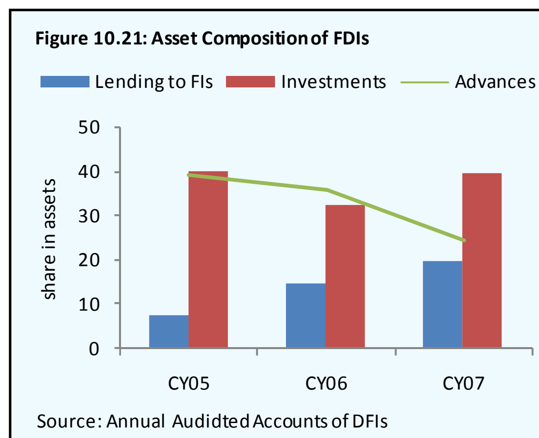
Source: Annual Audited Reports of DFIs

Having given the overall profile of the DFIs, the rest of this section reviews the finnancial performance of the DFIs during CY07.

[18] The asset of the DFIs further increased to Rs 97.7 billion by end H1-CY08.

DFIs' asset composition indicates that their advances' portfolio registered a massive decline of 44.8 percent during CY07, not all of which can be attributed to the exit of PICIC as in the case of the decline in total assets (**Table 10.14**). This trend is also visible from the noticeable decline in the share of advances in total assets, which declined to only 24.3 percent by end-CY07, compared with 35.7 percent as of end-CY06 (**Figure 10.21**). Again, this decline was on account of PICIC, which had 50.2 percent of its assets in the form of advances. The asset composition indicates that the existing DFIs are primarily involved in investment activities, which account for nearly 40.0 percent of their assets. Further breakup of investments indicates that the DFIs' investments in corporate debt instruments (TFCs/PTCs) have increased significantly during CY07, pushing its share in total investments to 13.3 percent compared to 8.9 percent in CY06 (**Table 10.15**). Similarly, investments in government securities and the equity market have also increased over the same period. The surge in investment activities is primarily attributed to fresh capital injection in the DFIs sector that was channeled into the investment portfolio, as well as lending to financial institutions, which surged to 19.8 percent by end-CY07 compared to only 8.3 percent in CY05. These statistics reflect the DFIs' focus on investments as their primary business.

Figure 10.21: Asset Composition of FDIs



Source: Annual Audidted Accounts of DFIs

Table 10.15: Investments Portfolio of DFIs

percent of total investment

	CY05	CY06	CY07
Subsidiaries	11.0	11.5	11.6
Govt. Securities	12.9	14.8	17.2
Quoted Shares	20.3	23.7	26.2
TFCs/PTCs	8.0	8.9	13.3
Others	47.9	41.2	31.7

DFIs' assets are primarily funded by equity and borrowing from financial institutions, as deposits fund only 8.0 percent of assets (**Table 10.16**). Capital injections into three key existing DFIs and the equity base of the new entrant during the year increased the total equity to Rs 40.7 billion by end-CY07, from Rs 37.4 billion in CY06, despite the elimination of PICIC's equity of Rs 7.6 billion due to its merger. However, the deposits of DFIs declined by Rs 18.5 billion during CY07, by an amount almost equivalent to the size of PICIC's deposits. The funding composition also shows that DFIs continued to rely heavily on borrowings from financial institutions in CY07. Despite the Rs 5.5 billion decline in borrowing from the financial institutions during CY07, 46.7 percent of assets are financed by this source.

Table 10.16: Funding Composition of DFIs

as percent of assets

	CY05	CY06	CY07
Equity	31.5	32.0	42.7
Borrowing from FIs	32.5	42.8	46.7
Deposits	32.6	22.4	8.0
Others	3.4	2.9	2.6

The funding composition shows that, like the NBFCs, DFIs lack a sustained source of funding, which is essential for the long term sustainability of operations. This also makes business expansion dependent on the lending decisions of other financial institutions, borrowing from whom is generally a high cost form of funding in comparison with deposit mobilization. This issue carries negative implications for the overall profitability of the DFIs.

With the entry of new institutions in the DFIs sector, along with injection of fresh capital by existing DFIs, the capital adequacy indicators strengthened during CY07 despite the capital reallocation of PICIC. As a result, their CAR improved to 44.4 percent in CY07 from 32.9 percent in CY06. A similar improvement is also visible from the tier-I capital to RWAs ratio, which increased to 42.1 percent in CY07, from 30.4 percent in CY06 (**Table 10.17**). This strong capital base of the DFIs reflects their ability to withstand unexpected losses (if any) on account of their business operations. The noticeable increase in the equity of the DFIs is also visible from the improved equity to liability ratio, which reached 74.5 percent in CY07 from the already high level of 51.8 percent as of end-CY06.

Asset quality indicators also recorded sharp improvements during CY07. The NPLs to loans (gross) ratio significantly dropped to 8.6 percent in CY07, from 21.1 percent in CY06. Similarly, the net NPLs to net loans ratio dropped to 1.1 percent in CY07 from 13.2 percent in CY06.

Table 10.17: Key Performance Indicators of DFIs
percent

	CY05	CY06	CY07
Capital RWA Ratio	17.24	32.9	44.4
Tier I Capital to RWA ratio	15.12	30.4	42.1
Capital to Liability ratio	50.5	51.8	74.5
Equity to Asset ratio	34.6	35.2	42.7
NPLs to Loan Ratio (Gross)	49.4	15.2	8.6
Net NPLs to Loan Ratio	18.5	8.6	1.1
Provisions to NPLs	62.5	43.1	87.7
Earning to total assets ratio	86.8	82.6	83.4
Expense to total income	45.9	68.8	58.2
ROA (before tax)	5.5	2.6	2.5
ROA (after tax)	5.5	2.6	2.5
ROE(before tax)	6.0	2.2	3.0
ROE(after tax)	16.0	7.5	6.5
Net Interest Margin	1.9	1.4	2.1
Liquid to total assets	14.2	15.3	17.3

Source: Annual Audited Accounts of DFIs

Another significant development during the year was the high profitability of the DFIs, which recorded a strong YoY growth of 27.4 percent to reach Rs 3.2 billion, despite the fact that profits of PICIC were no longer part of DFIs' profit in CY07. This development becomes more relevant when compared with the profitability of CY06, which recorded a YoY drastic decline across all entities in the sector. One of the key factors in this sharp reversal is the gain on sale of securities, which recorded a YoY growth of 87.0 percent during CY07 to reach Rs 2.8 billion. Moreover, decline of Rs 0.5 billion in the amount of provisions & bad debts written-off directly also contributed to the strong profitability. The net interest income also increased by 19.2 percent during the year. As a result of all these developments, the pre-tax ROA improved to 3.3 percent in CY07 from 2.1 percent in CY06.

In Pakistan, DFIs were set up with the objectives of attracting foreign capital for carrying out industrial, agro-based and export oriented projects, setting up industries in areas like shipping, sugar, and fertilizer, projects in areas like inland transportation, tourism and hotels, and in particular, promoting economic collaboration by prioritizing projects in which investors of the two countries could potentially collaborate. Their mandate also envisages a number of ancillary services, which are equally instrumental in an economy's capital formation process. These services, inter alia, include securities' underwriting, facilitating mergers and acquisition, arranging and funding syndicate loans, arranging and managing public issues, and providing financial advice to businesses.

However, DFIs have not been able to truly focus on these priority areas, and have largely been observed to be deviating from their primary objectives. Although their operating performance and profitability is satisfactory, yet they have fallen short in achieving their objective of promoting economic cooperation by the implementation of long-term industrial projects as mandated. The major reason for their lackluster performance has been the tough competition from the commercial banks which, following the philosophy of universal banking, are increasingly

taking up activities which were once considered to be the exclusive domain of DFIs. Besides, it is also being realized that DFIs themselves lack the necessary dynamism that is the characteristic of a private enterprise. Accordingly, they are faced with under-leveraging mainly due to their inability to effectively manage their asset-liability profile by raising long-term deposits and lending them onwards for financing longer-term projects.

The risk profile of the DFIs has significant similarities with those of the banks. Their regulatory framework under SBP is the same as that for banks. In order to infuse dynamism into the sector, the need for the increased participation of the private sector is being realized. For this purpose, a gradual divestiture of the government's stake in DFIs has been envisaged.[19] The phased introduction of private enterprise into the sector is likely to provide the much needed dynamism and drive for the DFIs to explore alternative avenues to achieve their defined objectives in an effective and efficient manner.

10.4 Conclusion

The non-bank financial institutions (NBFIs) have historically played a significant role in meeting the diverse financial needs of various sectors of the economy and hence, contribute to the economic development as well as to the deepening of the financial system. However in recent years this component of the financial sector has faced a challenging operating environment given the universal banking approach of the banking sector, and their competitive advantage over the NBFCs in being able to mobilize funds at a relatively lower cost.

SECP's new regulations which focus on increasing the minimum capital base, and more stringent requirements for the classification of non-performing loans is expected to increase the resilience of the NBFC sector towards adverse shocks. While the increase in minimum capital requirements has served the interest of the sector well, the lack of capital adequacy requirements for NBFCs and modarabas based on risk-weighted assets, continues to have strong bearings for the effective risk management of these institutions. DFIs, on the other hand, are already in compliance with a regulatory regime uniformly applicable on banks which requires maintenance of a minimum CAR of 8 percent, in addition to the need to implement Basle II in compliance with the timelines laid out by SBP.

It is expected that once all the NBFCs are in compliance with the requirements laid out in the NBFCs Regulations 2008, they would be better placed to compete and operate in the rapidly expanding financial sector. Furthermore, SECP's initiatives in formulating the regulatory framework for Real Estate Investment Trusts (REITs) (**Box 10.3**) and private equity funds are also expected to contribute to the growth and diversification of the financial system.

[19] SAPICO was converted from private to public limited company in April, CY08.

Box 10.3: Real Estate Investment Trust (REITs)

Real Estate Investment Trust is a mutual fund that invests in properties and derives income from such investments for its unit holders. In Pakistan, Real Estate Investment Trusts (REITs) have been launched under the Real Estate Investment Trust Regulations 2008, notified by the Securities and Exchange Commission of Pakistan on 31 January 2008. A wide range of associated stakeholders, including representatives of Federal and Provincial governments, valuers, real estate developers, contractors, designers and other financial market participants, were consulted and detailed discussions were held prior to the promulgation of the REITs' regulatory framework. The objective of REITs is to introduce an alternative asset class which will add depth to the capital market and provide transparency to the real estate sector in the form of comprehensive disclosures and accountability through a trust mechanism engrained in the REITs Regulations.

According to the regulations, REITs is proposed to be in the form of a closed-end trust structure. The REIT Management Company (RMC) can be incorporated as an NBFC with minimum paid-up capital of Rs. 50.0 million. However, the RMC is required to raise the capital to Rs. 500 million within 30 days of the date of registration of the REIT scheme by the SECP. The minimum fund size for a REIT is Rs. 5.0 billion. REITs are exempted from taxes in case of distribution of 90 percent of their income as dividends. The unit holders will be able to trade the units in the secondary market for capital gain purposes.

A REIT can undertake two types of projects - developmental or rental. Developmental projects are those wherein a REIT will develop/construct a property and then sell it on profit and distribute the proceeds among the unit holders as dividends. Rental projects, on the other hand, would focus on income generation, where the rental income of the property will be used as dividends for the unit holders.

The introduction of REITs is expected to improve price discovery for both the rental and sale transactions of real estate properties and will help in promoting development of the long-term rental market. It will also help in building capacity in the areas of valuation, professional fund management and trusteeship.

For capital market participants, REITs will provide an alternative asset class which will increase the supply of securities with the combined benefits of an 'equity security' and 'real estate'. Since the units will be listed and traded on the stock exchange, this asset class will serve to broaden and diversify the mutual fund industry. At the initial stage, REITs will be offered in Islamabad, Rawalpindi, Karachi, Lahore, Peshawar and Quetta

Source: SECP