4 Performance of Non-Bank Finance Institutions[1]

The last five years have seen non-bank finance institutions (NBFIs) transforming rapidly through restructuring and improved supervision. Regulatory policies focused on consolidating weak institutions, resulting in a large number of mergers and acquisitions, which in turn, lead to a decline in the number of NBFIs. However, asset growth has largely remained intact as the total asset base of NBFIs has increased from Rs 239.2 billion at end FY00 to Rs 388.1 billion at end FY05,[2] depicting an average annual growth of 11.2 percent. The growth during FY05 was larger than the average growth of previous five years but was relatively lower than the preceding year. The strong growth of mutual funds, DFIs and leasing companies mainly contributed in the overall expansion of the NBFIs' business.

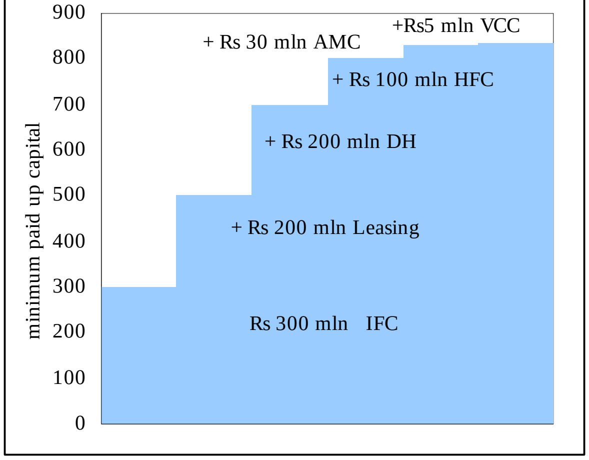
Going forward, the overall business environment has become quite challenging for the NBFIs. Specifically, inter-industry competition, in particular with commercial banks, has increased and interest rates are on a rising trend, following monetary tightening by the SBP. Therefore, it is high time for NBFIs to innovate considerably; first in their asset products to maintain a sizable niche in the market and; second, in liability products to keep an access to low cost financial resources.

Following sections will discuss in detail the key issues and major developments in the NBFI sector. Section 4.1 will discuss the changing regulatory environment in which these institutions are operating; Section 4.2 will discuss the ownership structure and growth in the sector during the preceding five years in general and FY05 in particular; Section 4.3 will discuss the individual performance of each NBFI group in detail followed by conclusion in Section 4.4.

4.1 Operating Environment

Excess fragmentation and generally poor financial health of NBFIs, by the late 1990s, had created an emerging need to reshape the infrastructure of the sector; both in terms of regulatory environment and institutional strengthening. In particular, there was a strong need to strengthen the capital base of these institutions and also to diversify their business portfolio. With these objectives in mind, a comprehensive reform process was initiated in FY00.

Figure 4.1: Capital Requirement Model of NBFC



For strengthening the NBFIs' regulatory framework, the most important structural change was the legal demarcation of supervisory responsibility between the SBP and SECP whereby the supervisory role of NBFIs

[1] NBFIs include Development Finance Institutions-DFIs, Investment Finance Companies-IFCs, Leasing Companies, Modarabas, Mutual Funds-MF, Housing Finance Companies, Discount Houses, and Venture Capital Companies-VCCs.

[2] FY denotes the end of the financial year. Since the financial year of NBFIs varies across groups, a common definition like calendar year or fiscal year can not be used.

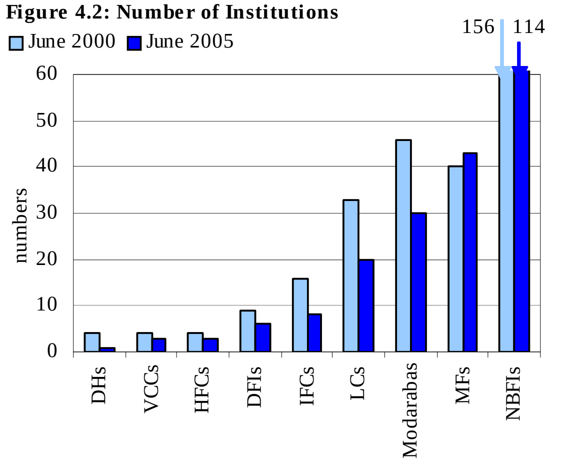
was transferred to SECP[3] (except for DFIs and HBFC). This was done to promote the efficacy of the supervision of the overall financial system.[4] The SECP, from time to time, has been amending the rules of NBFI business to promote their operational efficiency and efficacy for the overall development of the economy.

With this perspective, the SECP introduced the concept of a non-bank finance company (NBFC). An NBFC is allowed to undertake a wide variety of financial services under one roof by a ‘step up’ in equity capital. For instance, while minimum paid-up capital requirement for an investment bank is set at Rs 300 million, by adding up another Rs 200 million the investment bank can obtain a license of leasing operations, as well. Similarly by injecting more equity, the NBFC can start other operations as well **(**see **Figure 4.1**). The concept of NBFC is expected to strengthen the capital base of such financial institutions. Moreover, it will allow these institutions to reap the benefit of economies of scales and economies of scope.

4.2 Ownership Structure and Growth of NBFIs

The focus of the NBFI reform process was primarily on the consolidation of the sector with a leading role for private sector. As a result, the number of institutions in the sector has declined significantly in the preceding five years (see **Figure 4.2**). Nevertheless, the remaining institutions have over-performed in terms of business expansion and earnings as evident from their asset growth which recorded a healthy growth of 11.2 percent during FY01-05. Macroeconomic stability and high economic growth in the low interest rate environment played a vital role in achieving this robust growth by NBFIs. Envisaging the continuation of good macroeconomic performance and thus the demand of financial services, new institutions are opening up and striving for their niche in the sector (see **Table 4.1**).

Figure 4.2: Number of Institutions



4.2.1 Ownership Structure of NBFIs

The ownership structure of the NBFI sector changed considerably during the period FY01-05 (see **Figure 4.3**). The share of public sector NBFIs declined to 22.3 percent at end FY05 compared with above 30.5 percent in FY01. This was mainly due to two reasons: (1) all the public sector DFIs, including NDFC, BEL, etc., were either liquidated or merged with the banking institutions; and (2) all the public sector closed-end mutual funds were taken over by the private asset management companies.

Table 4.1: New Entrants in the NBFIs Sector during FY05

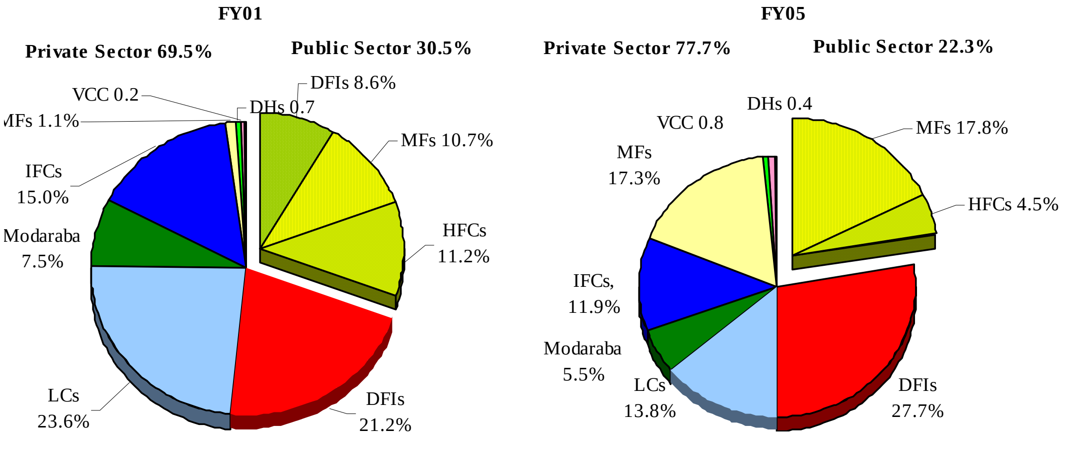
1	AlFalah GHP Investment Management Ltd
2	BMA Asset Management Company
3	Noman Abid Investment Management Ltd
4	Pak-Kuwait Financial Services Ltd
5	AKD Investment Management Ltd
6	KASB Funds Limited
7	Askari Asset Management Ltd
8	Total Hospitality Management (Pvt..) Ltd
9	Global Econo Trade (Pvt.) Ltd
10	Vanguard Modaraba Management Company (Pvt.) Ltd

Source: SECP

[3] Pakistan is the only country in South Asia (India, Nepal, Sri Lanka, and Bangladesh) where NBFIs are not regulated by the Central Bank.

[4] By allowing SBP to concentrate on supervising the operations of scheduled banks and conduct of monetary policy, while leaving the supervision of NBFIs on SECP.

Figure 4.3: Ownership Strucuture of NBFIs



Looking at the group-wise composition, up till FY03 DFIs had maintained the largest share in the asset base of NBFIs. However FY03 onwards mushroom growth in mutual funds and buoyant stock market enabled mutual funds to take over the leading position in NBFIs during CY04 (see **Table 4.2**). Comparing since FY01, share of all the remaining groups registered a decline in FY05 with venture capital companies as the only exception. It should be noted that the changes in the relative size of the NBFIs' sub-categories were not only determined by the pace of expansion in business activities, but it also reflects the consolidation process within and across sectors.

For instance, three DFIs, and four investment banks were merged into scheduled banks that shifted the asset base of these institutions from NBFIs to scheduled banks during FY01-FY05. Similarly a number of leasing companies, investment banks and modarabas opted for voluntary liquidation during the period under review. As a result, although the number of institutions in the NBFI sector has declined significantly during the period; the sector is now centered on institutions that are standing on strong capital footing and are better placed to compete for a sizable share given the increasing demand for financial products and services as a result of the growing economy.

Table 4.2: Assets of the NBFIs

	FY01	FY02	FY03	FY04	FY05
Assets (in billion Rs)	205.4	213.5	261.1	325.2	388.1
Growth rate (percent)	*-14.1*	*3.9*	*22.3*	*24.5*	*19.4*
Asset shares (in percent)					
DFIs	29.8	32.2	30.2	29.1	27.7
IFCs	15.0	12.6	14.5	13.1	11.9
Leasing	23.6	22.0	17.9	13.8	13.8
Modarabas	7.5	8.2	6.1	5.5	5.5
HFCs	11.5	10.5	8.3	6.0	4.8
VCCs	0.2	0.1	0.3	0.3	0.8
MFs	11.8	13.6	21.9	31.7	35.1
DHs	0.7	0.7	0.8	0.4	0.4

Source: SECP

4.2.2 Growth of NBFIs

NBFI assets have registered a robust growth of 11.2 percent on average during FY01-05 and reached at Rs 388.1 billion at end FY05. As mentioned earlier, improved macroeconomic stability and high growth have played an important role. Indeed, the empirical analysis based on the panel data of NBFIs' sub-groups supports this proposition. As reflected by **Table 4.3**, one percentage point increase in real GDP growth leads to 1.32 percentage points increase in the growth rate of NBFIs' assets while inflation and interest rates are negatively related with the NBFIs' assets growth. Thus, the low interest rates, higher economic growth and inflation for most of the period FY01-FY05 contributed significantly in the better performance of the NBFI sector.

As shown in **Figure 4.4**, the share of advances in total assets of NBFIs declined significantly during FY01-FY05. This was attributable to a sharp increase in the investments of NBFIs due to (1) prospects of earning capital gains through investing in government securities amid declining interest rates; and (2) increase in the stock market activities. During FY05, however, the share of advances in total assets has increased to 35 percent on the back of growth in the lending activities of leasing companies and DFIs.

From the funding side, though borrowings continued to constitute the bulk of NBFIs' liabilities during FY01-FY05; the quantum and share of deposits in total liabilities has been increasing constantly overtime (see **Figure 4.5**). This is an encouraging development, as it signifies the ability of NBFIs to mobilize savings and in turn fund their business activity.

4.3 Group-wise Performance of NBFIs

A more detailed discussion on the individual performance of each NBFI group is presented in the following sections.

4.3.1 Development Finance Institutions

Development Finance Institutions (DFIs) had experienced a significant deterioration in their financial health during the 1990s. This was mainly on the account of weak management performance that resulted in poor asset quality, low earnings and inadequate level of capital base in these institutions. Therefore in the late 1990s, DFIs went through a broad base restructuring and consolidation process. Accordingly, during FY01 Banker's Equity Limited (BEL) was liquidated, National Development Finance Corporation was merged with NBP, and Small Business Finance Corporation (SBFC) and Regional Development Finance Corporation (RDFC) were merged to form SME Bank Limited. At present there are only five institutions left in

Table 4.3: Estimates of NBFIs Asset Growth

Dependent variable: Growth rate of NBFIs' assets

	Coefficients	**t-stats**
Constant	18.57	14.90
Macroeconomic variables		
Growth in real GDP	1.32	12.51
Inflation	-1.66	-8.83
6-m T-bill rate	-2.36	-24.09
Control variables		
Leasing companies	5.23	6.50
Investment finance companies	17.72	18.73
Development finance institutions	2.98	3.61
Mutual funds	35.39	39.77
Housing finance companies	38.63	12.94
R-squared	0.15	
Total panel (unbalanced) obs		

Note: Reference group is the Modarabas

Figure 4.4: Advances of NBFIs

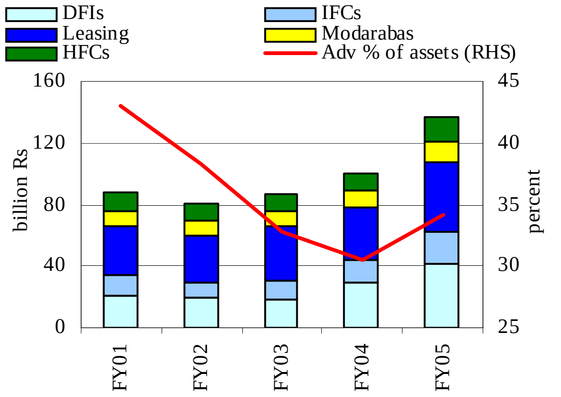
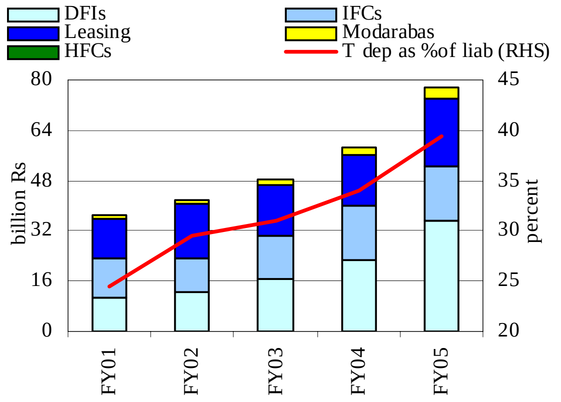


Figure 4.5: Deposits of NBFIs



this sector all of which, excluding PICIC, are foreign sponsored.

Asset Growth: With Macroeconomic Perspective & Statistical Support

Like other financial institutions, the DFIs also benefited from the uptrend in economic activities and especially the increase in development expenditures from FY03 onwards. Assets of DFIs registered an average annual growth rate (AAGR) of 5.5 percent during FY01-05. However, the assets of existing DFIs registered a relatively sharp growth of 20.6 percent during the same period (see **Figure 4.6**). The contribution to this tremendous growth came from both investments and advances of DFIs. In specific terms, the declining interest rate environment during FY01-FY03 provided significant earning opportunities in money market as well as in capital market; and DFIs capitalized well on both. Supplemented by the fact that during this phase the demand for long term investment was low, the share of investments in total assets of DFIs registered a sharp uptrend.

Figure 4.6: Growth in DFIs' Assets

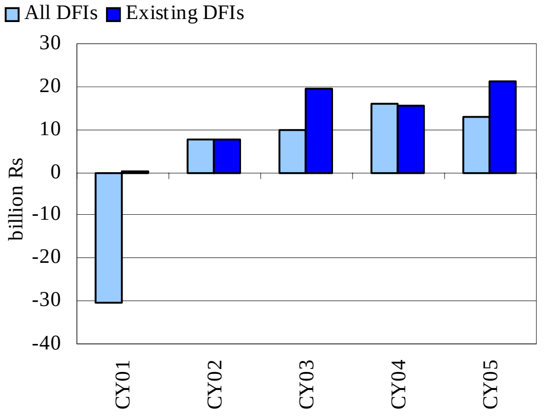


Table 4.4: Estimates of DFIs Asset Growth

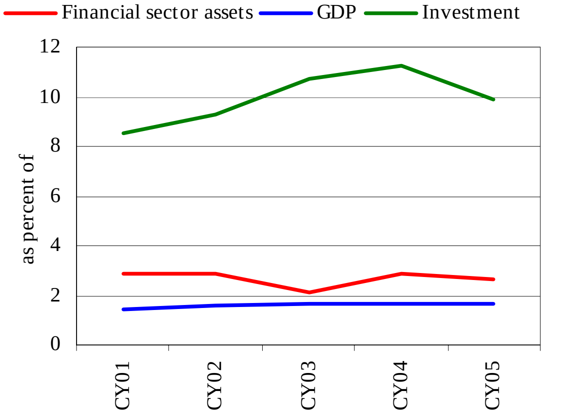
Dependent variable: asset growth of DFIs (1990-2005)

	Coefficient	t-Statistic
Constant	-26.89	-2.58
Growth in KSE share index	0.31	3.90
Development expenditures[1]	6.62	2.22
Growth of import of machinery	2.01	2.01
Inflation	0.30	2.32
Adjusted R-squared	0.30	
Total panel (unbalanced) obs	88	

[1] as percent of GDP

Later on, from FY04 onwards, when the investments in the economy picked up and the interest rates started rising gradually after bottoming out, DFIs resorted back to their core business, i.e. long term financing to on-going development and infrastructure projects, and import of machinery especially in the manufacturing sector. As a result, the share of long-term financing to total assets of DFIs saw a sharp increase. Empirical analysis indeed supports this proposition. Controlling for the other factor, one percentage point increase in import of machinery leads to 2.01 percentage points increase in the growth rate of DFIs' assets (see **Table 4.4**).

Figure 4.7: Assets of DFIs

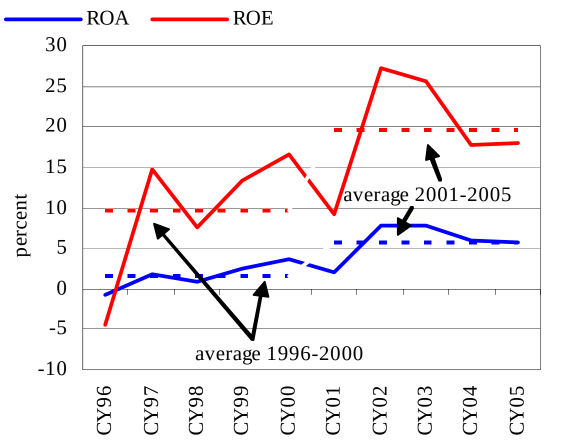


However, despite the robust growth in the size of the sector, the relative size of the DFI sector in terms of GDP and in financial sector assets remained almost stagnant (see **Figure 4.7**). This perhaps can be attributed to three factors: (1) the role of commercial banks in funding the domestic economic activities has increased mainly on the back of favorable rates and an expanded outreach; (2) the liquidation of BEL and the merger of NDFC with NBP has resulted in a decline of over Rs 30 billion in the asset base of DFIs; and (3) these institutions have a rather conservative approach in credit appraisal standards given their history of huge volume of infected loans especially during the 1990s.

Sectors' Profitability: Major Determinants

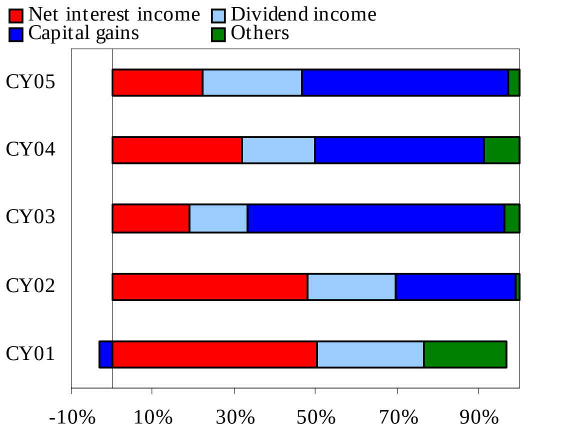
The profitability of DFIs has shown significant improvement during FY00 onwards. Both, return on assets and return on equity, exhibited significant improvement over the preceding years (see **Figure 4.8**). This was mainly due to declining interest rates through most of the period that resulted in huge capital gains to these institutions.

Figure 4.8: Profitability of DFIs



As a result, the share of non-interest income to total income has increased significantly during the period. As shown in **Figure 4.9**, non-interest income constitutes almost 78 percent of total earnings in FY05; up from 46.5 percent in FY01. From the commercial perspective, this development appears to be a triumph of the respective treasuries of the institutions; but from the social perspective, this development is not welcome as rising profit-oriented placements contradict with the DFIs' core business. From sustainability perspective also, the DFIs' increasing reliance on non-interest income is disquieting simply because such earnings are generically one-off and do not necessarily persist for longer period.

Figure 4.9: Sources of DFIs' Income



As shown in **Table 4.5**, the changes in the profitability of DFIs have depended significantly upon the trends in interest rates during the last 15 years. As per estimates, one percentage point decline in interest rates (proxied by inter-bank call rates) results in 96 basis points increase in DFIs' ROE and vice versa. In addition, the profitability of DFIs also depends significantly upon the sources of funds. In specific terms, there exists a positive relationship between deposits to liability ratio and the profitability of DFIs as financing from deposits mobilization/COIs is relatively cheaper than other source of funding. Further, the asset quality also determines the DFIs' profitability given the fact that a lower quantum of non-performing loans lessens the provisioning requirements which in turn improves the profitability of these institutions.

Table 4.5: Estimates of DFIs' ROE

Dependent variable is ROE

	Coefficient	t-stats
Constant	20.09	4.45
Deposits to liability ratio	0.08	1.78
Asset growth	0.08	3.29
interest rates	-0.96	-1.76
NPLs to asset ratio	-0.21	-2.38
R-squared	0.42	
Total panel (unbalanced) obs:	88	

Financial Soundness Indicators

The major improvement in the soundness indicators of DFIs during FY01-05 appears to be the asset quality as shown by a significant decline in the ratio of non-performing loans to total loans from 59.7 percent at end FY00 to only 15.4 percent at end FY05.

In fact, this is the key area that brought in all-around improvements in the financial health of these institutions. In specific terms, due to the improvement in asset quality, these institutions were able to contain the provisioning expenses as can be seen from a sharp decline in provisioning expense to total expense ratio from 33.5 percent during FY00 to only 7.6 percent at end FY05. Consequently, the improvement is visible in the profitability indicators and hence the capital adequacy indicators that have shown tremendous improvements during FY01-05.

The improvement in asset quality of DFIs is mainly the function of overall better performance of the economy, a low interest rate environment during the period and the changing composition of asset portfolio where banks focused more on investment activities compared with the lending activities during FY01-05. As shown in **Table 4.6**, one percentage point increase in interest rates leads to 1.43 percentage point increase in NPLs to advances ratio. Similarly, one percentage point increase in advances as percent of total earning assets leads to 21 basis points increase in the NPLs to asset ratio.

Table 4.6: Estimates of DFIs' NPLs

Dependent variable is NPLs to advances ratio

	Coefficient	t-Stats
Constant	17.32	1.63
Advances to earning assets	0.21	2.80
Earning assets to total assets	-0.15	-1.80
Inflation	-1.30	-2.02
Interest rates	1.43	1.84
R-squared	0.23	
Total panel (unbalanced) obs:	86	

In addition to the asset quality, another major factor contributing to the improvement in the overall soundness indicators during FY01-05 has been the liquidation and mergers of the financially weak institutions. In fact, the weak financial health of NDFC, BEL, SBFC and RDFC has eclipsed the relatively better performance of PICIC and foreign sponsored DFIs due to the larger share in the sector. Most importantly, the capital to liability ratio was declining continuously during the 1990s, almost reaching the negative level in FY00, indicating an *actual* erosion in the capital base. However, the same ratio for PICIC and foreign sponsored DFIs was 29.7 percent showing that these institutions were adequately capitalized even at that time (see **Table 4.7**).

Table 4.7: Financial Soundness Indicators of Existing DFIs

in percent

	FY01	FY02	FY03	FY04	FY05
Capital adequacy					
Capital to liability ratio	31.3	47.4	52.0	48.5	45.0
Growth rate of capital	5.0	58.5	35.7	16.8	18.6
Growth rate of assets	0.7	17.6	2.7	22.3	24.7
Asset quality					
NPLs to total loans	NA	49.4	46.5	31.9	15.4
Net NPLs to net loans	NA	26.9	16.0	10.0	7.9
Earning assets to total assets	82.3	84.9	86.7	89.3	86.8
Inv in gov. sec. to earning assets	2.3	23.5	20.0	16.0	4.4
Equity investment to total investment	37.2	40.5	33.2	27.5	8.3
Management					
Expense to total income	80.9	37.0	33.2	34.7	49.8
Intermediation cost	4.3	-1.0	3.0	2.2	2.7
Admin exp to total exp	11.0	42.7	31.2	45.2	24.2
Earning and Profitability					
Growth rate of profits	-3.1	256.9	32.5	-11.8	16.2
Return on average assets	2.1	7.7	7.7	5.9	5.7
Return on average equity	9.1	27.3	25.6	17.8	17.9
Interest rate spread	1.4	1.7	1.0	1.8	0.4
Net interest margin	3.5	3.9	2.2	2.6	1.9

Source: BSD, SBP.

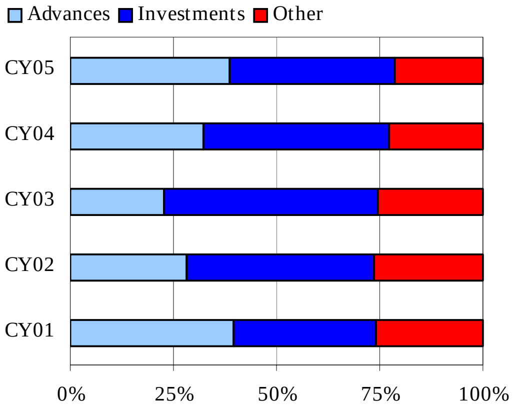
Performance during FY05: More Focus on Lending Activities

Though the capital base of these institutions registered a robust growth of 18.6 percent, the capital adequacy ratio of the DFIs has declined slightly during FY05. Apparently the decline in CAR seems reflective of the weakening risk absorptive capacity of these institutions; however, it should be noted that the ratio is still significantly higher than the required level of 9 percent. Further, it is important to see that this decline in CAR is a natural outcome of the changing asset mix of these institutions which is in conformity with the DFIs' core objective (see **Box 4.1**). In specific terms, the advances to earning assets ratio has increased during FY05 given the growing financing needs of the economy which has resulted in an increase in risk weighted assets of these institutions.

Box 4.1: Asset Composition of DFIs: Theory and Practice

Theoretically, the role of DFIs is principally to bridge the gap between the commercial investments and the development projects. In specific terms, attributable to the low risk-high return objective of the commercial banking industry, certain 'strategically' important niches of the economy remain financially underserved. This is mainly because these institutions take a myopic view and usually do not consider the social benefits of the projects. In such circumstances, the role of DFIs becomes increasingly important as these complement the commercial banks in providing finances to the sectors that are considered crucial for long term economic development.

Figure B.4.1.1: Asset Portfolio of DFIs in Pakistan



Pakistan's DFIs, however, have not realized this important aspect of their very existence as exhibited from the asset composition of these institutions. Specifically, the share of loans and advances in total assets is confined to 32.3 percent on average during FY01-05 whereas the share of investments is 43.4 percent during the same period (see **Figure B.4.1.1**). It should be noted here that all around the world; most of the DFIs have continued to maintain long term/project finance as the core of their business despite having widened operational activities.

For instance, in India, the share of loans and advances to total assets of DFIs is around 70 percent while in Malaysia this ratio is 47 percent compared with 38 percent at end FY05. In addition, it should be noted that many DFIs around the world have specified various sectors where these would provide specialized financing, for instance (1) the Development Bank of Japan focuses mainly on providing long term finances to qualified infrastructure projects; (2) the Business Development Bank of Canada focuses mainly on developing the SME sector; (3) In Malaysia, there are two large DFIs that specialize in supporting the development of SME sector (of these, one provides financial services and advisory/consultancy services while the other provides credit guarantees to increase SME's credit accessibility).

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Source:
(1) Bank Negara Malaysia, Annual Report 2005.
(2) Reserve Bank of India, Report on Trend and Progress of Banking in India, 2004-05.

The asset quality, as mentioned earlier, continued to improve mainly on the back of better credit appraisal practices by DFIs, stable earnings of the corporate sector, and stable macroeconomic environment. Further, the decline in share of stock market investments in total earning ratio also exhibited an improvement in the risk profile of DFIs' assets.

The profitability of DFIs has also improved despite the decline in net interest income during FY05. In fact, envisaging the rise in interest rates during the year and to avoid the reliance on costly borrowings, DFIs made strenuous efforts to mobilize deposits/COIs by offering competitive returns. Therefore, though the deposits to liability ratio had increased, the interest expenses also increased significantly.

As a result, net interest income declined during FY05 to Rs 1.3 billion compared with Rs 2.1 billion during FY04. On the other hand, the trend of robust growth in non-interest income continued into FY05 as well. However, both the profitability ratio, ROA and ROE declined slightly during the year as part of the rise in non-interest income during FY05 was offset by a decline in net interest income.

4.3.2 Investment Finance Companies-IFCs[5]

The performance of IFCs has improved considerably during the FY01-05 period, as reflected by a rapid business expansion; a diversification of products and services; and an improvement in financial health of institutions in this group. Despite the fact that the present legal infrastructure allows these institutions to undertake a vast variety of financial activities including those that are the part and parcel of commercial banking; still the institutions in the sector are resorting towards the principal function of investment finance (see **Box 4.2**). IFCs have capitalized well on the buoyant capital market in the recent years and have focused on enhancing prospects of non-fund based earnings. In future, this would not only help these institutions in further diversifying their services; but would also alleviate somewhat the level of competition in the lease finance sector from leasing companies, modarabas and commercial banks. Therefore, there is a considerable potential for the IFCs to increase their business by focusing on becoming multi-business entities.

Box 4.2: The Separation of Commercial and Investment Banking

Worldwide, the definition of investment banks/investment finance companies in terms of their undertaken activities varied significantly from time to time. Strictly speaking, IFCs assist companies in raising funds from capital markets (both debt and equity). In addition, IFCs also provide strategic advisory services for mergers, acquisitions and other financial transactions. In USA during 1933, the activities of investment banks and commercial banks were separated through an Act that prohibited banks from taking up underwriting activities.

The New York stock exchange crashed during 1929 and was followed by the Great Depression of 1930s. At that time the overzealous commercial bank involvement in stock market investment was considered to be the main causative factor for the financial crisis. Commercial banks were not only investing their assets but were also buying assets to resale to public. In addition, banks were also involved in extending loans to the companies in which the banks were investing. Therefore, when the stock market plummeted, over 11000 banks failed or had to merge, reducing the number from 25000 to 14000.

As a response, the Glass Steagall Act was enacted during 1933 to protect bank depositors from any repetition of the wide spread bank closings that occurred during the Depression. At that time, "Congress was persuaded that speculative activities, partially attributable to the connection between commercial banking and investment banking had contributed to the rash of bank failures". As per the act, commercial banks were prohibited to collaborate with full service brokerage or participating in investment banking activities.

However, at present the line between investment and commercial banking has blurred; not only commercial banks are taking on investment banking activities but also involved in deposit taking and retail lending activities.

Source: George J. Benston; The separation of commercial and investment banking The Glass-Steagall Act Revisited and Reconsidered, Macmillan Press 1990.

The Restructuring of IFCs in Pakistan during FY01-05

In Pakistan, IFCs, since their inception in the 1980s, have been undertaking a wide range of business activities but their success story has been very limited, given especially the lack of professional expertise and business acumen. In particular, the slowdown in overall economic activities and weak performance of capital markets during the late 1990s and the freezing of FCAs during 1998 has caused a severe deterioration in the financial health of most of the investment banks. To keep up the financial soundness of these institutions, and to minimize the excess fragmentation in the overall financial sector, a rigorous consolidation process was started from FY00 onwards through mergers/acquisitions/liquidation.

[5] These institutions were formerly known as Investment Banks.

As a result, the number of investment banks declined from 16 at end FY01 to only 9 at end FY05. However, since most of the investment banks were either merged with or acquired by commercial banks, part of the asset base of the investment banks was shifted to the commercial bank industry. Nevertheless, total assets of these institutions has increased to Rs 46.0 billion at end June FY05 compared with Rs 40.9 billion at end June 2000 (see **Figure 4.10** and **4.11**); showing an AAGR of 4.7 percent. Indeed the presently existing institutions have seen a much rapid growth during FY01-FY05 (i.e. 37.0 percent AAGR) that resulted into this double-digit growth of IFCs, despite the decline in the number of institutions. Encouragingly, 9 institutions that have remained in the sector following the consolidation process have better earnings potential and have relatively been well-capitalized compared with the institutions that opted for voluntary liquidation or mergers.

Figure 4.10: Assets of IFCs

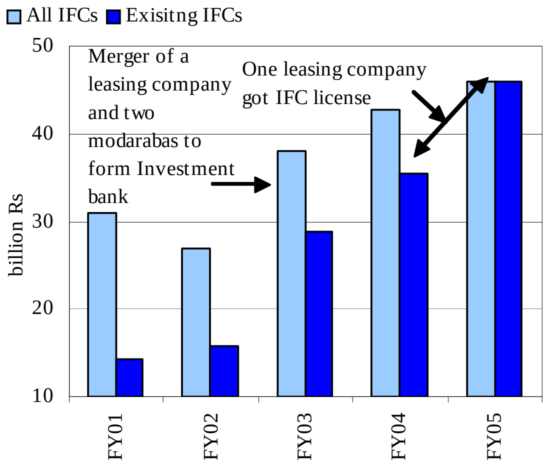
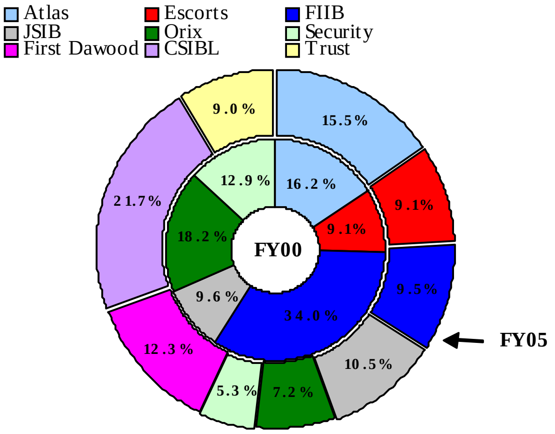


Figure 4.11: Structure of IFCs



The Activities of IFCs: A Gradual Shift from Quasi Commercial Banking

It may be recalled that as per the Rules of Business for NBFCs (Establishment and Regulation) FY03 and under the regulatory purview of the SECP, investment banks are classified as investment finance companies with a more widened scope of business. As a result, the existing companies are undertaking, in addition to conventional lending activities, a number of corporate finance activities, including securities underwriting, private placements, and financial advisory services for acquisitions, restructuring, etc, in line with the international practices (see **Box 4.3**). In addition, IFCs have also sped up brokerage activities either through obtaining brokerage licenses or through acquiring independent brokerage houses. The asset management company will become operational in FY05-06 and will focus upon introducing a range of mutual funds. Moreover, another IFC has also launched its housing finance services during FY05.

In addition to product diversification, the existing IFCs have also focused on geographical diversification in offering their products and services. For instance, the Escorts Investment Bank has opened its Investment Services (brokerage) Center (ISC) in Faisalabad recently and is planning to open up such ISCs in Sialkot and Peshawar soon. Similarly, the Atlas Investment Bank is setting up a branch in Faisalabad for doing leasing and equity brokerage business and its Islamabad Branch will soon be commencing the brokerage business.

Financial Soundness Indicators-FSIs

The overall better performance of the economy during FY01-05 shaped the structure of the IFCs' financial health. In specific terms, increased economic activities provided a large appetite for project and lease finance that helped IFCs in expanding their business. In addition, an upbeat performance by the stocks has also improved earnings prospects for these institutions as the growth in investments contributed most in the growth of IFCs' asset base during the period.

The major development in the FSIs of IFCs during FY01-05 has been the improvement in management and profitability indicators (see **Table 4.8**). In particular, despite the tremendous expansion of operational activities of IFCs in the preceding five years, the intermediation cost has remained well contained during the period. Expense to income ratio, on the other hand, improved significantly mainly due to better earnings during the period on the back of higher investment incomes.

As a result, the ROA and ROE remained fairly stable throughout the period and increased significantly during FY03 and FY04 due to rising interest rate spread. It is pertinent to mention here, that unlike commercial banks where the interest rate spreads squeeze when interest rates fall and vice versa; IFCs enjoy widening spreads at the time when interest rates fall and vice versa. This is because, a major source of funding for IFCs is the bank borrowings, the cost of which tends to fall much sharply compared with the cost of deposits that the IFCs mobilize. This is evident from the fact that during these two years, the share of borrowings in total liabilities increased to 57 percent on average, compared with the average of 44 percent in the preceding two years. Perhaps this is the plausible reason why the growth rate of IFCs' assets is positively related with the interest rates in the economy. During FY05, however, the trend in the interest rate movement reversed and therefore IFCs registered a squeeze in interest rate spread and as a result their profitability declined slightly.

Box 4.3: A Brief Review of Global Investment Banking

The revenue from global investment banking has reached US$ 52 billion during 2005 up by 14 percent during 2004. This was attributed mainly to the recovery in global economy in general and capital markets in particular. The primary source of investment banking earnings has been the mergers and acquisitions advisory activity that comprised around 46 percent of total fee revenue during 2005. This was mainly on the back of 38 percent increase in M&A activities that reached US$ 2.7 trillion during 2005. While the equity underwriting generated US$ 18.1 billion or 34 percent of investment banks' fee revenue during 2005; fixed income underwriting accounted for 20 percent of revenue. In terms of the industrial distribution, unlike the 1990s when there was a gradual shift from financial services and industrial sectors to the media and telecommunication sectors; during 2005, the major contributor to investment banking revenue was the financial services sector that accounted for 26 percent of their revenue followed by technology related companies and energy sector with 17 percent and 16 percent revenues respectively.

Source: International Financial Services London, Financial sector reports City Business Series 'Banking' February 2006.

Table 4.8: Performance of Existing Investment Banks

Percent

Ratios	**FY01**	**FY02**	**FY03**	**FY04**	**FY05**
Capital adequacy					
Capital to liabilities	19.1	20.4	19.7	23.2	21.1
Growth of capital	60.3	16.4	77.2	40.6	20.6
Growth of assets	77.4	9.9	82.9	22.8	30.1
Asset quality					
Equity to asset	16.0	17.0	16.4	18.8	17.4
EA to total assets	83.5	81.7	89.3	87.1	81.9
Lease finance to EA*	21.2	19.8	27.9	26.5	33.2
Investments to EA*	50.4	53.9	55.5	56.3	45.3
Management					
Expense to income	89.5	87.8	69.4	53.4	61.9
Oper. exp to total exp	14.1	16.1	23.5	34.3	30.6
Intermediation cost with provisioning	3.1	3.3	2.9	3.3	3.3
Intermediation cost with out provisioning	3.0	3.9	3.2	3.9	4.5
Earning and profitability					
ROA	1.4	1.3	3.1	4.4	3.3
ROE	8.1	7.7	18.9	25.0	18.5
Interest rate spread	4.3	4.2	3.5	5.6	4.7
Net interest margin	5.2	5.1	5.3	7.1	6.0

*: EA represents earning assets

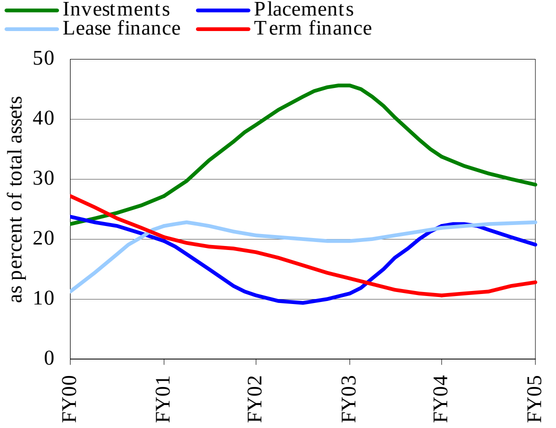
Source: SBP (these indicators are computed by using the annual audited account IFCs).

Performance During FY05

During FY05, assets of the IFCs registered a growth of 30.1 percent compared with 17.3 percent in the preceding year with all the institutions posting strong positive growth[6]. Given the fact that the business specialties vary across institutions, the increase in asset base is caused by increase in stock market activities, lease finance activities and the term financing. Besides buoyant stock market, the increase in lease finance and term finance activities was driven primarily by a continued growth in economic activities, in both commodity producing and services sectors, during FY05 as depicted in the highest GDP growth in the last two decades.

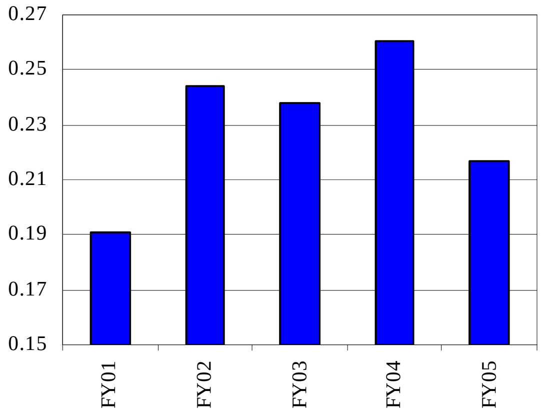
The asset portfolio of these institutions exhibits the rising share of advances compared with investments (see **Figure 4.12**).[7] Most of the increase in advances came through IFCs' increased investments in lease finance, especially in the plant/machinery and motor vehicles. As a result, the contribution of revenues from financing activities (both project and term finance) in total revenues of IFCs increased during FY05. The investments, on the other hand, registered a smaller increase during FY05 compared with FY04.

4.12: Composition of IFCs Asset



The profitability of IFCs deteriorated slightly during FY05 mainly attributed to the squeezing interest rate margins. However, it is encouraging to see that the increased diversification in IFCs' business in recent years has brought down the concentration in their revenues as evident from Herfindahl concentration index of IFCs' incomes that has declined during FY05 and is the lowest in the preceding four years (see **Figure 4.13**). In specific terms, almost all the IFCs have increased the brokerage activities which coupled with a buoyant capital market during the period has led to a sharp growth of IFCs' income from brokerage activities. In addition, IFCs incomes from lease finance and investing in subsidiaries has also registered a robust growth. As a result, the share of income from project/term finance and investments declined slightly during FY05.

Figure 4.13: Herfindahl Index of IFCs Income



4.3.3 Leasing Industry

Overview

Leasing companies were among those few financial institutions that recorded a satisfactory performance throughout the 1990s. While the economic downturn towards the end of the 1990s did

[6] This was mainly because, one leasing company acquired the license of investment financing during FY05. Adjusting for it, the assets of IFCs registered the growth of 18.4 percent.

[7] In fact, the advances of the IFCs increased by Rs 3.0 billion in FY05 compared with Rs 0.9 billion in the preceding year.

decelerate the growth in leasing business, financial indicators continued to depict a fairly stable position[8] mainly due to their preemptive approach. Specifically, instead of adhering to the conventional business of corporate lease, leasing companies started focusing on the commercial vehicle lease. The surge in macroeconomic economic activity, from FY03 onwards, helped this sector to continue with double-digits assets growth (on average).

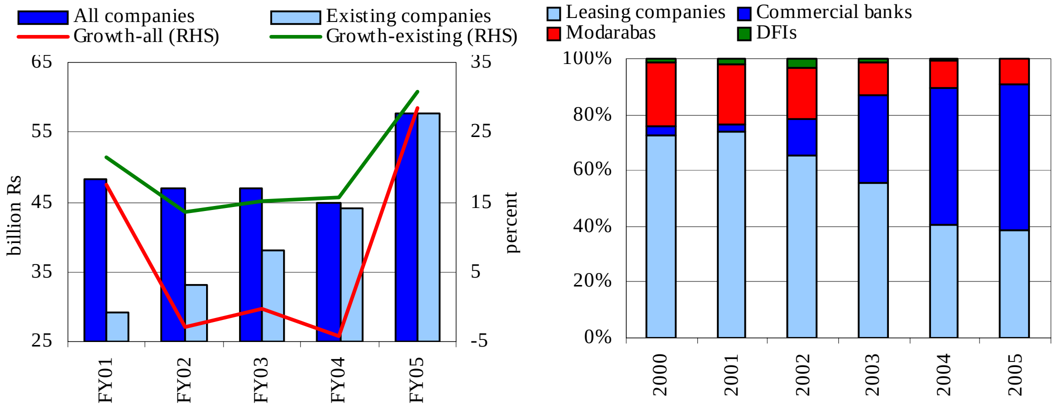
Having said this, a number of *small* companies failed to maintain their financial viability. The continuity of reform process, in particular the increase in minimum capital requirement, and banks' entry into the leasing business from FY03 onwards, made the situation even more challenging for such companies. As a result, a number of weak companies found their way out by opting either for mergers with strong institutions or voluntary liquidations, consequently, the number of leasing companies shrank from 33 in FY00 to only 20 by FY05. The present structure of the leasing sector is still highly skewed, as the top five companies' share is above 70 percent of the total leasing sector assets base.[9]

Business Expansion and Product Diversification

The demand for lease finance saw a record growth during the last couple of years. Despite, commercial banks having taken-up a substantial share in the overall lease business, particularly from FY03 onwards; assets of leasing companies registered 5.9 percent AAGR during FY01-05 (see **Figure 4.14**). In fact, the growth of leasing companies is even more impressive as this was achieved despite the fall in number of institutions.[10] Considering only the current operating companies, the assets of the leasing industry surged at a robust 19.5 percent AAGR during FY01-05.

Figure 4.14: Assets of Leasing Companies

Institutional Share in Leasing Business



While high economic growth has raised the demand for leasing business, increasing inter-industry competition (mainly with commercial banks) forced leasing companies to adopt better marketing tactics and diversify their clientele. Moreover, leasing companies have made strenuous efforts to improve the quality of customer services through minimizing the time lag involved in formal documentation and transaction cycle, and by acquiring specialized expertise to provide financing guidelines to their customers.

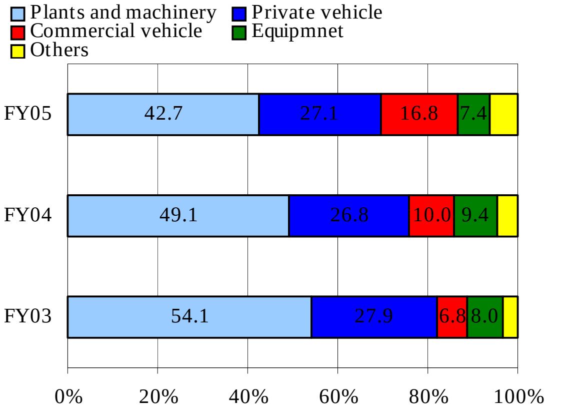
[8] For details, see Chapter 4 in SBP Report on Pakistan: Financial Sector Assessment 1990-2000.

[9] Various indicators including Lorenz Curve, Gini coefficient, and M-ratios confirmed that business concentration has increased in leasing sector during FY01-FY05.

[10] As some of the leasing companies merged with/acquired by banks and other NBFIs, this shifts a part of the assets from the leasing sector to these institutions.

In addition, leasing companies have diversified their product range as well. In specific terms, as commercial banks were mainly focusing on providing lease finance for plants and machinery and private sector vehicles; most of the leasing companies brought a slight change in the target market and started providing financing for commercial vehicles (see **Figure 4.15**).[11] In addition, leasing companies have also started focusing on operating lease by providing machinery for a shorter tenor of 1 week to 2 months.

Figure 4.15: Asset-wise Break up of Lease Finance



Going forward, it is expected that under the NBFC umbrella the business horizon of leasing companies would widen further. In this regard, one leasing company has already secured the license of investment finance services; two companies have received licenses for housing finance services; and one company has secured license of discounting services from SECP up till the end of FY05.

Financial Indicators During FY01-05

During FY01-05, the capital of existing leasing companies registered an AAGR of 11.9 percent. Both increase in paid-up capital and rise in reserves shared this capital growth. While the latter represents increased profitability of leasing companies during FY01-05; former is the outcome of leasing companies' efforts to comply with the minimum capital requirements (see **Table 4.10**). In specific terms, the minimum paid-up capital has been set at Rs 200 million and leasing companies were required to achieve this target by end of FY99; later on, the timeline was extended to FY00. However, by end June-FY00 only four companies were able to meet the increased capital requirement. During the period FY01-05, eight more companies took their paid-up capital to the set limit.[12] Nevertheless, the capital growth was well below the assets growth. As a result capital to asset ratio, an indicator of capital adequacy, declined by 2.6 percentage points during FY01-05 (see **Table 4.10**).

Table 4.10: Financial Indicators of Existing Leasing Companies.

	FY01	FY02	FY03	FY04	FY05
Capital adequacy					
Capital to liability	18.3	17.3	17.7	17.9	15.3
GR capital	4.5	10.2	17.4	16.0	11.7
GR of assets	23.8	15.6	15.3	14.8	27.8
Asset quality					
GR of lease finance	27.9	11.2	49.3	18.4	28.0
EA to total assets	64.3	63.1	85.5	88.8	88.4
Lease finance/earning asset	92.0	90.2	86.2	85.6	86.1
Investments / earning asset	6.5	7.2	10.4	12.4	10.7
Management					
Exp to income (incl prov)	94.6	95.1	83.5	77.9	80.6
Financial exp to income	66.4	65.9	54.3	42.6	43.7
Operating exp to income	15.3	16.4	21.4	26.0	27.3
Earnings and profitability					
ROA	0.5	0.6	1.9	2.2	1.9
ROE	2.9	3.7	12.8	14.6	13.7
Interest rate spread	4.1	9.1	3.7	4.0	2.9
NIM	6.3	6.6	6.0	5.6	4.5
Liquidity					
Liquid assets to total assets	16.5	18.2	3.6	1.5	1.3
Current ratio	1.4	1.3	1.5	1.3	1.1

[11] This could be supplemented by the fact that during the preceding three years, the services /activities of commercial vehicles, including intra-city bus services in Karachi, buses and oil tankers, have increased manifold; this shift in the business focus has resulted in a sharp increase in the share of commercial vehicle lease in total lease finance of the sector

[12] By the end-June FY05, 8 companies were falling short of the required paid-up capital.

In the previous five years, assets composition of the leasing industry saw a positive change. The share of earning assets (in total assets) has jumped from 64.3 percent in FY01 to 88.4 percent in FY05. Within the earning asset, a slight shift in share has been observed from lease finance to investment, as these companies have capitalized on the recent boom in stock market activities. However, the former continued to dominate the earning assets (see **Table 4.10**).

The rising share of earning assets and declining financial cost ratio up to FY04 resulted in a continuous improvement in profitability. ROA surged from 0.5 percent in FY00 to 2.2 percent in FY04. Although profitability indicators remained strong, they depicted deterioration in FY05. The financial decisions made by leasing companies in the earlier period squeezed the profit margins in the rising interest rates scenario in FY05.[13] Specifically, during FY03-04 leasing companies booked most of the leasing contracts at fixed interest rates; in contrast borrowings were largely obtained on floating rates.[14] Thus, as interest rates started moving up, net interest margins and interest rate spread depicted sharp decline (see **Box 4.4**). Consequently interest expenses of leasing companies grew at a faster pace than interest income, which weakened the profitability of the sector.[15] Nevertheless, ROA and ROE of the leasing sector in FY05 at 1.9 percent and 13.7 percent, respectively, show a considerably good performance.[16]

Box 4.4: Determinants of Leasing Companies Profits
In order to analyze the main determinants of leasing companies after tax profits, a simple econometric exercise, using unbalanced panel data of all leasing companies operating during FY00-05, has been performed and the results are summarized in **Table B4.1**.

As per estimates, the increase in benchmark interest rates puts downward pressures on net profit of leasing industry. In specific terms, an increase in 6-month T-bill rates by 100 basis points caused profit to squeeze by Rs 1.5 million. As expected, financial charges and provisioning expenses negatively affect profitability. It is also evident from the results that business expansion, as depicted by coefficient of assets, leads to an increase in net profit. An increase in assets worth of Rs 100 million causes net profit to increase by Rs 2 million.

Table B4.1: Pooled Least Square Estimates of Profits

Dependent Variable: Profits

Variable	Coefficient	t-Statistic
Constant	13.80	2.19
T-bill rate	-1.46	-1.70
Assets	0.02	5.29
Provisioning	-1.02	-7.11
Income from lease operations	0.08	1.92
Other income	0.29	2.96
Financial and bank charges	-0.11	-3.70
R-squared	0.83	
Total panel (unbalanced) obs	125.00	

While, on aggregate, the financial health of the leasing companies has remained fairly stable, there still exists a significant disparity between large and small companies. Specifically, the companies with the smaller share in assets of the leasing sector are facing critical setbacks with managerial efficiencies and profitability (see **Box 4.5**)[17]. Therefore, the regulatory authorities are envisaging further consolidation in the sector, not only to ensure financial soundness in the entire industry but also to bring down the level of concentration.

[13] Empirical investigation also suggests a negative relationship between interest rates and net profits of leasing sector (see **Box 4.4**).

[14] Primarily linked with KIBOR rates.

[15] It may be important to note that leasing companies are now writing new lease contracts on floating rates.

[16] A continuously rising operating expense to income ratio during FY01-FY05 could be a source of concern. However this was mainly because of continuous expansion in the leasing business, which is reflected from a sharp compound growth rate of 26.0 percent during FY01-FY05.

[17] These leasing companies are categorized on the basis of their assets shares in the leasing sector. The least 5 leasing companies have only 44.9 share of earning assets in the total assets portfolio while out of total earning assets, these leasing companies have only 50 percent share in lease finance and 46.9 percent investments.

Box 4.5: Comparison Between the Top 5 and the Smallest 5 Leasing Companies

To assess the level of fragmentation in the leasing sector, it is imperative to compare the financial health of large and small companies in the sector. The financial indicators of the smallest 5 and top 5 leasing companies are presented in the **Table B.4.5.1**.

A major distinction between the large and small companies in the sector is the level of operating expenses. Specifically, the small leasing companies are operating with over 180 percent expense to income ratio. Operating expenses, in particular, comprise of over 75 percent of the income depicting the managerial inefficiencies in these companies. Similarly, the intermediation cost of the small companies is quite large compared with the large companies. As a result, the smaller companies, operating with lower spread, have accumulated net losses in the preceding four years. These losses have eaten up the equity of these companies as depicted by a negative growth of capital during the same period.

In addition, the small leasing companies could not keep intact the marketability of their products and services following the increased competition from other financial institutions in the preceding five years. This is reflected in a sharp decline in the lease finance to asset ratio from 2001 to 2005. Rather, these companies focused more on investment activities in the stock market during the period. In contrast, the top leasing companies have been able to maintain 88.4 percent share of their assets in lease finance.

In sum, it can be argued that the leasing sector is still confronted with excess fragmentation where small companies are operating under severe financial distress. In fact, these small companies do not even comply with the minimum paid-up capital requirements set for leasing companies. Therefore, it is expected that either these companies would be liquidated or would merge with others to form relatively stronger institutions.

Table B.4.5.1: Comparison between the Top 5 and the Smallest 5 Leasing Companies

Financial Indicators	**Top 5 companies**		**Smallest 5 companies**		**Overall**	
	2001	**2005**	**2001**	**2005**	**2001**	**2005**
Capital adequacy						
Capital/liability ratio	13.1	12.0	96.1	58.3	22.0	15.9
GR of capital	7.9	9.9	3.2	-24.3	6.6	8.1
GR of total assets(TA)	26.0	26.6	13.7	-14.3	21.8	28.6
Asset quality						
Earning assets/TA	63.1	90.7	70.1	44.9	69.2	87.5
Lease finance/earning assets(EA)	88.2	88.4	86.8	50.9	89.7	86.7
Investments to EA	11.1	8.4	4.8	46.9	8.5	10.3
Management						
Expense/income ratio**	88.7	81.7	241.2	183.1	94.5	78.2
Financial expenses/income	68.4	46.1	41.9	11.5	65.3	43.0
Opr. expenses/income	11.2	27.1	67.6	75.7	15.5	26.0
Intermediation cost **	5.2	4.6	68.1	45.4	7.3	5.0
Earnings and Profitability						
Return on average assets	1.5	1.8	-16.3	-7.7	0.5	2.2
Return on average equity	12.3	16.0	-31.8	-19.6	2.4	15.1
Interest rate spread	4.1	3.3	2.6	2.9	2.8	3.1
Net interest margin	6.2	4.6	5.9	3.2	6.0	4.7
Liquidity and sensitivity						
Liquid assets to total assets	17.2	0.4	9.0	17.7	13.5	1.6
Current ratio	1.3	1.1	1.4	1.5	1.3	1.1

* Excluding Provisioning, ** Including Provisioning

Suggestions and Future Prospects

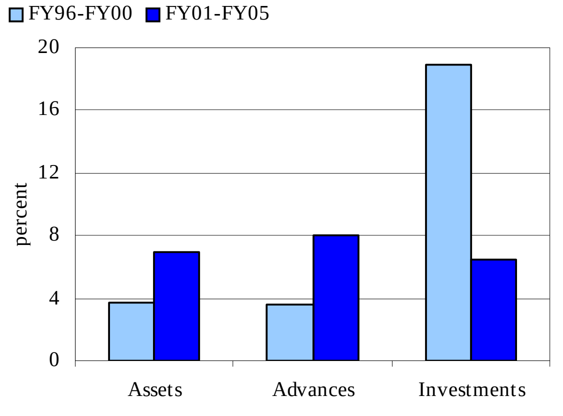
Going forward, leasing companies are strongly required to place special emphasis on broadening their branch network. In particular, companies can open new branches in small industrial and agriculture towns, for which, they can get helping hands from commercial banks. Albeit putting major emphasis on expanding lease business as its primary concern, the leasing sector needs to open new avenues of leasing besides auto, machineries and equipments. Diversification through searching new business avenues will lead leasing companies to lower the risk of potential losses. In this regard, a few large leasing companies have experimented with leasing in agriculture products. They have also achieved a contribution in profit through expanding operating lease. Similar to searching for new business, leasing companies should also search for new deposits hands which can help them to rely less on financial borrowings which translate into high financial charges.

4.3.4 Modarabas

Modarabas have registered a mushroom growth during the late 1980s and early 1990s primarily because of Shariah compliant and tax free status (subject to 90 percent dividend distribution). Further, the impetus to modarabas came in the early 1990s following the booming stock exchanges and growth in financial market in response to the liberalization of economy and the start of financial sector reforms. However, this growth momentum was disturbed in the late 1990s following the withdrawal of tax free status and a slowdown in economic activities in the country. This coupled with the inability of modaraba managements to tailor diversified products for their business resulted in the loss of confidence of both investors and certificate holders in modarabas and the financial health of modarabas.

Therefore, in order to promote the Shariah compliant mode of financing in the economy, the government and the financial regulators started making efforts to improve the financial health of modarabas. On the one hand, the government restored the tax free status of non-trading modarabas during FY99; on the other hand, SECP issued detailed Prudential Regulations for modarabas in FY00. To reduce excess fragmentation in the sector, minimum paid up capital for modarabas was set for the first time that ultimately resulted in mergers, acquisitions and takeover of modarabas within and across other sectors during FY01-05. As a result, the number of modarabas has significantly reduced from 45 in FY00 to just 30 in FY05. Moreover, to increase access of modarabas to low cost resource mobilization, the SECP has granted them permission to issue musharaka based term finance certificates (TFCs) during FY03. Finally, the Religious Board for Modarabas has been reconstituted during FY05, after a lapse of four years. It is expected that the reconstitution of the Board would help in introducing more innovative financing products and new Shariah compliant avenues for resource mobilization for modarabas.

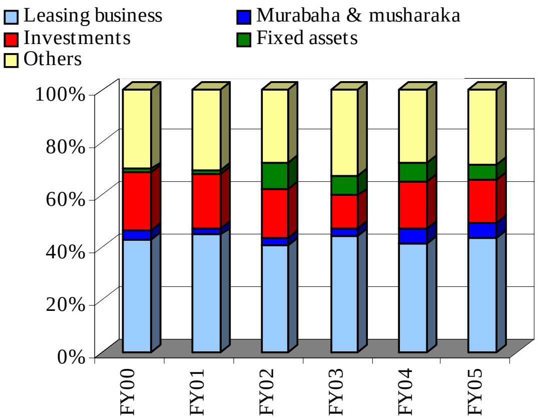
Figure 4.16: Growth of Modarabas



The assets of modarabas have registered a 7.4 percent AAGR during FY01-05; compared with 4.3 percent growth during FY96-00 (see **Figure 4.16**). Excluding a number of modarabas which have ceased to operate during FY00 and FY05, the assets of existing modarabas registered an AAGR of 12.9 percent during FY01-05. This relatively higher growth was driven mainly by an overall increase in lease finance demand in the economy. The composition of assets during the preceding five years has almost remained unchanged as the lease finance continued to hold the largest share at 47 percent in total assets (see **Figure 4.17**). However, due to the stiff competition in the leasing business especially with the commercial banks, modarabas have started focusing on diversifying their business.

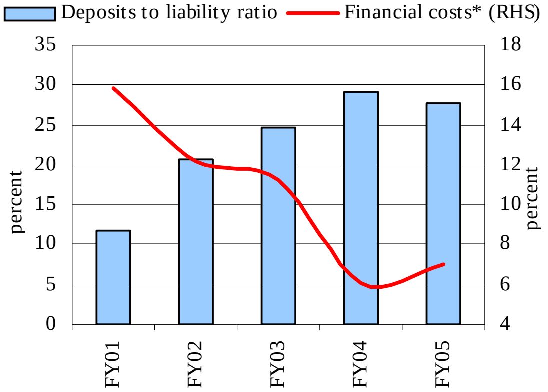
This is evident from the fact that a number of modarabas, including First Al-Noor Modaraba, First Prudential Modaraba and First Fidelity Modaraba have approached the Religious Board for amendment in their prospects for undertaking housing finance. Similarly, First Paramount Modaraba has started providing funds for the establishment of CNG filling stations and is also establishing its own stations. In addition, First Paramount Modaraba is also in the process of starting a Radio Cab project. Moreover, Modaraba Al-Mali has entered the business of mobile tower site sharing whereby the modaraba would build tower sites either on rented or owned premises, and will sub-lease it out to wireless operators. Finally, efforts are being made to ensure the modarabas' presence in agriculture, SME finance, and Takaful (Islamic concept of insurance).

Figure 4.17: Asset Composition of Modarabas



Similarly, some diversification has also been observed on the liability side as the share of deposits and COIs mobilized by modarabas in total liabilities has increased during FY01-05 (see **Figure 4.18**). As a result, the reliance of modarabas on borrowings from financial institutions, a relatively costly source of funding, has declined substantially. This has resulted in the declining share of financial expenses in total expenses of modarabas during the same period.

Figure 4.18: Financial Expenses of Modarabas



*Financial expenses divided by risk sensitive liabilities

Performance during FY01-05

The capital of existing modarabas registered a robust AAGR of 10.0 percent during FY01-05. This was partly on the back of launching of a manufacturing modaraba during FY02 with a paid-up capital of Rs 0.9 billion[18].

The assets of existing modarabas registered a robust growth of 12.9 percent during FY01-05. The highest annual growth was registered during FY05 at 21.2 percent. The composition of assets during the preceding five years has almost remained unchanged; as the share of lease finance to earning assets declined only slightly. Share of investments to earning assets also remained unchanged except during FY03 and FY04. Specifically, the FY03 decline in investments came only from one modaraba that had encashed certificates of investment worth US $ 5 million; while the sharp increase during

[18] This manufacturing modaraba is a specific purpose modaraba that was formed with an objective to construct, operate, manage and own a polyester staple fibre spinning and processing plant at the premises of ICI Pakistan Limited.

FY04 was brought about by modarabas' increased investments in equity following the boom in stock market.

The profitability of modarabas, like other NBFIs, showed improvement in the preceding five years as a result of low interest rate environment through most of the period (see **Table 4.11**). This was attributed to both a higher income stream mainly from lease finance business and capital gains on investments; and a decline in financial expenses that partly offset the increasing depreciation costs of modarabas. While former was the outcome of a higher demand for lease finance products; latter was attributed mainly to the increase in deposits to liability ratio through most of the period (see **Figure 4.18**).

This phenomenon is also reflective in a slight decline in the ratio of total expenses to income despite a sharp increase in depreciation and operating expenses during FY01-FY05. Similarly, return on average assets and returns on average equity have also shown improvement during the said period.

Table 4.11: Financial Indicators of Existing Modarabas

	FY01	FY02	FY03	FY04	FY05
Capital adequacy					
Capital / liability ratio	85.7	90.9	102.3	91.1	82.7
Growth rate capital	-4.7	22.4	8.6	9.1	14.7
Growth rate of assets	7.2	18.7	2.7	14.5	21.2
Asset quality					
EA / TA*	80.6	73.4	77.5	77.2	80.4
Lease finance / EA	60.5	57.7	58.5	57.6	58.7
Morabha, Musharaka / EA	19.1	21.1	25.5	19.2	20.4
Investments to EA	20.5	21.2	16.0	23.2	20.9
Management					
Expense to income ratio	79.8	76.6	78.0	73.6	78.8
Admin exp to total exp	7.5	10.9	11.1	15.4	14.2
Earnings and profitability					
Return on average assets	0.5	5.7	6.8	5.8	4.1
Return on average equity	1.1	12.1	13.8	11.9	8.7
Liquidity and sensitivity					
Liquid assets / TA	4.1	5.4	6.1	9.2	8.2
Current ratio	1.3	1.2	1.1	1.3	1.3

Note: EA: Earning Assets; TA: Total Assets
Source: SBP (these indicators are computed by using the annual audited accounts of Modarabas).

Although the profitability of modarabas remained robust during FY05 as well; the high amortization and depreciation charges have dampened the net profit margins to Rs 794 billions in FY05 against Rs 932 billions in the previous year. Correspondingly, the return on assets and on equity also deteriorated slightly. This was attributed to three factors: (1) while the funding cost of modarabas increased significantly amid tight monetary posture, the returns on advances did not increase proportionately due to stiff competition; and (2) bulk of FY04 profit was constituted of the non-recurring income like capital gains on investments that was absent during FY05 and (3) the expanding business has also increased the operating expenses, which have squeezed the net income margins.

Outlook

Although modarabas are making efforts to diversify their product line; a major part of their assets is still concentrated in lease finance. However, in recent years, when other financial institutions have extensively diversified the range of product and services; it is quite imperative for modarabas to introduce new or improved Shariah compliant financial services and also to achieve competitiveness over other institutions. In this regard, SECP has been taking various legislative measures to provide room for modarabas to generate funds from their in-built capacity in recent years. In doing so, the SECP has permitted modarabas to issue musharaka-based TFCs in FY04. In addition, the reconstitution of the Religious Board during FY05 would also help in removing all the legislative impediments in the sector so that modarabas could not only expand their businesses but also achieve diversification and economies of scale.

4.3.5 Housing Finance Companies

Worldwide, the housing finance market is the largest consumer finance market. According to an estimate, around US$ 14 trillion of the global wealth is held in residential real estate assets; while US$ 10.5 trillion of these assets are secured by debt.[19] Over the last two decades, the size of the mortgage finance industry has increased tremendously as exhibited by a continuous increase in mortgage loans to GDP ratio especially in the developed economies. This ratio varies significantly from country to country, with the housing finance to GDP ratio of over 125 percent in Switzerland to over 60 percent in US and 10 percent in Mexico. In emerging market economies, this ratio ranges from 15 to 20 percent; while in South Asian economies, the ratio is quite miniscule at 2.5 percent in India and less than 1 percent in Pakistan.

Structure and Growth of HFCs in Pakistan

Presently, four Housing Finance Companies (HFCs) are operating in Pakistan. However, almost 97 percent of overall assets are concentrated in the state-owned House Building Finance Corporation (HBFC).[20] Despite a high potential for housing finance in Pakistan, HBFC has been the sole provider of formal housing finance in the country up till FY91 (see **Box 4.6**). Thereafter, three private companies entered the business and since FY02 commercial banks have been granted permission to extend housing finance.

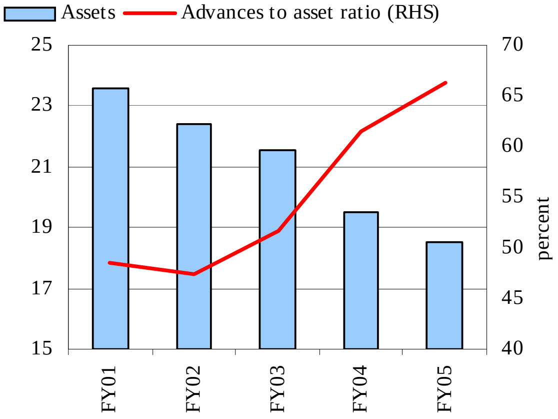
HFC is the only group among the entire NBFI sector that registered a net decline in assets during FY01-05. By end FY05, assets of these companies have reached to Rs 18.5 billion from Rs 22.0 billion in FY00; showing a negative AAGR of 3.3 percent (see **Figure 4.19**). In contrast commercial banks recorded a fast growth in housing finance capturing most of the share in housing finance market in the preceding three years. Specifically, at end-June FY05, HFCs constituted 23.6 percent of outstanding housing loans from the formal

Box 4.6 Potential for Housing Finance in Pakistan & HFCs' performance

According to Pakistan Economic Survey 2003-04, there are around 19.3 million housing units compared with the total requirement of 25 million; exhibiting a shortfall of 6 million units. Moreover, due to the growing population needs, especially in urban areas, around 0.5 to 0.7 million housing units are additionally required every year. Thus in order to completely overcome the backlog and additional requirement in the next 20 years' time, almost 1 million houses need to be built every year. In contrast, actual production at 0.3 million housing unit per year is considerably low; even not sufficient to meet the incremental requirements. Certainly, the financial resources of the government are not sufficient to meet this huge backlog. Rather, similar to a case in many other countries, the financial system can play a vital role in developing this sector in Pakistan.

In this perspective, the existence of only one formal housing finance company (i.e. HBFC) up till 1991 exhibits perhaps the general ignorance of this critical area. A look at the performance of HBFC overtime depicts that given the unregulated nature of the real estate sector (especially in terms of clear titling and ownership issues), the activities of HBFC remained fairly limited. This is evidenced through a comparison made between the HBFC and HDFC (Housing development finance corporation)-India. Although the HBFC was established well before (almost 25 years) the establishment of HDFC in 1977; still, the number of housing units financed by HDFC is significantly larger compared with HBFC. In specific terms, during its 29 years of operations, HDFC has financed around 2.7 million housing units compared with mere 0.43 million units financed by HBFC in its 54 years of operations.

Figure 4.19: Assets of HFCs



[19] Source: Committee on the global financial system CGFS paper No. 26 "Housing finance in the global financial market" January 2006, Bank for International Settlements-BIS.

[20] HBFC was established in 1952.

financial sector; while the share of commercial banks was at 76.4 percent.

Performance During FY01-05

Despite a booming real estate and construction business activities during the last couple of years, the continuously declining assets of Housing Finance Companies (HFCs) clearly show a dismal performance by these institutions.[21] It may be important to note that HFC is the only group among the entire NBFI sector that registered a net decline in assets during FY01-05 (see **Figure 4.19**). However, this should be seen in the perspective of the on-going restructuring of HBFC. Specifically, given the poor financial health of the institution towards the end 1990s, a rigorous restructuring process has been started from FY00 onwards. In this regard, the focus primarily remained on dealing with the huge non-performing loans through (a) increasing provisioning against NPLs; (b) writing off bad debt; and (c) improving quality of fresh loans.

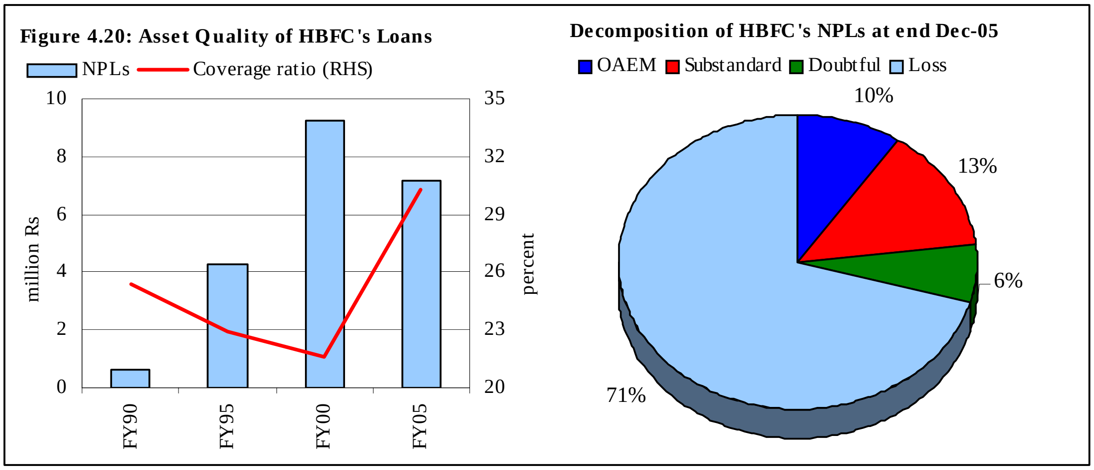


Figure 4.20: Asset Quality of HBFC's Loans

As a result, some improvement has been registered during FY01-05. As shown in **Figure 4.20**, not only the volume of NPLs has declined, the coverage ratio (provisioning as percent of total NPLs) has also improved exhibiting a relatively better provisioning of the bad assets.[22]

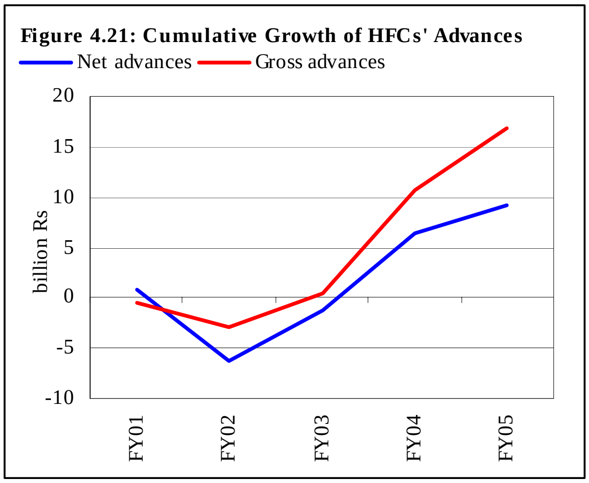


Figure 4.21: Cumulative Growth of HFCs' Advances

However, this restructuring process has badly affected the growth and profitability of the sector. The negative growth in net assets of HFCs was primarily because of the large provisioning against non performing loans and suspended income and relief packages provided by HBFC from time to time.[23]

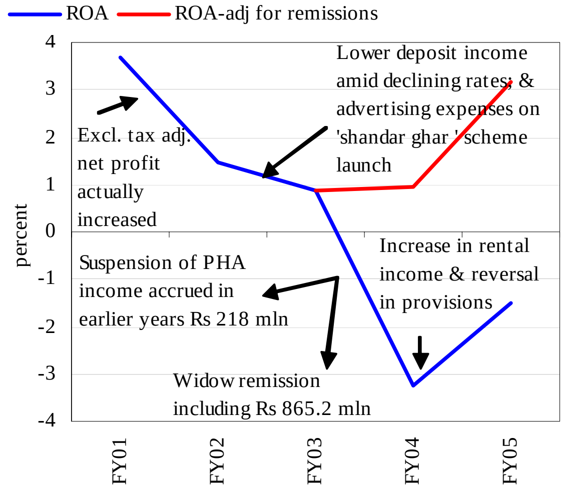
[21] By FY05, assets of these companies have declined to Rs 18.5 billion from Rs 22.0 billion in FY00.

[22] Moreover, a larger portion of NPLs, classified in loss category, reflects a possibility that bad loans of HFCs are largely comprised of historical loans and that the newly extended loans are of a relatively better quality.

[23] During FY05, the Government of Pakistan announced a relief package under which the customers were entitled to waiver of outstanding mark-up and demand changes on payment of the entire principal amount and certain percentage of mark-up and demand charges due. Under this package, balances amounting to Rs 225 million have been recovered and Rs 1.465

In specific terms, the housing finance provided by HFCs registered a compound growth of 1.8 percent during FY01-FY05; however, adjusting it for provisioning, remissions and suspended income the growth reaches to 3.2 percent (see **Figure 4.21**).

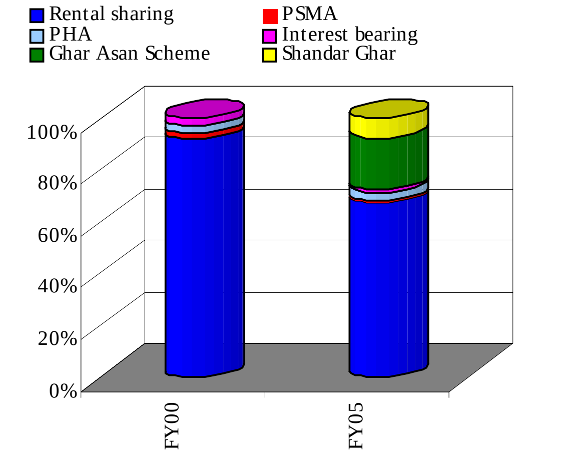
Figure 4.22: Profitability of HFCs



Stepping back, the increased provisioning, along with reversal of rental income due to relief package to widows, orphans and ex-employees of HBFC, have been the major causative factors for the decline in profitability. The ROA of HFCs, which was continuously declining since FY01, turned negative from FY04 onwards. However, adjusting for provisioning and reversal of rental income, the profitability of HFCs has actually increased in recent years (see **Figure 4.22**). The upturn in (adjusted) ROA is primarily caused by (a) improved earning assets to total asset ratio; (b) rapid growth in income; and (c) decline in operating expense to income ratio.

It is important to note that from FY03 onwards HBFC has spurred up their activities through: (a) introducing new financing products for the purchase, repair and construction of houses, for example '*Shandar Ghar Scheme*' and '*Ghar Asan Scheme'* (see **Figure 4.23**); (b) expanding its outreach by opening up new branches and also setting up franchises in far flung areas of the country; and (c) focusing on diversifying the target market by developing small and medium housing finance products.

Figure 4.23: Composition of HBFC's Housing Finance



Conclusion

In sum, given the ongoing restructuring of HBFC, it would be too early to comment on the performance and future prospects of HFCs . Down the road, once the reform process will be completed, it will be pertinent to see whether the financial soundness indicators reflect any improvement in the sector, especially in the area of asset quality and profitability. With regards to institutional strengthening, it is encouraging to see that HBFC has increased its paid-up capital to Rs 3 billion through utilizing its reserves; and is planning to raise it to Rs 6 billion gradually. Certainly, this would not only aid in expanding HBFC business but would also provide an adequate support against any adverse movement in HBFC's asset quality.

billion has been written off up to the balance sheet date. The reversal represents the rental income that was credited to profit and loss account in previous years

In addition, HBFC is also keen to diversify the liability products to lower its reliance on credit lines from other financial institutions. In particular, the institution is all set to launch the first ever Real Estate Investment Trust (REIT) in the country and is also planning to issue mortgage backed TFCs through securitization of its future receivables (see **Box 4.7**). Given the level of diversification in the housing finance sector, it is expected that the HFCs would not only be supportive in fulfilling the demand supply gap in housing sector but would also contribute in the development of the capital and bond market in Pakistan through introducing innovative liability products.

Box 4.7: Real Estate Investment Trust

The Real Estate Investment Trust (REIT) is an investment trust that pools funds for investments in real estate, mortgages and mortgage backed securities. REIT provides an opportunity for investors (especially small investors) to invest in a professionally managed real estate portfolio; without getting into the hassle of direct property acquisition. Typically there are three kinds of REITs; (1) equity REITs that own and invest in property directly and their revenues come from rents; (2) mortgage REITs that extend or own loans/obligations that are collateralized by real estate; and (3) Hybrid REITs that own both property as well as mortgages.

In Pakistan, HBFC has planned to launch the first ever REIT in the country. This will not only provide a mode to small investors for participating in the real estate activities; but can also help in organizing the real estate market to some extent. Specifically, it is expected that the institutionalization of investments in real estate would help in: (a) computerization of land record system; (b) improvements in tenancy and foreclosure laws; and (c) rationalization of real estate transaction costs. For HBFC, the rationale for launching REITs is to mobilize financial resources, which the corporation has planned to utilize in constructing residential and commercial complexes in Lahore, Peshawar and Islamabad. HBFC has already acquired technical advisory service from a Malaysian asset management company.

In order to promote REITs in Pakistan, SECP has issued Real Estate Investment Trust Rules in 2005. According to these Rules, the structure of REITs would be similar to an asset management company. In specific terms, REITs scheme will consist of a closed-end collective investment scheme; constituted as a REIT fund and managed by the REITs Management Company. The minimum paid up capital has been set at Rs 250 million and Rs 50 million for REIT fund and REIT Management Company, respectively. Just like mutual funds, the units of REITs fund would also be listed in the stock exchanges and will be freely tradable. In order to ensure that the desired objectives for launching REITs are achieved, at least 70 percent of the REITs funds are required to invest directly in real estate; while the remaining 30 percent can be allocated among real estate related and other (non-real estate) assets. Moreover, to avoid speculative investments in the real estate sector, REIT funds are required to hold the real estate assets at least for two years; unless the rationale for pre-disposal of the unit is clearly communicated to the unit holders.

Besides issuing these rules, SECP has developed a regulatory framework as well. Similar to a mutual fund or asset management companies, income of REITs will be tax exempted if 90 percent or more of its accounting income is distributed among the unit/share holders. Only unit/share holders pay tax on the dividend income or on the gains earned against the selling of units/shares. Thus, REITs will be one of those vehicles that do not face double taxation.

Sources:
1. Research Paper on Real Estate Investment Trust, KASB Securities, December 2005.
2. The Real Estate Investment Trust Rules 2005, Securities and Exchange Commission of Pakistan.

4.3.6 Mutual Funds

Mutual funds provide investors the access to a well-diversified portfolio of equities and bonds through investing in various securities from their pool of savings. Typically, mutual funds are managed by asset management companies, ideally a hub of business qualification and professional insight, who manage the funds of their shareholders and invest in a number of securities/bonds thereby reducing the risk of investing in a single security. This inherent diversification of portfolio that the investors can achieve by investing in mutual funds, coupled with the attraction of liquidity and transparency has been the major factor in a continuous growth of the mutual fund industry all over the world (see **Box 4.8**).

Box 4.8: A Brief Overview of Global Mutual Fund Industry

As shown in **Table B4.3**, the growth in mutual funds industry has been registered all over the world including America, Europe, Asia & Pacific and Africa. Both, the number of mutual funds and the total net assets of the mutual funds of the world have increased. The net assets of the mutual fund industry have increased more than eight-fold from US $ 2.7 trillion during 1990 to US $ 16.1 trillion. Approximately 48 percent of the assets of mutual fund industry are placed in the equity market, both domestic and foreign; around 38 percent in the domestic bond markets and 3 percent in foreign bond markets.

Interestingly, however, the impact of this growth has been varying from country to country. For instance, mutual funds in United States hold the largest proportion (around 44 percent) of their assets in equities. Latin American funds have most of their assets allocated in the fixed income securities; while the European mutual funds' investment is relatively balanced between the equity and the bond market.

Table B 4.3: Worldwide Number of Mutual Funds

	FY00	FY04
World	**51,692**	**55,528**
Americas	**12,676**	**14,067**
Europe	**25,524**	**29,307**
Asia and Pacific	**13,158**	**11,617**
India	234	394
Pakistan	38	29
Japan	2,793	2,552
Korea, Rep. of	8,242	6,636
Philippines	18	24
Africa	**334**	**537**

Worldwide Total Net Assets of Mutual Funds

in billion US $	FY00	FY04
World	**11,871.1**	**16,152.4**
Americas	**7,424.1**	**8,792.4**
Europe	**3296**	**5,628.2**
Asia and Pacific	**1,134**	**1,677.9**
India	13.5	32.8
Pakistan	0.3	1.8
Japan	432	399.5
Korea, Rep. of	110.6	177.4
Philippines	0.1	1
Africa	**16.9**	**54**

Source: Investment Company Fact book 2005, Investment Company Institute

Shift in the Structure of Mutual Funds in Pakistan

In terms of ownership, nature, and investment strategies, Pakistan mutual fund industry has seen a drastic shift during FY01-05. In specific terms, the share of publicly owned mutual funds in aggregate assets of overall sector has declined significantly; from above 90 percent in FY01 to close to 50 percent in FY05 (see **Table 4.12**). This sharp decline in public-ownership was primarily a result of privatization of ICP funds during FY03. The nature of funds has also seen significant changes as assets of closed-end mutual funds has increased almost five times during FY05 compared with FY00. Finally, in terms of investment strategies, the proportion of equity funds in the overall sector is still the largest at the end of FY05; but has declined slightly to the share of bond and balanced funds.

Table 4.12: Structure of Mutual Funds

in percent

	FY01	FY02	FY03	FY04	FY05
Total assets (billion Rs)	**24.2**	**29.1**	**57.2**	**103.1**	**136.2**
Share by ownership					
Public sector	91.1	90.0	78.9	55.6	50.8
Private sector	8.9	10.0	21.1	44.4	49.2
Share by type					
Closed-end	18.8	24.3	21.5	24.8	28.5
Open-end	81.2	75.7	78.5	75.2	71.5
Share by investment strategies					
Balanced fund	5.4	5.3	5.1	6.9	6.3
Equity fund	94.6	94.7	84.3	84.2	85.1
Bond/income fund	0.0	0.0	2.7	0.9	1.0
Money market fund	0.0	0.0	7.8	8.0	7.6

Source: SBP data is computed from annual audited financial annual reports of mutual funds.

While the ownership changes bid well to the efficiency of the funds; the evolving structure in terms of type and investment strategies appears favorable in terms of growing diversification and earning prospects of the industry. In particular, the rising share of the closed-end funds in total mutual funds assets would help in improving the cost and liquidity structure of the mutual fund industry.

Specifically the portfolio managers of the closed-end funds do not have to maintain sufficient liquidity as, unlike the open-end funds, the units are sold through IPOs and are not redeemable on demand. In addition, the closed-end funds usually operate with a low expense ratio compared with the open-end funds. This is mainly because the closed-end funds do not bear the marketing and distribution cost as; (1) these funds do not require to sell their short term assets (securities) to meet redemptions; and (2) do not advertise regularly like open-end funds, as theses are offered only through IPOs. This advantage can be seen from the fact that in Pakistan, at end period FY05, the expense ratio (total expenses adjusted by total investments) for closed-end mutual funds is 3.5 percent; whereas the same for open-end mutual funds is 4.9 percent. Similarly, the open-end mutual funds in Pakistan are operating with a relatively high liquidity ratio (in the form of cash in hand and bank balances), so as to meet inconvenient redemptions, at 14.0 percent compared to the 12.1 percent of the closed-end funds (see **Table 4.13**). Therefore, rising share of closed-end funds may be viewed as a precursor of better earning prospects for the local mutual fund industry. Moreover, it also shows rising confidence level of customers towards this business.

Table 4.13: A Comparison of Open-end and Closed-end Mutual Funds

Expense ratio				
	Median	**Mean**	**Min**	**Max**
Closed-end	3.0	3.5	1.2	7.6
Open-end	4.2	4.9	0.9	11.0
Liquidity ratio				
	Median	**Mean**	**Min**	**Max**
Closed-end	8.7	12.1	0.2	31.9
Open-end	11.5	14.0	0.3	38.2

New Entrants in the Sector During FY05 and Onwards

As mentioned in **Section 4.1.2**, during the year FY05, seven new asset management companies were given license. In addition, the public offering of ten funds was approved during the year which included; (1); UTP-Aggressive asset allocation fund; (2) Atlas stock market fund; (3) Pakistan Strategic allocation fund; (4) Meezan balanced fund; (5) First Dawood mutual fund; (6) Al-Falah GHP value fund; (7) Atlas fund of funds; (8) PICIC energy fund; (9) UTP fund of funds; and (10) AKD index tracker fund. Of these, 4 funds are open-end while 6 funds are closed-end. The launching of these new funds on the one hand would increase the level of competition to the mutual fund industry by providing investors a wide array of investing opportunities; on the other hand, it would also bring innovation in the financial services provided by the sector. In specific terms, the concepts of ‘fund of funds’ and ‘index tracker’ are totally new in Pakistan’s financial scene and, therefore, is

Box 4.9: An Elaboration of the Key Concepts

The index tracker fund

The principal objective of an index tracker fund is to mirror the performance of a specific stock market index (in Pakistan, the KSE index). This is done by investing 100 percent of the fund’s capital in equities with same weightage of holdings as in the index it tracks. These types of funds need to be managed relatively passively as the fund managers do not need to make decisions on where to invest. The advantage of investing in index tracker fund is that the fund theoretically can never perform worse than the index it tracks. In addition, the transparency of holdings and the relatively lower management fees are additional advantages which generally make such funds attractive for investors and individuals.

Fund of funds

A fund of funds is a mutual fund that invests in other mutual funds. A major advantage of a fund of funds is the double diversification. Specifically, a mutual fund diversifies its portfolios by investing in different securities, while a fund of funds double diversifies its portfolio by investing in different mutual funds. However, a disadvantage of such funds is that most fund of funds carry high expense ratio because their expenses carry part of the expense fee of the mutual fund in which they invest.

expected to increase depth and diversification in the sector (see **Box 4.9**).

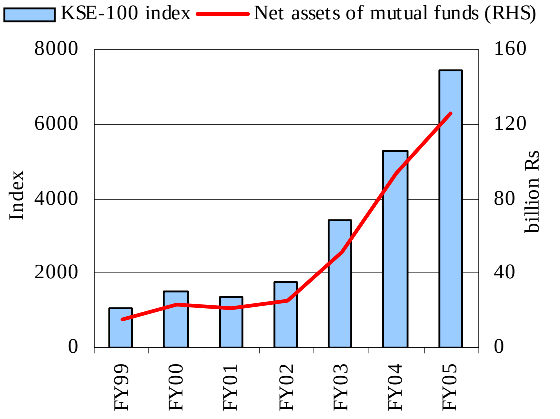
Performance During FY05

The continuous robust performance of the domestic stock market has boosted the growth of mutual fund industry. Total net assets of mutual funds registered a growth of 33.7 percent during FY05 and reached at Rs 125.3 billion (see **Figure 4.24**).

Fund Size

In absolute terms, the increase in the size of open-end funds was Rs 6.7 billion larger than the increase in assets of closed-end funds during FY05. However, the growth rate of assets of closed-end funds was almost double the same of open-end funds.

Figure 4.24: Performance of Capital Market



The net assets of open-end funds registered a growth of 27.7 percent during FY05 as four new funds started their operations during the year. NIT, that alone constitutes around 72.4 percent of the total assets of open-end funds, registered a growth of 23.2 percent in its net assets during FY05.

Stepping back, the robust growth in the assets of mutual fund was driven mainly by; (1) stable macroeconomic fundamentals that build up an optimistic view of the investors regarding the stock performance; (2) expectations of healthy profitability of the corporate sector; (3) expedited process of privatization of government-owned units; and the (4) heavy influx of foreign portfolio investment of US dollar 334 million during Jul-Jun FY06 compared with an aggregate inflow of US dollar 202 billion in the preceding three years. Moreover, absence of alternative modes of investments especially for institutional investors also played a role in the high growth of mutual funds industry. In specific terms, the real returns on deposits offered by commercial banks remained negative for most of FY01-05. Also, ever since the yield structure on national savings schemes has been rationalized and the institutional investors were banned to invest in NSS instruments; the stock market has been the major recipient of the maturing NSS investments. Indeed, this was a prime factor in diverting investors' interests towards the mutual funds.

Table 4.14: Estimates of MFs' Net Asset

Dependent variable: Log of net assets

Explanatory variables	Coefficient	t-Stats	Prob.
Constant	0.490	0.886	0.38
Log of market capitalization	0.184	2.764	0.04
Growth in foreign portfolio investment	0.029	2.053	0.03
Interest rate	-0.044	-3.104	0.00
Lag dependent variable	0.809	-2.397	0.00
Adjusted R-squared	0.97		
D-W stat	1.87		
Total panel observations:	140		

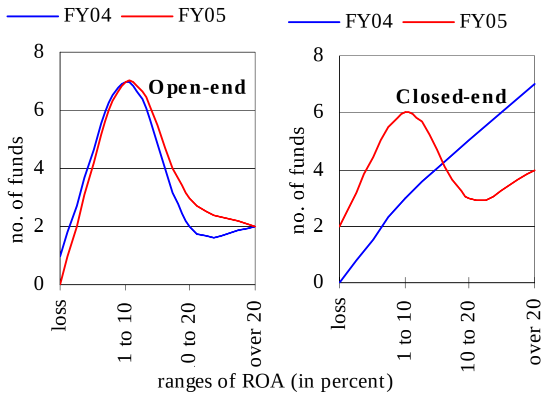
As shown in **Table 4.14**, the growth rate in mutual funds' net assets depends upon the stocks performance. Higher foreign portfolio investment also leads to an increase in mutual funds assets growth however, only marginally while rising interest rates negatively effect the growth of mutual funds.

Profitability

In absolute terms, the profitability of the mutual funds improved during FY05 as the after tax profit rose to Rs 23.5 billion during the year from Rs 21.0 billion in the preceding year. However, ROA declined from 20.0 percent during FY04 to 17.0 percent during FY05. A plausible reason to this fall in ROA in FY05 was the absence of capital gains (both realized and unrealized) of a similar magnitude that was available during FY04. It should be noted that during FY04, approximately 81.4 percent of the total income of these funds was based on capital gains. This does not appear to be a healthy phenomenon since earnings through capital gains are one-off earnings and do not represent the true performance of the funds. In this perspective, it should be noted that during FY05 as well, dividend income constituted only 16.8 percent of the total income, even lower than 17.3 percent during FY04.

Further, the data shows that most of the open-end funds maintained their FY04 profitability during FY05 while the closed-end funds registered mostly the decline in profitability (see **Figure 4.25**). The frequency distribution shows that most of the open-end funds either maintained the previous year's profitability range or improved it; whereas the profitability of most of the closed-end funds declined during FY05.

Figure 4.25: MFs Net Profit to Asset Ratio



Outlook

The current developments in the mutual fund industry in terms of asset growth and the number of institutions reflect an encouraging outlook of the industry. However, the persistence of present performance would depend significantly upon the continuity in economic fundamentals that would shape the future stock market performances. In addition, the recent decision of the government to re-allow the institutional investments in NSS instruments may be viewed as a downside risk to the mutual fund industry.

This is because in the past, the high level of interest rates in alternate mode of savings, especially the national savings schemes, has acted as a disincentive for the investors to invest in mutual funds. However, the SBP disallowing the institutional investments in NSS, rationalization of returns on NSS and overall low interest rate environment in the economy has contributed to the growth of mutual funds in recent years. Nonetheless, the speedy growth in closed-end mutual funds depicts the growing investors' confidence on these arrangements and especially after the mini stock debacle in March FY05 this confidence has further increased. Specifically, it was observed that the small investors who invested through mutual funds suffered relatively much lesser erosion in share prices compared to those who invested directly. In addition, the confidence on mutual funds would further build up as the SBP has allowed funds to invest 30 percent of their assets abroad (with a cap US $ 15 million).[24]

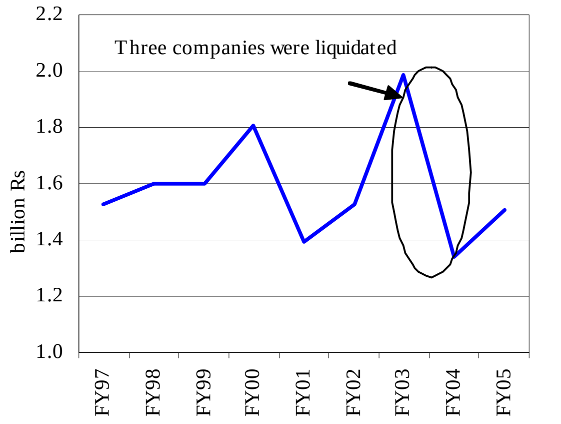
4.3.7 Discount Houses

The principal objective of Discount Houses (DHs) is to provide liquidity to the financial and other sectors of the economy through discounting /rediscounting of securities issued by government and corporate entities. However, in Pakistan, where the corporate bond market is at an emerging stage and therefore the bond market lacks depth; the DHs had insignificant volume of business activities. Moreover, as commercial banks also provide discounting facilities, the DHs have remained largely incapable of establishing a significant market niche. In specific terms, total assets of DHs at end June 2005 were even below 0.02 percent of GDP.

[24] F.E. Circular No. 11 dated August 12, 2005

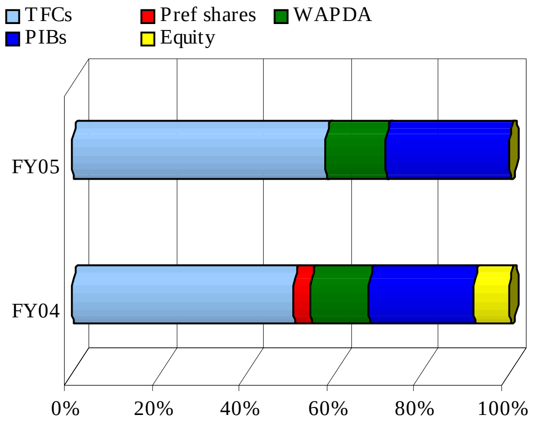
As shown in **Figure 4.26**, DHs saw a sharp decline in assets during FY03 and FY04. Even despite some recovery in FY05, assets remained at below FY02 level. The fall in assets was primarily because of liquidation of three companies out of total four in that period. The remaining institution is an unlisted subsidiary of National Bank of Pakistan, which is mainly involved in investing, discounting and trading in negotiable instruments. However, during FY04 the company has been granted NBFC status and the license was given by SECP to conduct leasing business. In addition, the company has also been issued license for asset management services and investment advisory services. While the company has started lease financing in FY05, it has yet to start the asset management and investment advisory services.

Figure 4.26: Assets of Discount Houses



The assets of National Bank of Pakistan Capital Limited (NBPCL) have registered a growth of 12.2 percent during FY05 to reach at Rs 1.5 billion. This increase was attributed in principal to the company's take up of lease finance activity during the year, as around 97 percent of the *increase* in total assets was comprised of lease finance.[25] The lease business executed by the company in FY05 was for a term of 3 to 5 years and the fixed return implicit in the lease ranged from 10.8 to 18.0 percent per annum.

Figure 4.27: Investment Composition of NBPCL



Investment in financial assets constituted more than an half of the total assets of the company, which registered an increase of Rs 37 million during FY05. Contrary to the past practice, when the investments were limited to the WAPDA bonds alone; composition of company's investment exhibited some significant changes during FY04 and FY05 (see **Figure 4.27**). In specific terms, the company has made significant investments in mutual funds and in other financial instruments during the preceding two years. In addition, the investment in TFCs also reflects a diversified portfolio given the exposure of the company in TFCs of energy sector, financial, chemicals, textiles, telecommunications and services sector.

The key issue, with the NBPCL is the lack of focus on core business. Decomposition of income in FY05 shows that only 14 percent was earned through discounting of securities. This ratio has peaked in FY02 when it reached to 35 percent and since then there is a continuous decline in the share of discount income in total income. On the other hand, in FY05, 62 percent of the total income comprise of return on investments made by the institution.

[25] The share of lease finance activity in total asset base of the company has reached to 10.5 percent by the end of June 2005.

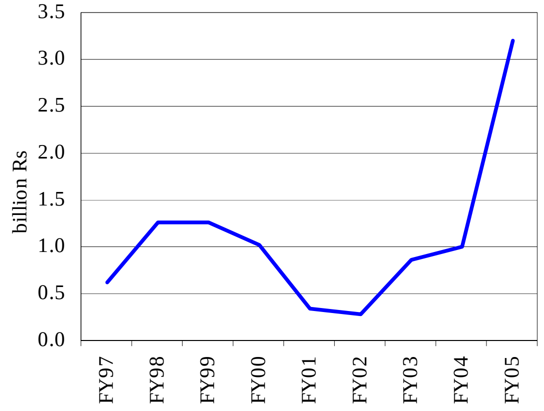
As mentioned earlier, NBCL has acquired the license to conduct leasing business and it is quite likely that the company will increase its lease finance activities in coming years. This is because unlike the other leasing companies, fund mobilization should not be a source of concern since the company is a subsidiary of a large commercial bank[26]. Simultaneously, the discounting activities of NBPCL are also expected to increase given the large clientele and expanded business activities of the parent bank.

4.3.8 Venture Capital Companies

The venture capital companies have the smallest share in total NBFCs sector and have shown very limited activities since their inception in early 1990s. At present, three VCCs are operating in the country, with an aim to invest in emerging businesses that have a strong success potential. Interestingly, all the three companies in the sector are investing in companies in media and telecom sector driven by the tremendous potential in the industry in recent years.

After remaining more or less unchanged in the preceding years, the assets of the venture capital companies registered a sharp growth of 218 percent during FY05 to reach at Rs 3.2 billion (see **Figure 4.28**). However, this increase stemmed almost entirely from the increased investment of one company during the year; while the assets of the other two companies increased only marginally.

Figure 4.28: Assets of Venture Capital Companies



Major Activities of the Existing VCCs

All the three existing companies are involved mainly in Business Process Outsourcing (BPO), which is a fast growing business around the globe (see **Box 4.7**). For instance, AMZ Ventures Limited has invested its entire proceeds of the public issue in its fully owned subsidiary, the AMZ Access. Under the BPO structure, this company conducts the data production and processing activities in Pakistan, while the business is sourced in the US (mainly in healthcare and financial sector).

Box 4.10: Business Process Outsourcing (BPO) Around the Globe

BPO is the leveraging of technology or specialist process vendors to provide and manage an organization’s critical and/or non-critical enterprise processes and applications. In fact many large businesses outsource because it increases the product quality and/or reduces the costs substantially. This is the reason why the size of global outsourcing market has reached US $ 234 billion and is expected to US $ 310 billion by end year 2008. In fact, 59 percent of the global BPO market is in United States followed by 27 percent in Europe; while India being the most preferred destination for offshore BPO. In fact, in India, the size of the BPO market has reached US $ 5.7 billion with an average growth rate of around 49 percent during the preceding three years.

The reason for the expanding BPO activities stems from the benefits achieved by both the source and destination of outsourcing. The source of BPO (mostly the western countries) benefits in terms of cost savings while the destination of BPO benefits from the patronage of the outsourcing companies. For instance, according to an estimate, United States benefits US $ 1.12 to US $ 1.14 for every dollar spent on outsourcing to India; on the other hand, India benefits in terms of increased wages, job prestige, education, quality of life, etc.

[26] Usually the financing from parent company is either in the form of internal funds transfers; or, in case of borrowing, is priced at significantly lower rates compared with the market rates.

Similarly, the principal activity of The Resource Group (TRG) Pakistan is to directly and/or indirectly acquire, manage and / or maintain the business of telephone answering services and call centers. Specifically, the company has acquired call centre operations in North America and Europe of those companies that are experiencing losses presently. This has been done to improve the profitability and hence the cash flows of those companies by fulfilling the labor requirements through relatively lower cost call center operations in Pakistan.

Finally, the Telecom Media and Technology (TMT) ventures provide following services to its portfolio companies; (1) provide business strategy consultation; (2) help companies find suitable candidates for top marketing or financial positions; (3) facilitate marketing efforts; and (4) provide a centralized system of secretarial services to its portfolio companies.

Outlook

Presently, Pakistan is far behind from India in terms of capturing a sizeable niche in the growing BPO around the world. However, the potential in Pakistan to increase its share is quite prominent especially in the IT enabled services. According to an estimate, there are presently approximately 500 registered IT companies in Pakistan with 8000 IT professional working in the IT export industry. Given the fact that venture capital companies and other financial institutions fulfill only 18 to 21 percent of fund requirements of the domestic software houses; there is an emerging need for the venture capital companies to concentrate on this sector, especially in aiding the local companies in product development and marketing the IT-enabled services of local companies abroad to get any sizeable share in the global BPO market.

4.4 Conclusion

The consolidation process of the NBFIs that was initiated from 2000 onwards has resulted in drastic changes in the structure of the NBFIs. Specifically, number of institutions declined considerably due to mergers within and across sectors and liquidation of some of the financially week institutions. In addition, most of the public owned entities were transferred to private management to achieve cost efficiency, especially in DFI and mutual funds sectors. However, now that sizable efforts have been made for the consolidation of financial sector, it is observed that the level of institutional concentration has generally increased especially in leasing and modarabas. This perhaps calls for a continuation of consolidation process so that companies, with small capital base at present, could get into mergers to achieve a relatively better level playing field.

In terms of business expansion, the growth in NBFI sector in recent years is an outcome of the low interest rate environment through most of the period during 2001-2005, increased economic activities, low inflation, increased development expenditures, domestic and foreign investments and more importantly the robust performance of the stock market. However, in order to achieve a sustainable business growth, it is a high time for these institutions to develop and innovate upon their offered products and services given the increased competition arising from both (a) the take up of leasing business by commercial banks; and (b) the start of the NBFC regime whereby institutions can take up various businesses irrespective of which category their core business is from. In particular, these institutions will have to devise various modes of resource mobilization for their businesses especially to achieve cost competitiveness.

In this regard, the SECP is making efforts to promote the asset backed securitization especially in the leasing industry and mortgage backed in the housing finance industry. Through this, not only NBFIs could achieve new avenues for resource mobilization but would also be able to contribute significantly in the development of the domestic bond market. In this perspective, the upcoming launch of the first ever REIT by HBFC is a welcome development. SECP has already issued guidelines for the REITs arrangement and it is expected that the NBFI sector and especially the mutual fund industry would get more diversification in their businesses.

Finally, NBFIs can play a critical role in the promotion of those sectors in the economy which, although contribute significantly to the aggregate national income, do not fulfill the desired criterion to avail commercial financing such as small and medium enterprises and the agriculture sector.