4 Performance of NBFIs and CDNS During 1990s

Non-bank Financial Institutions (NBFIs) and Central Directorate of National Savings (CDNS) play a pivotal role in mobilizing savings in the economy. NBFIs collect savings by accepting term deposits of different maturities and provide financing to a variety of sectors of the economy. Parallel to the banking sector, financing activities of these institutions registered a healthy growth in 1990s, except for last three years. Deposits mobilized by NBFIs were 2.6 percent of GDP in FY90, which increased to 5.2 percent in FY97. This rapid growth, however, witnessed sharp reversal for the rest of the decade, as deposits to GDP ratio declined to 2.9 percent in just three years. This was mainly attributed to overall economic slowdown along with freezing of foreign currency accounts.

CDNS, a major source of non-bank borrowing for the government, also helps to mobilize savings by offering various saving schemes of different maturities. The net amount received from these schemes is directly used by the government to bridge the gap between revenues and expenditures. Total outstanding amount in all these schemes was 15.4 percent of GDP in FY90, which increased to 19.9 percent in FY00, mainly as a result of higher profit rates offered on these schemes as compared to deposit rates in the banking sector.

4.1 Non-Bank Financial Institutions

For the sake of analysis, NBFIs can be categorized into eight groups. The list of NBFIs in their respective groups is given in **Annex 1.2**. Wide variation exists within and across these groups in terms of their size. Development finance institutions (DFIs) is the largest in terms of assets on end June 2000, followed by investment banks (IBs), leasing companies, mutual funds, housing finance companies (HFCs), modaraba companies, discount houses (DHs) and venture capital companies (VCCs). The asset shares of all these institutions (as a proxy of their size) in overall NBFIs are presented in **Table 4.1**, reflecting that the DFIs and HFCs jointly held almost 91 percent assets of NBFIs in FY90, also pointing toward the meager share of the rest of NBFIs at that time. Furthermore, as all DFIs, one major HFC and two mutual fund management companies are state-owned, this also reflected the extent of public sector ownership in NBFIs.

Table 4.1 Assets of NBFIs

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Assets (billion Rs)	133.9	167.8	231.9	269.6	335.3	360.1	377.1	410.3	369.3	356.4	351.7
Growth rate (percent)	-	25.3	38.2	16.3	24.3	7.4	4.7	8.8	-10.0	-3.5	-1.3
Asset shares (percent)											
DFIs	78.6	71.1	58.4	59.3	54.0	55.3	56.6	61.5	61.3	58.7	57.0
Investment banks	1.8	2.8	3.6	7.7	8.4	8.5	9.8	10.2	12.4	13.7	12.0
Leasing	4.7	3.1	3.5	4.0	4.7	5.7	7.3	7.6	8.9	10.0	11.1
Mutual funds	1.9	12.4	26.4	21.6	23.4	21.3	17.3	11.9	6.7	6.7	8.6
HFCs	12.3	10.0	7.7	6.9	5.7	5.4	5.3	5.0	5.8	6.0	6.3
Modaraba	-	-	-	-	3.5	3.5	3.4	3.4	4.1	4.2	4.3
Discount houses	0.7	0.7	0.4	0.5	0.2	0.2	0.3	0.4	0.4	0.4	0.4
VCCs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.4	0.3

This highly skewed distribution of assets has changed significantly since 1990, which is partially explained by the emergence of new institutions under the reform process, particularly IBs, leasing and modaraba companies. These newly established institutions witnessed rapid growth in the first half of 1990s, as compared to other NBFIs. Furthermore, leasing companies outperformed other groups during the later half of 1990s.

Despite all these developments, asset distribution is still skewed as DFIs continue to dominate the NBFIs, but obviously less so than in 1990. Asset shares recorded in **Table 4.1** reveal that the prime

losers were the HFCs, whose share declined sharply from 12.3 percent in 1990 to 6.3 percent in 2000, and the clear gainers were the IBs and leasing companies. Relatively big institutions like DFIs, IBs, and leasing companies held around 80 percent of total assets in FY00 compared with 85.1 percent in FY90. Since DFIs, HFCs and mutual funds were mainly state-owned, during the decade of 1990s, the private sector share in NBFIs increased significantly from 7.2 percent to 28.6 percent.

Deposits of NBFIs portrayed almost the same picture as those of assets. As is evident from **Table 4.2**, leasing companies continued to attract larger share of savings towards NBFIs. The overall deposit growth of NBFIs also remained healthy except for the last three years, as total deposits increased from Rs 22.4 billion in FY90 to Rs 127.2 billion in FY97 and then declined to Rs 93.3 billion in FY00. Sharp upsurge in FY97 was mainly on account of heavy inflows in foreign currency deposits of a foreign sponsored DFI, while reversal in FY98 was explained by the outflow of deposits from the same institution. The freezing of foreign currency deposits in 1998 (after nuclear tests) seriously undermined NBFIs' ability to mobilize deposits. In the post detonation period, the domestic deposit mobilization efforts could not keep pace with increasing outflow from foreign currency deposits. This resulted in negative deposit growth in the last three years of 1990s.

Table 4.2: Deposits of NBFIs

	FY90	**FY91**	**FY92**	**FY93**	**FY94**	**FY95**	**FY96**	**FY97**	**FY98**	**FY99**	**FY00**
Deposits (billion Rs)	22.4	31.0	40.4	57.1	71.5	80.8	94.0	127.2	110.7	106.7	93.3
Growth rate (percent)	-	38.4	30.4	41.4	25.2	12.9	16.4	35.3	-13.0	-3.6	-12.5
Deposit shares (percent)											
DFIs	90.6	87.7	83.1	68.9	66.1	67.0	62.8	69.5	62.5	59.1	61.9
Investment banks	8.2	11.1	14.6	28.2	29.6	28.5	31.6	25.6	32.0	34.4	28.4
Leasing	1.3	1.2	1.8	2.4	2.8	2.6	3.7	3.7	4.1	5.0	8.2
Modaraba	-	-	-	-	0.6	0.7	0.7	0.6	0.7	0.7	0.9
Mutual funds	0.0	0.0	0.5	0.6	1.0	1.1	1.0	0.6	0.6	0.6	0.4
HFCs	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.1	0.1	0.2	0.1

Loans and advances of NBFIs are reported in **Table 4.3**, revealing almost same ranking as in case of asset shares. The growth rate of loans and advances followed the pattern of deposit growth rates; healthy positive growth upto FY97 and negative for rest of the decade.

Table 4.3: Loans and Advances

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Advances (billion Rs)	98.3	114.4	123.6	143.5	162.2	176.1	185.8	218.3	194.1	185.4	171.2
Growth Rate (percent)	-	16.4	8.0	16.1	13.0	8.6	5.5	17.5	-11.1	-4.5	-7.6
Shares in advances (percent)											
DFIs	80.4	80.9	79.5	75.6	72.3	74.0	71.7	74.1	70.3	70.1	71.6
Leasing	1.9	2.2	3.4	4.1	5.3	5.8	8.1	7.3	7.7	8.8	10.1
Investment banks	1.7	3.1	4.3	9.1	10.4	9.3	10.2	9.7	11.6	11.3	7.9
HFCs	14.8	12.8	11.7	10.2	8.8	7.8	7.3	6.2	6.9	6.3	6.7
Modaraba	-	-	-	-	4.7	4.3	3.9	4.1	5.1	5.2	5.7
Mutual funds	1.1	1.0	1.0	1.0	0.7	0.6	0.4	0.3	0.3	0.2	0.1
Discount houses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1

The overall business activities (in terms of deposit mobilization and extending loans and advances) of NBFIs registered double-digit compound annual growth up to FY97. Later years witnessed negative growth due to reasons described above. Given the overall position of dominance in terms of assets, advances, and deposits; relatively big institutions like DFIs, IBs and leasing companies that control over 80 percent business activities of NBFIs will be focused in our discussion, while discount houses

and venture capital companies will be discussed in brief. At present, SBP is using CAMELS framework to review the health of NBFIs,[1] which is used here to analyze the performance of these major groups of institutions.

4.1.1 Development Finance Institutions

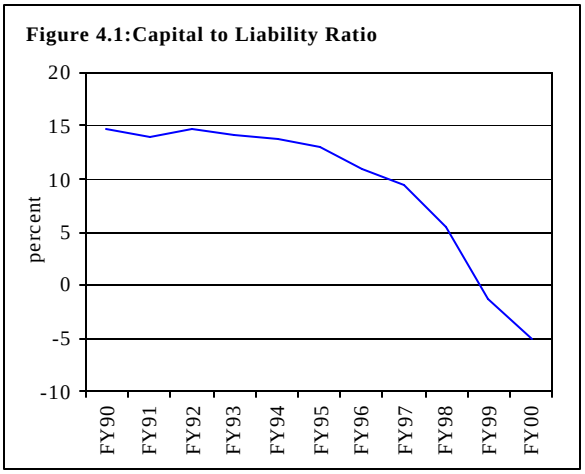
The list of DFIs includes 12 institutions (see **Annex 1.2**); their names along with asset shares of individual institutions are given in **Annex 4 (**see **Table 4A.3)**, showing that ADBP, NDFC and IDBP with around two-thirds of the total assets dominate the rest of DFIs. The list also contains three foreign sponsored DFIs (PLHC, SPIAIC and PKIC) and four specialized banks. Specialized banks include IDBP, ADBP, FBC and PPCB, which are almost similar to DFIs, but are licensed as scheduled banks.[2] The framework used to gauge the financial health of these institutions is almost same as used in **Chapter 3** for banks.

Capital Adequacy

Capital adequacy is generally gauged by capital to risk-weighted assets ratio, while other indicators include capital to liability ratio, growth rate of capital, growth rate of assets etc. Due to non-availability of data on risk-weighted assets, capital to liability ratio and some other indicators are discussed to assess the capital adequacy. Higher capital to liability ratio promotes public confidence in that institution and vice versa. In **Table 4.4**, four indicators of capital adequacy are reported, which jointly highlight the problem of weak capital position of DFIs.

Capital to liability ratio has not only declined from 14.7 percent in FY90 but also reached a negative level of 5.0 percent in FY00, indicating the severe erosion of capital base in second half of 1990s (see **Figure 4.1)**. The steep decline in second half of 1990s was the consequence of financial weakening of two big state-owned DFIs, including NDFC which technically became insolvent. The BEL, another public sector DFI also contributed to this end. Contrary to this poor position of capital adequacy, all foreign sponsored DFIs have maintained a relatively sound capital base.

Figure 4.1:Capital to Liability Ratio



Another important indicator of capital adequacy is the ratio of growth rate of capital to growth rate of assets. This ratio explains that the capital should grow in relation to growth in assets, so that the institutions' ability to absorb shocks and unanticipated losses remains intact. If this ratio is less than one, it implies that growth of capital did not keep pace with the growth of assets. It is clear from **Table 4.4** that the ratio was less than one for most of the period and even negative for the last two years.[3] The erosion of capital base was mainly attributed to heavy losses, which stemmed from loan defaults as well as rising non-performing loans experienced by public sector DFIs. The above trend indicates that the group of DFIs is facing a severe problem of capital adequacy, and points to the need of a drastic restructuring of DFIs on urgent basis.[4]

[1] Due to differences in the structure of banks and NBFIs, their respective CAMELS frameworks differ slightly with each other.

[2] These four specialized banks are part of scheduled banks, however, these are included in our list of DFIs because of similarity of their functions.

[3] This ratio must be interpreted with caution as negative growth in both assets and capital will provide positive figure; similarly negative growth in one variable will lead to a negative ratio.

[4] NDFC was subsequently merged with NBP on November 1, 2001. RDFC and SBFC were also merged with each other to form SME bank on January 1, 2002.

Table 4.4: CAMELS Indicators of DFIs
Percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	14.7	13.9	14.7	14.2	13.8	12.9	11.0	9.4	5.5	-1.3	-5.0
Growth rate of capital (GRC)	75.5	7.9	19.0	14.7	10.7	3.4	-7.2	2.6	-45.7	-123.1	287.2
Growth rate of assets (GRA)	153.3	13.3	13.5	18.1	13.3	10.0	7.2	18.1	-10.2	-7.6	-4.2
Ratio of GRC to GRA	0.5	0.6	1.4	0.8	0.8	0.3	-1.0	0.1	4.5	16.1	-69.0
Asset Quality											
Earning assets to total assets ratio	86.7	85.4	85.3	85.2	83.7	80.5	78.6	80.7	75.0	77.0	77.4
NPLs to gross advances	27.9	18.3	20.3	22.0	30.9	29.0	40.2	36.9	44.6	52.2	58.7
Loan default to gross advances	6.8	5.7	6.7	8.9	10.7	12.0	17.4	16.4	18.8	17.5	22.0
Provisions to gross advances	3.5	3.7	4.6	5.4	5.2	4.5	5.1	4.2	10.4	15.3	13.6
Recoveries of default to total default	69.0	54.1	56.9	40.0	33.4	31.2	19.8	28.5	33.4	28.1	32.3
NPLs to total assets	21.7	14.7	15.5	15.8	21.1	19.9	26.5	24.7	30.0	38.3	41.6
Advances to earning assets ratio	86.6	90.8	85.1	79.6	77.3	81.3	79.4	79.4	80.3	80.7	79.1
Investment to earning assets ratio	13.1	8.8	13.5	17.1	18.1	16.9	18.9	18.1	16.9	18.3	19.1
Management Soundness											
Total expense to total income ratio	73.6	76.6	73.5	71.7	78.7	87.9	98.6	89.1	115.1	104.8	101.9
Earnings per employee*	0.7	0.8	0.9	1.2	1.3	1.3	1.3	1.6	1.8	1.6	1.7
Operating expense per employee*	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.6	1.2	0.7	0.9
Total expense per employee	0.5	0.6	0.7	0.8	1.0	1.1	1.3	1.4	2.1	1.7	1.7
Earnings and Profitability											
Return on assets	1.5	1.5	1.3	1.5	1.9	0.8	-0.7	0.5	-3.9	-3.3	-1.7
Net interest margin	3.1	3.0	3.4	3.7	2.9	2.9	2.7	3.4	3.3	2.6	3.5
Net income to total assets	8.9	9.5	9.8	10.7	10.6	9.7	9.3	9.8	10.8	10.5	11.4
Interest income to total assets	6.4	6.5	6.8	7.6	7.5	7.2	7.6	7.9	8.0	8.6	8.6
Interest expense to earning assets	4.3	4.6	4.6	5.2	6.0	6.1	7.0	6.5	7.3	8.6	7.6
Interest income to total income	69.2	67.9	68.3	70.5	70.3	74.7	80.7	80.7	73.3	81.2	75.4
Interest expense to total expense	54.9	53.8	53.0	57.9	59.9	57.8	59.4	59.5	44.0	59.5	50.5
Provisions to total assets	2.8	3.1	3.6	4.0	3.7	3.2	3.5	3.0	7.7	11.7	10.6
Liquidity and Sensitivity to Market Risk											
Liquid assets to total assets	12.8	9.8	15.0	17.3	16.2	11.7	11.0	12.0	15.7	13.1	12.8
Loans to deposit ratio	389.8	340.5	292.9	275.9	248.0	240.7	225.6	183.0	197.1	206.2	212.2
Borrowing to advances ratio	72.0	72.7	77.3	82.9	84.9	83.7	88.3	75.6	92.4	99.4	102.7
Borrowing to liabilities ratio	62.0	64.2	64.3	64.3	62.6	61.8	61.1	53.0	58.7	61.0	59.7
RSA to RSL ratio	118.2	107.9	105.5	105.4	103.3	98.2	95.0	96.7	87.0	83.8	84.4
Gap to capital ratio	104.0	51.0	34.8	34.9	21.9	-12.7	-41.9	-32.1	-215.0	1145.2	271.9
Gap to total assets ratio	13.3	6.2	4.5	4.3	2.7	-1.5	-4.2	-2.8	-11.2	-14.9	-14.3

*: million Rupees

Asset Quality

The asset quality of DFIs is measured in relation to the level and severity of non-performing loans, the adequacy of provisions, recoveries, distribution of assets etc. **Table 4.4** shows that non-performing loans in relation to total assets and gross advances have significantly increased in late 1990s, hinting towards mismanaged loans and advances portfolios of these institutions. Besides, loan default to gross advances also increased significantly over the period under consideration. Mounting non-performing loans also eroded the earnings base of these institutions. **Figure 4.2** displays ratio of non-performing loans to gross advances, indicating massive increase over the whole decade. Moreover, declining recoveries to default ratio added an extra dampener to DFIs' growth.

The severity of non-performing loans becomes more pronounced when analyzed in the context of capital adequacy. **Figure 4.3** shows non-performing loans and capital to asset ratios as almost a mirror image of each other, particularly after FY97--the year in which prudential regulations for DFIs were strengthened. The prudential regulations enacted in FY97 made it mandatory to disclose a

Figure 4.2: NPLs to Gross Advances Ratio

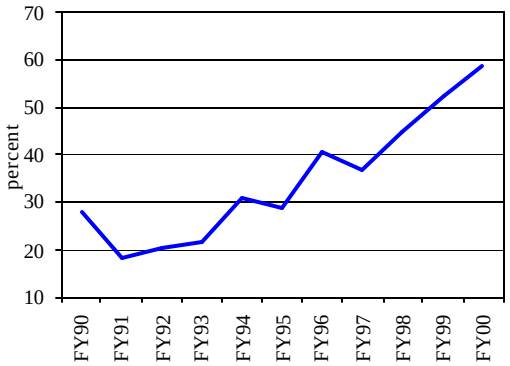
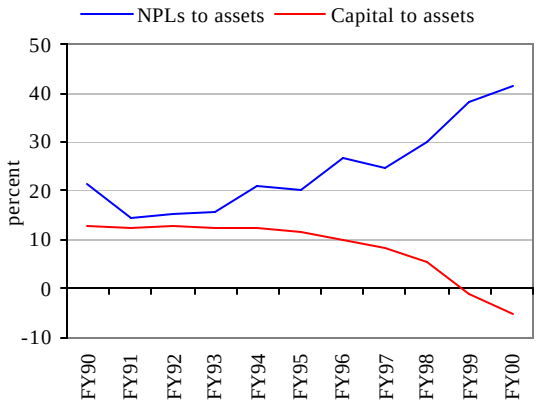


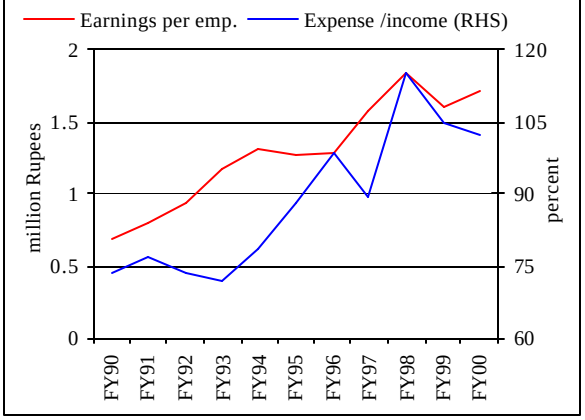
Figure 4.3: NPLs and Capital to Assets Ratio



certain level of information about non-performing loans and make provisions for loan losses according to a set of criteria. These regulations, together with slower economic and industrial sector growth, lack of proper monitoring of pre and post disbursement of loans, and lack of professionalism resulted in steep increase in non-performing loans.[5] Furthermore, declining trend in earning assets to total assets ratio signaled the gravity of the problem. The only positive point in reported asset quality indicators is the positive trend in default recoveries to gross advances in late 1990s, mainly due to special loan recovery drives.

Despite overall weak asset quality, foreign sponsored DFIs and PICIC performed relatively better as compared to overall trend for DFIs. Since the share of these institutions was not very high in total assets of DFIs group, the overall asset quality indicators of DFIs hardly showed any sign of improvement over the decade.

Figure 4.4: Management Soundness



Management Soundness

The evaluation of management includes performance in relation to capital adequacy, asset quality, earnings, sensitivity to market risk and liquidity. Compliance with set norms, ability to plan and adoption to changing circumstances also indicate management soundness. In addition, technical competence, leadership and administrative ability also matter a lot. An overall good management results in a strong financial structure with consistent earnings performance. **Table 4.4** presents four indicators of management soundness. Earnings per employee witnessed a positive trend in 1990s, mainly caused by a reduction in staff through Golden Handshake Schemes (GHS) in late 1990s.[6]

This apparently positive point loses its credibility, when observed jointly with total expense per employee, which also included GHS cost. Per employee expenses continued to increase over the whole decade and even exceeded the earnings per employee in FY98. A more meaningful ratio is

[5] This does not mean that prudential regulations are responsible for poor health of DFIs. The only point is that the hidden risks to DFIs were exposed by these regulations.

[6] Five DFIs, including two specialized banks launched GHS in late 1990s.

expense to income, which jumped from 73.6 percent in FY90 to 115.1 percent in FY98 before declining to 101.9 in FY00. It seems that staff reduction did not have the intended result of better profitability because of other structural weaknesses in these institutions. Major increase in earnings, operating expense and total expense per employee ratios in FY98 was a consequence of GHS. **Figure 4.4** displays that total expense to total income ratio gradually increased after FY93, indicating weak management of DFIs. Although this ratio marginally declined in last two years, it remained over the mark of hundred percent due to losses suffered by DFIs.

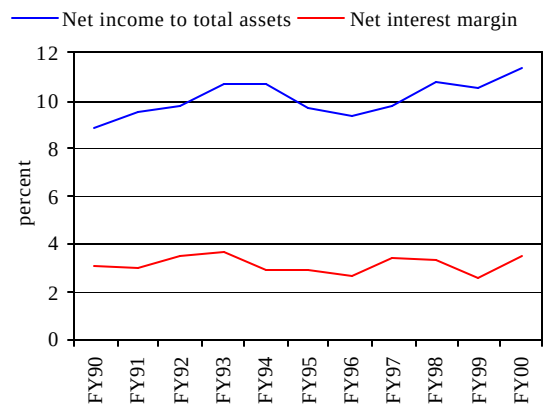
These indicators, combined with capital inadequacy and poor asset quality, gave clear indication that the managements of DFIs were unable to generate consistent income stream for the institutions. However, foreign sponsored DFIs again stayed within the healthy circle, as their management performance indicators were exceptionally good.

Earnings and Profitability

Table 4.4 reports various indicators that depict the earnings and profitability of DFIs. Most important ratios are return on assets and net interest margin (NIM). The former registered a marginal increase over the period, mainly due to widened interest rate spread.

Increasing trend of break-even yield (BEY) along with marginal increase of NIM provides clear indication of increasing interest rate spread. The former also reflected that the profitability of these institutions required higher interest rates. In addition, return on assets was negative during the second half of 1990s, indicating losses to DFIs. Moreover, as can be seen from **Figure 4.5**, the net income to total assets and NIM fluctuated in a narrow band over the entire period of analysis. As we have already discussed, expenses to income ratio not only increased considerably in late 1990s, but also crossed the alarming level of hundred percent, indicating losses to DFIs.

Figure 4.5: Earnings and Profitability



The period of losses (second half of 1990s) coincided with the weak performance of other indicators like capital adequacy, asset quality etc., reflecting that persistent poor performance in one area will ultimately eclipse the good performance of other indicators. Tabular and graphical representation provide strong evidence to conclude that earnings and profitability of DFIs has rapidly gone down in late 1990s, requiring structural reforms for smooth functioning in future. Again, foreign sponsored DFIs retained their separate identity, as management soundness indicators showed strong earnings and profitability profile.

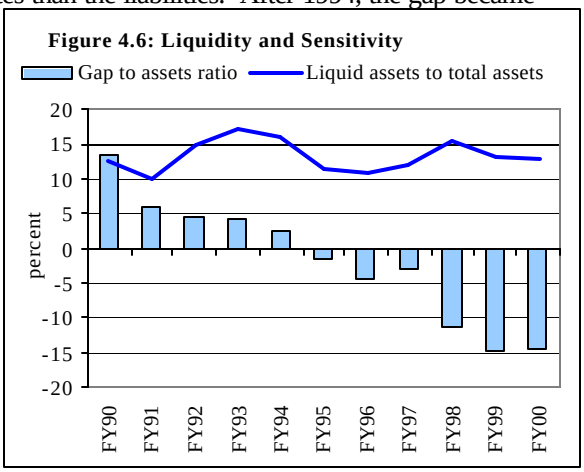
Liquidity and Sensitivity to Market Risk

Most commonly used indicator to assess liquidity position is liquid to total assets ratio. Liquid assets include cash and balances with other institutions, call money and investment in government securities. Since, NBFIs are not operating like commercial banks, their liquidity requirements are not as strapping as for commercial banks. **Table 4.4** reports various indicators to assess the liquidity position. Liquid assets to total assets ratio fluctuated in a narrow band during 1990s, indicating that the liquidity position of DFIs remained almost the same. However, other indicators like borrowing to advances and liabilities ratios indicated that DFIs heavily relied on borrowing to make investments, and loans and advances, as their borrowing to liability ratio remained above 50 percent.

Borrowing to advances and liability ratios also continued to increase over the period of analysis, pointing towards the inability of management to generate resources at a cheaper cost to meet its credit needs. Borrowing might be needed to bridge the gap between maturity of an investment and liability or to make exceptional lending to priority sectors; either way, a high ratio is not desirable.

Another important ratio used to judge liquidity position is the loans to deposits ratio, which signals the ability of a financial institution to mobilize deposits to fulfill its credit needs. However, this ratio must be interpreted with caveat for NBFIs, as certain groups of institutions were not initially mobilizing deposits. Further, most of NBFIs have a limited deposit taking authority (not of less than 30 days maturity). Therefore, deposits with NBFIs are of different nature as compared to demand deposits with commercial banks. Initially, loans to deposits ratio was very high because of their low deposit base and heavy reliance on long-term borrowing. Although liquid assets to total assets ratio remained almost stable, the increasing trend of borrowing to advances and liability ratios indicate deteriorating liquidity position.

Difference between rate sensitive assets and rate sensitive liabilities--known as the gap--is used to measure interest rate risk exposure. The gap was positive upto 1994, indicating that DFIs were asset sensitive. It means that DFIs were able to realize an increase in income if interest rate rose because more assets could be reinvested at higher market rates than the liabilities. After 1994, the gap became negative, showing that DFIs were liability sensitive in second half of 1990s. Other indicators like gap to equity ratio showed considerable variations, ranging from positive 1145.2 to negative 215.0, exceeding the test limits of prudence (+200 and –200 percent). Similarly, as can be seen from the **Figure 4.6** that gap to asset ratio varied from positive 13.3 to negative 14.9, again exceeding the prudent limit of negative 10. The ratio falls within test range[7] of +10 and –10 from FY91 to FY97 and crosses the prudence range after that, showing that DFIs are highly exposed to changes in interest rates. This has happened due to a variety of factors: freezing of foreign currency certificates of investment (COIs) and consequent decline in deposits; liquidation of advances against COIs; and unanticipated decline in short-term interest rates due to monetary policy actions of SBP to tackle the aftermath of freeze. Owing to these factors, balance sheets of NBFIs, especially DFIs and IBs, changed significantly from the asset as well as liability side. Moreover, the differing impact of variation in interest rates on assets and liabilities resulted in their gap to change its sign within a year.



Conclusion

Inadequate level of capital, poor asset quality, weak management performance, low earnings and profitability profile along with a deteriorating liquidity position are suffice to conclude overall weak financial health of DFIs. Current distressed state of DFIs is an upshot of the high level of non-performing loans, political interference in their management and business, and overall weak economic situation in 1990s.[8] In addition, increased competition in mobilizing deposits, discontinuation of credit lines from international finance institutions along with overall limited ability to generate

[7] Test range specifies the exposure of an institution towards interest rate risk. If an institution is highly sensitive to assets or liabilities, a small incorrect forecast of interest rate will result in exceptional losses to the institution. To avoid significant risk in the event of interest rate forecast, prudent limits are defined in terms of gap to equity and asset ratios.

[8] The distressed state of DFIs is not exceptional; Japan, Korea and New Zealand faced the same problems with DFIs in 1980s.

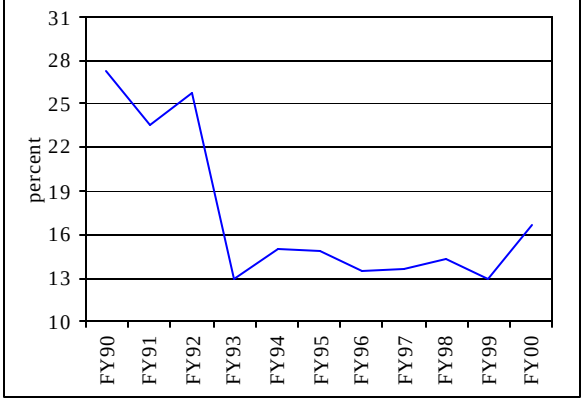
resources intensified the problem. Freezing of foreign currency accounts in FY98 also aggravated the problems. To cope with this situation, DFIs need drastic restructuring; at least minimum reforms aiming to resolve the problem of non-performing loans and concrete efforts to enhance sound management. Moreover, all DFIs must be set free from political pressure and steps must be taken to enhance their commercial business orientation along with efforts to manage these professionally and prudently.

4.1.2 Investment Banks

Investment banks (all in private sector) were established in late 1980s and early 1990s, and made rapid progress thereafter. Boom in stock exchanges, opening of FCAs along with favorable economic conditions in early 1990s contributed to speedy growth of investment banks. Total assets of investment banks witnessed sharp increase to Rs 42.1 billion in FY00 as compared to Rs 2.4 billion in FY90. As a result, their share in overall assets of NBFIs also increased significantly. The assets share of IBs increased from 1.9 percent in FY90 to 12.0 percent in FY00, indicating increased business activities of investment banks. As on end June 2000, 16 investment banks were in operation; their names along with their share in total assets are presented in **Annex 4 (**see **Table 4A. 4)**. The size of investment banks also varies considerably, as Al-Faysal and Crescent investment banks jointly hold around two-thirds of total assets.

Investment banks can undertake a wide range of business activities related to project financing and capital market, but they are not allowed to issue their own papers for less than 30 days maturity. IBs were also allowed to trade in listed securities, provide professional analysis of securities to investors, float and manage both open-end and closed-end mutual funds, and provide numerous corporate services. Due to these wide-ranging activities, IBs emerged as a new useful channel for both savers and borrowers, particularly when all banks were state-owned and lacked efficiency and quality of services. The favorable indicators like increasing share in assets, growth in deposits, and increase in loans and advances are suffice to prove the usefulness of these institutions. However, financial health review of these institutions requires detailed information about their capital adequacy, liquidity position, asset quality etc. Therefore, performance of investment banks in 1990s is evaluated with the help of CAMELS indicators.

Figure 4.7: Capital to Liability Ratio



Capital adequacy indicators of investment banks are reported in **Table 4.5**, indicating normal capital base. As shown in **Figure 4.7**, capital to liability ratio declined significantly upto FY93, mainly because of increasing liabilities (base effect). Since IBs were established in early 1990s, and as soon as business activities started to flourish, natural changes in their assets and liabilities structure occurred. In the initial years, the very high growth rates of assets and capital were due to lower base at that time. This, understandably, was not sustainable for longer period, implying a declining trend in capital to assets ratio in early 1990s, and a relatively stable trend for rest of the period, with most of the IBs well established by that time.

Table 4.5: CAMELS Indicators of Investment Banks

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	27.3	23.7	25.8	12.8	14.9	14.8	13.5	13.6	14.2	13.0	16.6
Growth rate of capital (GRC)	414.7	74.3	92.2	36.4	55.0	8.0	11.0	14.4	14.2	-1.7	7.2
Growth rate of assets (GRA)	2300.2	95.3	79.3	146.6	35.4	8.4	20.8	13.3	10.1	6.2	-13.5
Ratio of GRC to GRA	0.2	0.8	1.2	0.2	1.6	1.0	0.5	1.1	1.4	-0.3	-0.5
Asset Quality											
Earning assets to total assets ratio	82.9	84.6	84.3	83.0	84.2	84.2	79.7	81.2	75.4	74.4	74.1
NPLs to gross advances	0.0	0.0	0.0	0.0	0.7	0.7	1.6	4.2	3.8	8.1	15.7
Loan defaults to gross advances	0.0	0.0	0.0	0.0	0.2	0.2	1.4	1.9	2.7	5.2	12.0
Recoveries to total default	-	-	-	-	17.7	17.7	0.5	6.2	24.0	12.5	5.2
NPLs to total assets	0.0	0.0	0.0	0.0	0.4	0.4	0.8	2.1	1.6	3.4	5.0
Advances to earning assets ratio	86.3	88.1	74.6	75.6	71.6	63.8	64.4	62.5	65.0	57.6	43.0
Investment to earning assets ratio	13.1	11.9	25.4	24.3	26.9	34.8	34.9	37.4	34.7	41.0	56.5
Management Soundness											
Total expense to total income ratio	92.4	87.2	83.6	83.4	81.9	86.3	92.0	91.5	99.9	99.8	93.4
Earning per employee*	0.7	3.1	3.5	6.7	7.9	8.5	11.7	8.2	9.9	10.7	9.1
Operating expense per employee*	0.3	0.4	0.6	0.8	1.9	1.8	2.0	1.2	1.5	1.3	1.2
Total expense per employee	0.7	2.7	2.9	5.6	6.5	7.3	10.8	7.5	9.9	10.6	8.5
Earnings and Profitability											
Return on assets	0.7	2.0	1.9	1.7	2.5	1.7	1.0	1.1	0.6	0.9	3.5
Net interest margin	1.3	2.3	2.5	2.2	3.3	2.3	1.5	1.3	0.6	0.0	0.8
Net income to total assets	2.6	10.3	9.5	10.6	12.9	13.4	17.4	13.3	13.1	13.3	14.6
Interest income to total assets	2.5	9.8	8.7	9.7	10.6	10.9	14.6	11.6	11.8	11.8	12.5
Interest expense to earning assets	1.8	9.3	7.8	9.5	9.3	10.6	16.7	12.9	15.1	15.9	16.1
Interest income to total income	96.8	91.5	87.5	87.2	79.0	79.0	81.7	84.9	88.0	87.2	83.9
Interest expense to total expense	61.0	84.1	79.4	85.3	71.4	75.1	81.3	84.0	84.4	87.4	85.8
Provisions to total assets	0.0	0.1	0.2	0.1	0.3	0.8	0.8	0.6	1.0	0.4	1.2
Liquidity and Sensitivity											
Liquid assets to total assets	16.2	12.0	17.4	20.4	18.8	17.7	14.5	10.9	15.0	16.8	14.0
Loans to deposits ratio	93.7	101.9	89.6	80.9	80.1	71.1	63.5	65.0	63.5	56.9	50.7
Borrowing to advances ratio	0.2	4.5	7.5	11.4	12.3	12.1	4.6	6.6	10.5	16.1	42.3
Borrowing to liabilities ratio	0.2	4.2	6.0	8.1	8.5	7.5	2.7	3.8	5.9	7.8	15.7
RSA to RSL ratio	108.3	110.6	112.5	97.9	101.9	102.5	95.9	99.6	91.5	90.6	97.0
Gap to capital ratio	29.6	42.4	45.8	-15.5	12.1	16.1	-28.5	-2.4	-56.0	-67.1	-16.0
Gap to total assets ratio	6.4	8.1	9.4	-1.8	1.6	2.1	-3.4	-0.3	-7.0	-7.7	-2.3

* million Rupees

After FY93, capital to liability ratio also remained stable with little variations. The other indicators including growth rates of assets and capital also showed normal trend, except for last two years. Given the poor growth rate of capital and assets in FY99, it is apparent that some of the IBs started to face the problem of capital adequacy.

As can be seen from **Table 4.5** and **Figure 4.8**, earning assets to total assets ratio showed declining trend in 1990s, indicating the squeezing earning base. Other indicators like non-performing loans to assets and gross advances ratios have also picked up momentum in second half of 1990s that may create problems for IBs in future. In addition, increasing loan defaults to gross advances ratio combined with widely fluctuating recoveries to default ratio may further aggravate the problem.

Although investment banks have changed their lending strategies, as their loans and advances have substantially decreased in relation to earning assets, this may not be sufficient to resolve the problem. An upward trend in non-performing loans to total assets and gross advances along with increasing loan defaults to gross advances signaled deteriorating asset quality, particularly in late 1990s.

Management soundness indicators are presented in **Table 4.5** and **Figure 4.9**, indicating upward trend in earnings and total expense per employee. The operating expense per employee also displayed an increasing trend, especially in mid 1990s, indicating that investment banks might have adequately compensated their employees for inflation. The table and figure also depict that expense to income ratio continued to increase from FY94, except for FY00, demonstrating that management could not succeeded in curtailing total expenses.

Table 4.5 displays the earnings and profitability indicators of investment banks. These provide mixed type of evidence as return on assets showed an upward trend with some fluctuations, resulting in an inconsistent income stream over time. In addition, **Figure 4.10** depicts that NIM has decreased from 1.3 percent in FY90 to 0.8 in FY00, showing decreasing possibilities to make profits. Interest expense to earning assets ratio--break-even yield--has jumped up from 1.8 percent to 16.1 percent during the decade , which shows that investment banks require high interest rates to earn some profits. This is mostly due to the liquidation of foreign currency certificates of investment (COIs) and declining return from their investment portfolio. However, the situation has marginally improved in FY00, as return on assets, net income to assets ratio and NIM slightly increased. Along with freezing of foreign currency COIs, poor earnings and profitability was attributed to some weak investment banks, and overall slower macroeconomic situation. Furthermore, the fact that interest income accounted for around 80 percent of IBs total income shows that fee-based financial activities of IBs to capital market investors and corporate sector remained limited.

Figure4.8: Asset Quality Indicators

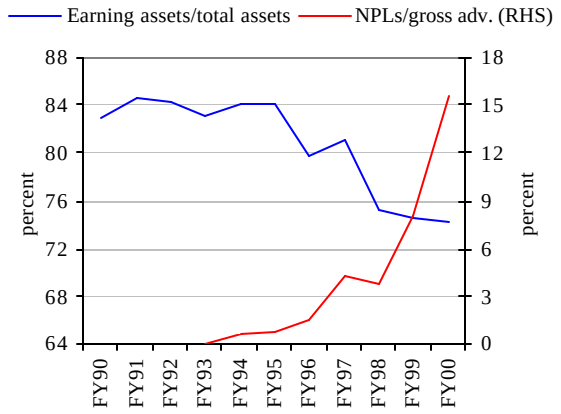


Figure 4.9: Management Soundness

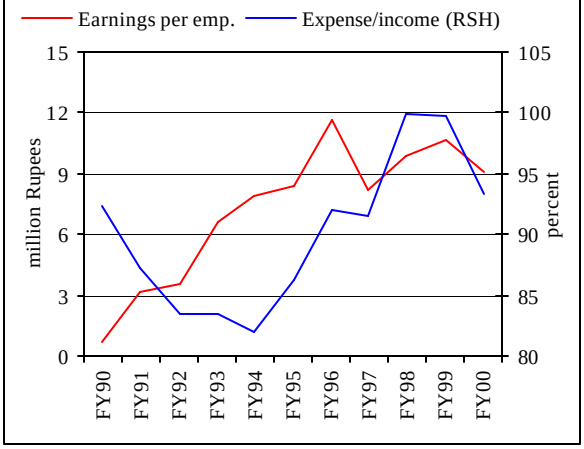
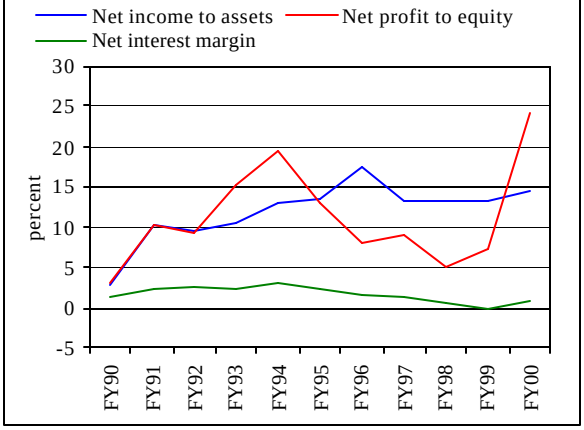
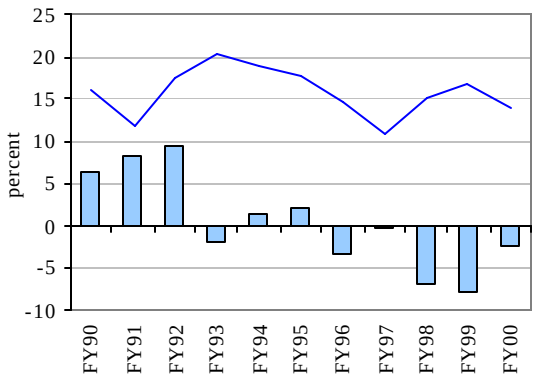


Figure 4.10: Earnings and Profitability



Liquidity indicators painted almost the same picture as in early 1990s. **Table 4.5** and **Figure 4.11** display that liquid to total assets ratio fluctuated in a narrow band and did not show any significant decline in 1990s. Another important indicator, loans to deposits ratio declined significantly, demonstrating the efforts to mobilize deposits to meet their financing requirements. It also depicts that risk exposure indicators remained within the range of test limits, reflecting prudent interest rate polices. IBs remained balanced in terms of asset and liability sensitivity as their gap to assets ratio remained within the test limits, but fluctuated around zero.

Figure 4.11: Liquidity and Sensitivity



In short, the indicators discussed above provide mixed type of analysis, as asset quality indicators show a trend of deterioration whereas liquidity indicators showed some improvement. This type of situation indicates that certain IBs are facing problems in select areas, like poor asset quality, but the intensity of the problem is not severe. However, the mounting non-performing loans may hurt investment banks in future by eroding their capital base. Recoveries of defaulted loans to total advances ratio witnessed negative trend in late 1990s, indicating the need for extra efforts from management side to cope with this problem. Furthermore, their market niche seems to have been affected particularly with the emergence of private banks, the freezing of FCAs, and limited activity of IBs in the area of project financing, a fact confirmed by some IBs in recent years merging with banks and NBFIs. In a nutshell, IBs could not perform their basic role as a promoter of project financing and provider of professional financial services to their clients.

4.1.3 Leasing Companies

The commencement of leasing business dates back to mid 1980s, when first leasing company was established in 1984. Since then leasing companies grew rapidly, particularly in late 1980s and early 1990s. Their share in business activities also increased significantly in 1990s. As already shown in **Table 4.1**, the assets share of leasing companies increased from 4.7 percent in FY90 to 11.1 percent in FY00. The driving force behind this phenomenal growth was increasing demand for corporate credit, and fiscal incentives provided to the leasing companies through depreciation allowance that reduced their current tax liabilities. The policy to introduce Islamic modes of financing in mid 1980s also played an important role in creation of leasing companies. To benefit from this favorable environment, many financial institutions and business groups set up their own leasing companies. Their focus was on special market segments like leasing of plant and machinery, vehicle leasing, and consumer durables.

As was the case with other NBFIs, leasing companies also experienced slackening of growth in late 1990s, mainly attributed to slower economic and industrial activities. Despite these adverse developments, leasing companies remained financially viable as compared to other NBFIs, mainly due to shift in their business focus toward consumer durables, like vehicle lease financing.

Performance of leasing companies also measured well in terms of key indicators. It is clear from **Table 4.6** that leasing companies enjoyed ease of capital adequacy, as their capital to liability ratio remained above 20 percent except for FY90, also indicating the ability of leasing companies to absorb shocks or unanticipated losses. In addition, this helped to build market confidence and attract new investment as well. However, this higher ratio witnessed significant decline in the second half of 1990s.

Two other indicators, growth rates of capital and growth rate of assets also recorded an increase for most of the years. The double digit growth in assets and capital was severely undermined in 1998 due to a variety of factors. Overall slower growth of the economy in late 1990s coupled with problems pertaining to the long-term resource mobilization was mainly responsible for the lower leveraging of leasing companies. That is one reason for better capital adequacy in this sector, as institutions were utilizing their own resources.

Table 4.6: Performance Indicators of Leasing Companies

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	13.2	29.3	33.4	32.5	27.3	35.3	30.4	29.9	29.1	26.9	25.1
Growth rate of capital	-	61.4	71.2	31.2	28.8	56.5	20.1	12.7	3.3	0.9	4.4
Growth rate of assets	-	-17.2	54.9	34.2	47.2	28.5	34.3	14.3	5.4	7.5	10.0
Asset Quality											
Earning assets to total assets ratio	84.8	88.2	89.2	89.8	89.6	87.3	89.4	88.5	87.1	87.3	87.0
Equity to total assets ratio	11.6	22.7	25.1	24.5	21.4	26.1	23.3	23.0	22.6	21.2	20.1
Lease finance to earning assets	85.8	90.0	89.1	90.7	90.3	89.1	89.6	89.0	87.0	87.3	87.2
Investment to earning assets	14.1	9.9	10.8	9.0	9.5	10.5	9.6	10.8	12.3	11.6	11.6
Earnings and Profitability											
Expense to income ratio	95.1	83.7	69.7	69.5	67.1	71.6	76.8	83.2	87.3	88.4	87.1
Return on Assets	2.6	3.4	4.0	4.3	5.5	4.2	3.9	2.4	1.5	1.5	1.7
Return on Equity	22.4	15.2	15.8	17.7	25.6	16.2	16.7	10.6	6.7	7.0	8.4
Operating expense to total expense	45.2	38.3	33.4	29.7	26.3	23.1	26.4	22.2	20.6	20.7	22.0
Financial expense to total expense	51.7	55.3	60.4	65.6	69.5	71.1	68.5	68.0	68.9	69.1	67.6
Provisions to total expense	3.8	7.8	9.1	7.6	7.1	8.7	7.8	9.8	10.5	10.3	10.3
Other Indicators											
Long-term liabilities to total liabilities	33.9	55.6	61.8	63.4	54.8	54.7	50.1	54.9	48.5	49.7	55.0
Long-term assets to total assets	30.9	50.4	52.2	56.0	54.3	52.3	55.8	51.6	46.3	47.7	46.3

Asset quality indicators, presented in **Table 4.6**, show that earning assets to total assets ratio remained over 80 percent for the period under consideration, fluctuating in a narrow band of 5 percentage points. This also highlights a strong earning base. Leasing companies are mainly engaged in extending lease financing, with over 85 percent earning assets locked therein. The rest of earning assets are parked in long as well as short-term investment activities. Initially, leasing companies were supposed to facilitate BMR activities of the industrial sector, with major focus on lease of plant and machinery, which constituted over 80 percent of total lease finance in early 1990s. This share later declined to around 50 percent due to slower growth in textile sector along with overall weak performance of the economy. This declining share was captured by vehicle lease finance as leasing companies changed their focus to consumer durables. The share of vehicle financing is now over 30 percent in total lease finance, indicating that these companies were able to retain good quality of assets by changing their focus of business from one sector to another.

Earnings and profitability indicators of leasing companies provide mixed evidence. Expense to income ratio, although remained lower than 100 percent during the period under consideration, witnessed persistent increase from FY94 to FY99.[9] However, this situation has marginally improved in FY00. Another important indicator, the return on assets, also declined significantly. Increasing

[9] This was the period of slower overall economic growth. At the same time, leasing companies were trying to change focus of lease finance form plant and machinery to consumer durables.

trend in other indicators like financial expense to total expense and provisions to total expense mainly drove down their profitability. Furthermore, these indicators also highlight the problem of resource mobilization. The rising portion of financial expense clearly suggests that leasing companies had to offer higher interest on certificates of investment as well as on long-term deposits. The increasing provisions against bad loans as well as investment also contributed to higher expenses and ultimately to lower profit.

Other indicators showed that long-term liabilities to total liabilities ratio increased from 33.9 percent in FY90 to 63.4 percent in FY93, which suggests that leasing companies were able to mobilize long-term resources in early 1990s. This ratio declined by around 15 percentage points from FY93 to FY98. This massive decline reflects the inability of leasing companies to generate long-term resources, which also led to higher financial expense over the same period. However, the situation slightly improved over the last two years. On the asset side, long-term assets to total assets ratio approximately followed the same path as the long-term liabilities to total liabilities ratio. This suggests that leasing companies were mostly able to match their long-term assets to long-term liabilities.

The above indicators jointly suggest that the business of leasing companies remained financially viable as a whole. However, the poor performance of some indicators like increasing financial expense to total expense, provisions to total expense, return on assets etc., provide indications of presence of some weak leasing companies. To protect the financial health of leasing companies, the minimum paid-up capital requirement was raised to Rs 200 million in 1997. The companies were asked to meet the new limit by the end of December 1999. Later on, this date was extended to 30th June 2001, as most of the companies were unable to meet the new minimum paid-up capital. Upto 30th June 2000, only nine companies were fully compliant with the new limit and this number increased to twelve on 31st December 2000. Besides this requirement, increasing competition in lease finance due to entrance of banks in this business, and proactive role of banks in SMEs may result in the merger of some leasing companies.[10] However, it is hoped that financially strong leasing companies will continue to play an increasingly vital role in overall activities of NBFIs.

4.1.4 Modaraba Companies[11]

Following leasing companies and investment banks, modaraba companies also grew rapidly in late 1980s and early 1990s. Specifically, the modaraba business came into being in July 1980 when the first modaraba company was established. Later on two other modaraba companies started business in 1985, and one in 1987. The driving force behind this growth of modaraba companies was Islamization efforts in mid 1980s, because their modes of financing were compatible with the views of Islamic Shariah. However, real impetus to modaraba business came in early 1990s, when financial market was growing in response to liberalization of the economy. Tax-free status of modaraba companies, subject to 90 percent dividend distribution, also played a critical role in the mushroom growth of these companies. Besides, modaraba companies established in 1990 to 1993 heavily benefited from the boom in stock exchanges. Furthermore, growing need of financing from corporate sector coupled with higher growth of the economy in early 1990s also contributed positively to create favorable environment for modaraba business. The wider range of financing activities of modaraba companies, including vehicles in addition to industrial machinery and other goods, also played its role. However, this smooth sailing of modaraba business was disrupted by the withdrawal of tax concession.[12]

[10] The process of mergers and issuance of right shares to meet the minimum paid up capital has been started, as Ghandhara Leasing Company Limited merged with Al-Zamin Leasing Modaraba; Ibrahim Leasing Limited with Ibrahim Modaraba; and Mercantile Leasing Cooperation Limited with Universal Leasing Cooperation.

[11] The analysis of modaraba companies is based on data from FY94 to FY00.

[12] In Finance Act 1992, modaraba companies were brought under tax net by withdrawing the exemption. However, these companies remained exempted from income tax for the first three years and taxed at the rate of 2.5 percent for another two

The number of operating companies increased from 10 to 45 over the period of analysis. Despite positive developments in early 1990s, the business activities of modaraba companies did not keep pace with growing activities of leasing and investment banking, and their share in overall assets of NBFIs only marginally increased from 3.5 percent in FY94 to 4.3 percent in FY00. As already mentioned, the prime dampener to their growth was the withdrawal of tax-free status in 1992. In this backdrop, the total assets of modaraba companies witnessed slower growth as it increased from Rs 11.8 billion in FY94 to only Rs 15.0 billion in FY00.

The performance indicators of modaraba companies painted an assorted picture. As can be seen from **Table 4.7**, the various indicators witnessed marginal improvements in the last couple of years. More specifically, modaraba companies were lucky enough to benefit from a very strong capital base, as the capital to liability ratio was over 100 percent for most of the years. This higher ratio could be explained by the fact that several modaraba companies based their financing activities on their own equity capital. Although this ratio witnessed persistent decline form FY94, it remained fairly high, indicating that modaraba companies were also facing difficulties in mobilizing long-term resources. Two other indicators, growth rate of capital and assets are also worth mentioning. Growth of capital was lower than the growth of assets, which suggests that capital base of these companies did not keep pace with the increasing assets.

Table 4.7: Performance Indicators of Modaraba Companies

percent

	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy							
Capital to liability ratio	142.2	138.7	138.2	119.2	107.7	90.5	89.4
Growth rate of capital	-	6.7	-0.7	2.8	4.1	-10.6	0.5
Growth rate of assets	-	7.8	-0.6	9.7	9.1	-2.5	1.1
Capital to Asset Ratio	58.7	58.1	58.0	54.4	51.8	47.5	47.2
Asset Quality							
Earning assets to total assets ratio	70.8	69.6	69.4	73.1	75.5	78.3	77.8
LT earning assets to total earning assets	54.3	60.7	64.9	59.2	64.3	65.9	67.4
Lease finance to earning assets	44.2	48.1	49.9	51.9	54.9	52.3	52.7
Investment to earning assets	11.9	17.4	21.2	15.2	17.5	20.8	20.8
Morabaha and Musharaka to earning assets	43.9	34.6	28.9	32.9	27.6	26.9	26.4
Earnings and Profitability							
Expense to income ratio	62.5	72.9	81.1	78.5	87.7	80.8	81.6
Return on Assets	10.7	4.9	3.3	4.4	2.2	4.6	4.6
Return on Equity	18.2	8.4	5.8	8.1	4.2	9.8	9.7
Operating expense to total expense	14.2	19.5	11.0	12.3	10.5	10.3	10.8
Financial expense to total expense	21.4	20.8	22.1	23.2	22.1	33.1	28.6
Provisions to total expense	4.3	12.3	11.9	9.4	18.7	7.6	5.8
Amortization/Depreciation	54.9	43.9	52.5	52.2	47.6	46.9	52.2
Dividend Payouts	39.5	49.7	91.6	69.7	121.1	85.4	86.7
Other Indicators							
Long term liabilities to total liabilities	15.2	17.4	39.6	35.9	44.2	44.6	42.7
Long term assets to total assets	40.2	45.0	49.0	47.5	51.9	53.3	54.4

Earning assets to total assets ratio had a moderately increasing trend over the period under consideration (see **Table 4.7**), indicating that earning capacity of these companies remained intact or marginally increased. However, this ratio should be interpreted with caveat as marginal returns on

years. After that the rate became 25 percent. Tax exemption status of modaraba companies was reviewed again in 1998 and restored for non-trading modaraba companies with effect from 1st July 1999.

earning assets have significantly declined over the same period. The portfolio of modaraba companies witnessed significant changes over the period under review. As can be seen from the **Table 4.7**, the modaraba companies were actively participating in lease financing, which in FY00 constituted over 50 percent of earning assets.[13] The share of investment in earning assets has increased while the share of Morabaha and Musharaka has significantly declined from FY94 to FY00.[14] This changing portfolio provides clear evidence that the share of risky assets (equity investment) increased in total earning assets of these companies. Furthermore, the profitability of the modaraba companies also depends heavily on the performance of equity market.[15]

Expense to income ratio has increased significantly over the period under consideration. More specifically, the ratio has surged from 62.5 percent in FY94 to 81.6 percent in FY00. This rise in the ratio stemmed from both declining income as well as increasing expenditure. The former was the upshot of overall slower economic growth along with weak performance of equity markets in late 1990s. Furthermore, declining capital gains on investment in equity market also resulted in lower growth in income. On expenditure front, despite almost stagnant operating expenses the growth in total expenditure was more visible. The push factors were increasing financial charges, higher provisions for bad debts and for diminishing value of investment in capital market. All these factors can easily be observed from **Table 4.7**. The higher provisions on investment in capital market are of vital concern and its roots date back to early 1990s when stock market was at its peak. The modaraba companies entered the market at that time and bought shares at high prices. When stock market collapsed, these companies were unable to off load their holdings to a large extent. This resulted in a large number of sick modarabas holding shares that were bought at higher prices. This can also be seen from increasing provisions against diminishing value of investment, which is one of the major push factors for higher expenditures.

Furthermore, the funds locked in equity investment also created a resource problem. Given the weak performance of equity market and limited ability of modarabas to mobilize funds, the tight regulations also played a role as modaraba companies with credit rating less than B-3 could not borrow from the banking system. Furthermore, instruments approved by Religious Board are also not acceptable for bank borrowing. This situation forced these companies to borrow at higher rates, which resulted in higher financial charges leading to higher expenditures.

Two other ratios, long-term liabilities to total liabilities and long-term assets to total assets have increased considerably from FY94 to FY00. The former shows that modaraba companies were able to attract long-term resources but at a very high cost as the financial expense to total expense was also increasing over the same period. While the latter suggests that modaraba companies have locked their assets for longer time.

In sum, the overall performance of modaraba companies was affected by the withdrawal of tax-free status granted to them earlier. Due to this reason, the business growth of modaraba companies was quite limited from FY94 to FY00. An additional dampener to modaraba companies came from weak position of stock exchanges as compared to early 1990s. The overall weak performance of the economy in the second half of 1990s compared to first half also played a role.

4.1.5 Housing Finance Companies

Like DFIs, HFCs were also on losing end, as their share in total assets of NBFIs declined from 12.3 percent in FY90 to just 6.3 percent in FY00. Although total assets of HFCs increased from Rs 16.5

[13] In FY00, around 70 percent of leased out assets were in plant and machinery, while the rest were motor vehicle lease.

[14] Like modaraba, morabaha and musharaka are different Islamic modes of financing. For definitions, see Faruqi, Shakil "Glossary: Banking and Finance" Institute of Bankers Pakistan, Second edition June 2001.

[15] The modaraba companies are allowed to invest 20 percent of their capital in equity market.

billion to 22.3 billion over the period, the growth was lower as compared to other NBFIs like investment banks and leasing companies.

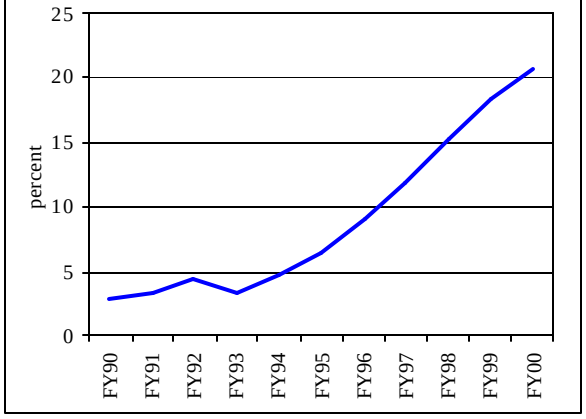
Before the emergence of new housing finance companies, HBFC enjoyed monopoly power in housing finance, as commercial banks were not allowed to enter into these activities. The share of HBFC is over 95 percent in overall assets of HFCs. The history of HBFC dates back to 1952, when it was established to cater the needs of housing finance sector. In 1990s, three new housing companies were established, but held a meager share in total assets of HFCs and still trying to find their niche. Asset shares of these companies are presented in **Table 4.8**, indicating that new entrants remained unable to provide any major break-through in housing finance.

Table 4.8: Asset Shares of Housing Finance Companies

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Total assets (billion Rupees)	16.5	16.7	17.9	18.6	18.9	19.4	20.2	20.4	21.3	21.5	22.3
Growth rate (percent)		1.5	6.6	4.0	2.0	2.6	3.7	1.0	4.6	1.1	3.3
Asset shares (percent)											
HBFC	100.0	100.0	99.4	98.7	97.7	97.0	94.1	94.6	95.2	95.9	96.9
LTV Housing Finance Ltd	-	-	-	-	-	0.3	0.2	0.2	0.2	0.2	0.2
International Housing Finance Ltd	-	0.0	0.0	0.4	0.3	0.3	2.0	2.0	1.9	2.0	1.8
Citibank Housing Finance Co. Ltd	-	0.0	0.6	0.9	2.0	2.5	3.6	3.1	2.7	1.8	1.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

The financial health of HFCs is evaluated with the help of CAMELS framework, indicating overall normal position of HFCs. Capital adequacy indicators presented in **Table 4.9**, showed considerable improvement in 1990s in terms of their capital to liability ratio, which increased from 2.8 percent in FY90 to 20.6 percent in FY00. **Figure 4.12** displays that capital to liability ratio witnessed a persistent increase from FY93. In addition, growth rate of capital remained higher than the growth rate of assets, indicating the efforts to improve their capital base. Despite all these positive indicators, the growth of assets remained very slow, which also explains the declining share of HFCs in overall assets of NBFIs.

Figure 4.12: Capital to Liability Ratio



Contrary to adequate level of capital, asset quality indicators painted a pale picture. As shown in **Table 4.9**, non-performing loans to total assets ratio showed a significant increase in 1990s, doubling in just five years. The problem is further intensified, when analyzed in the context of earning assets to total assets ratio, which has also declined from 90.8 percent in FY90 to 78.2 percent in FY00.

In addition, continuously increasing non-performing loans to gross advances ratio indicates the squeezed earning base of HFCs. **Figure 4.13** shows that NPLs to total assets and gross advances are constantly growing, which may hurt the HFCs in near future. Although capital to assets ratio is increasing, this trend does not seem sustainable. In brief, the asset quality of HFCs has deteriorated considerably because of increasing non-performing loans, but strong capital base may help to honor their liabilities in near future. Over the period under review, the composition of earning assets has drastically changed, as the share of investment in total earning assets has increased from 3 percent in FY90 to 34.5 percent in FY00. This also implies that HFCs were not extending loans to housing

sector (for which these companies were created) but diverting their resources towards investment. This is reinforced when seen in the context of declining earnings to total assets ratio.

Figure 4.13: Asset Quality

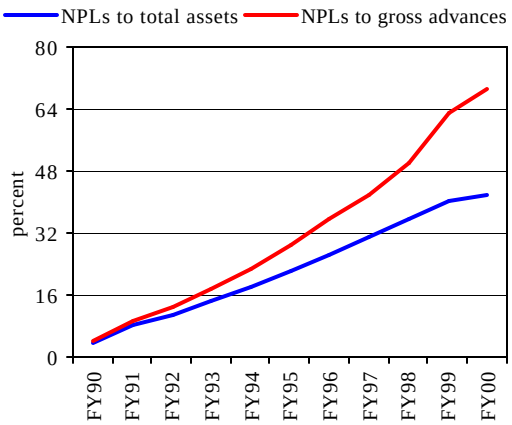


Figure 4.14: Management Soundness

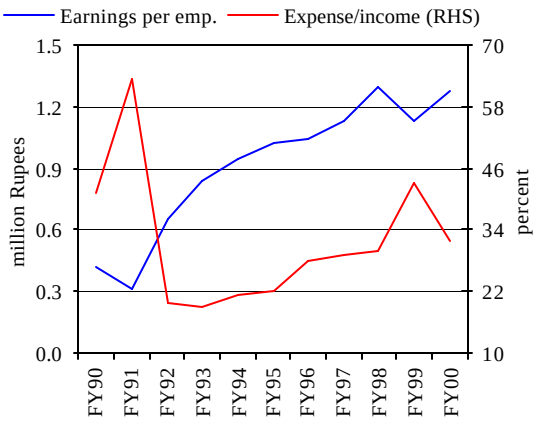


Figure 4.15: Earnings and Profitability

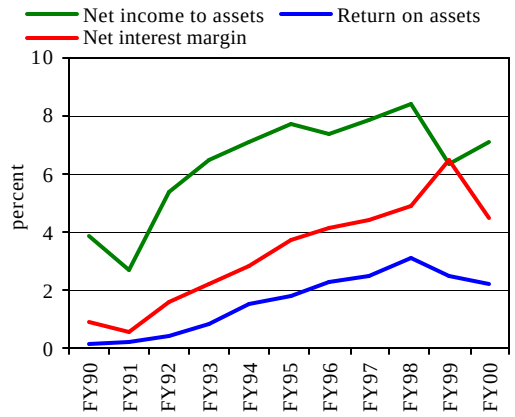
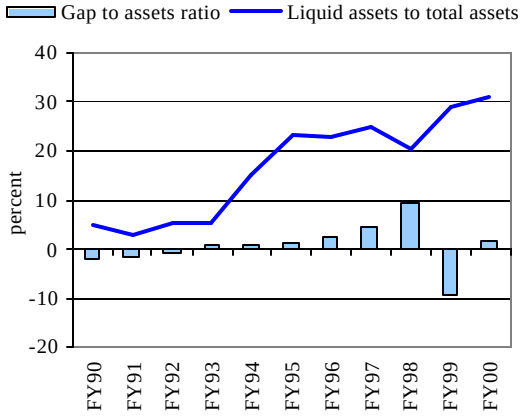


Figure 4.16: Liquidity and Sensitivity



Management soundness indicators are reported in **Table 4.9**, which provide some evidence of their cost effective policies, as total expense per employee are significantly lower as compared to earnings per employee. As can be seen from **Table 4.9**, the gap between earnings and total expense per employee was almost constant except for few years, indicating the management efforts to generate consistent income stream for the institutions. Operating expense per employee also remained constant upto FY97; marginal increase afterwards might be attributed to inflation compensation to employees in late 1990s.

Earnings and profitability indicators as shown in **Table 4.9** portray a strong earning profile in 1990s, as return on assets and interest income to total assets increased significantly. In addition, NIM has also increased from 0.9 percent in FY90 to 4.5 percent in FY00, reflecting the strong possibilities to earn profit. Interest expense to total assets ratio--break-even yield--remained below one percent, showing that profit earnings capability of HFCs have increased even at lower interest rates. **Figure 4.15** displays the rising trend of earnings and profitability indicators, with some fluctuation toward the end of the decade. Although provisions for loan losses to assets ratio have increased considerably, huge non-performing loans may hurt these institutions in future.

Table 4.9: CAMELS Indicators of Housing Finance Companies

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	2.8	3.3	4.4	3.4	4.6	6.4	9.1	11.9	15.2	18.3	20.6
Growth rate of capital (GRC)	7.5	18.2	39.3	-18.9	37.6	39.0	43.9	29.5	29.8	18.6	13.8
Growth rate of assets (GRA)	7.9	1.5	6.6	4.0	2.0	2.6	3.7	1.0	4.6	1.1	3.3
Ratio of GRC to GRA	1.0	12.1	5.9	-4.7	18.6	14.8	11.8	28.8	6.5	16.5	4.1
Asset Quality											
Earning assets to total assets ratio	90.8	91.8	89.5	89.7	90.0	88.4	89.4	89.8	90.6	70.1	78.2
NPLs to gross advances	4.3	9.2	13.2	17.7	22.6	29.2	35.8	41.8	50.4	62.9	69.3
NPLs to total assets	3.8	8.2	11.1	14.6	18.1	22.1	26.4	30.9	35.8	40.0	41.7
Advances to earning assets ratio	97.0	95.5	90.7	87.6	84.0	80.0	75.5	74.1	69.3	77.6	65.5
Investment to earning assets ratio	3.0	4.5	9.3	12.4	16.0	20.0	24.5	25.9	30.7	22.4	34.5
Management Soundness											
Total expense to total income ratio	41.3	63.4	19.7	19.3	21.4	22.1	27.9	29.5	30.3	43.2	31.8
Earnings per employee*	0.4	0.3	0.7	0.8	1.0	1.0	1.0	1.1	1.3	1.1	1.3
Operating expense per employee*	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4
Total expense per employee	0.2	0.2	0.1	0.2	0.2	0.2	0.3	0.3	0.4	0.5	0.4
Earnings and Profitability											
Return on total assets	0.1	0.3	0.5	0.9	1.5	1.8	2.2	2.5	3.1	2.5	2.2
Net interest margin	0.9	0.6	1.6	2.2	2.9	3.7	4.1	4.4	4.9	6.5	4.5
Interest income to total assets	0.9	0.6	1.5	2.0	2.8	3.6	4.2	4.8	5.0	5.1	3.9
Net income to assets ratio	3.9	2.7	5.4	6.5	7.1	7.8	7.3	7.8	8.4	6.4	7.1
Interest expense to earning assets	0.1	0.0	0.1	0.1	0.2	0.3	0.6	0.9	0.7	0.8	0.5
Interest income to total income	22.1	20.7	25.6	28.6	35.0	41.5	49.8	52.6	51.0	67.4	47.5
Interest expense to total expense	4.0	2.3	5.4	5.1	11.0	15.9	21.6	29.7	20.3	16.7	13.9
Provisions for loan losses to total assets	1.0	4.8	5.8	6.4	7.0	7.6	8.6	9.7	10.5	11.6	11.3
Liquidity and Sensitivity to Market Risk											
Liquid assets to total assets	4.7	2.9	5.3	5.1	15.2	23.4	22.9	24.6	20.5	29.0	30.8
Borrowing to advances ratio	105.6	106.6	111.4	113.1	118.0	123.5	127.5	127.2	128.4	144.0	148.0
Borrowing to liabilities ratio	95.7	96.6	94.4	91.9	93.3	92.8	93.9	94.8	92.9	92.7	91.4
RSA to RSL ratio	97.6	98.2	99.0	100.9	100.9	101.0	102.9	105.3	111.8	88.3	102.3
Gap to capital ratio	-80.5	-51.8	-22.2	25.0	17.3	14.0	30.8	42.5	72.3	-59.9	10.2
Gap to total assets ratio	-2.2	-1.7	-0.9	0.8	0.8	0.8	2.6	4.5	9.6	-9.3	1.7

*: million Rupees

HFCs enjoyed the ease of liquidity position because of high liquid assets to total assets ratio as shown in **Table 4.9** and **Figure 4.16**. The ratio has increased from 4.7 percent in FY90 to 30.8 percent in FY00. An interesting indicator is borrowing to advances ratio, which consistently remained over the mark of hundred percent during the period under review. This implies that HFCs are borrowing not only to finance their loans and advances but also to make other assets. This also suggests that the HFCs do not have their own resource base to finance higher demand of housing sector. Borrowing to liability ratio of over 90 percent also strengthens this point.

The sensitivity indicators portray a reasonable picture, as interest/markup policies remained effective. The gap to equity and assets ratios fluctuated within the test limits. In addition, difference between rate sensitive assets and rate sensitive liabilities did not follow any systematic pattern, indicating efforts of these companies to remain at balance, i.e. neither asset sensitive nor liability sensitive.

As a whole, increasing capital base, strong earning profile, easy liquidity position combined with prudent interest rate/markup policies indicate normal financial health of HFCs. However, these indicators do not reflect the true picture of HFCs as the deteriorating asset quality along with very high borrowing to liability ratios suggest that the financial health of HFCs is far from normal. The strong profitability indicators look contradictory when jointly seen with asset quality indicators. This might be attributed to two factors; first, these institutions might have classified the income against non-performing loans in receivable income, instead of showing in suspense account; and secondly, the poor asset quality might affect the profitability of the institution with some time lag. However, the first case is more likely, as the higher income may seem to be enhancing the performance of management and profitability indicators.

4.1.6. Mutual Funds

The history of mutual funds in Pakistan dates back to early 1960s, when National Investment Trust Limited (NIT) was established to manage an open-end mutual fund. In the second half of the decade, the government established another institution named Investment Corporation of Pakistan (ICP) to float and manage closed-end mutual funds. [16] On 30th June 2000, the total holding of mutual funds industry stood at Rs 30.4 billion, with 8.6 percent share in overall assets of NBFIs. As ICP and NIT deal with entirely different type of mutual funds, it is therefore necessary to analyze the closed-end and open-end mutual funds separately.

NIT is the largest open-end mutual fund in Pakistan, operating with the objective to cater long term investment requirement of the investors and play its role in the development of capital markets. NIT's open-end fund of size Rs 20.6 billion in FY00 represents over 98 percent of total open-end funds in the country. [17] NIT fund, which depicted a mixed growth performance over the decade, continued to dominate the open-end funds. As can be seen from **Table 4.10**, NIT fund recorded massive growth in first half of 1990s, as the size of the fund surged to Rs 52.1 billion in FY94 as compared to Rs 17.8 billion in FY91. This phenomenal growth, besides overall conducive environment of equity market, was largely driven by higher dividend payouts. In addition to this, capital gains in terms of higher price of NIT units were obviously contributing to this positive end.

Table 4.10: Key Statistics of NIT Open-end Mutual Fund

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Par value (Rupees)	10	10	10	10	10	10	10	10	10	10
Dividend payout (Rupees)	-	-	2.25	2.35	2.35	1.50	1.00	1.30	1.00	1.10
Net asset value (Rupees)	-	-	-	-	14.43	13.83	12.02	6.53	7.64	10.69
Capital (bln Rupees)	15.6	30.5	28.9	46.3	32.8	34.0	24.9	11.0	12.7	16.9
Size of fund (bln Rupees)	17.8	33.8	33.4	52.1	39.0	38.2	29.0	16.1	16.2	20.6

This massive growth in first half of 1990s witnessed sharp reversal in the second half, as NIT units started loosing its net asset value following the weak performance of equity markets. However, the situation has marginally improved in the last couple of years.

The financial health of National Investment Trust Limited (NITL), which manages NIT open-end mutual, closely followed the performance of this fund; impressive growth in early 1990s and deteriorating position later. Total equity of the company increased from Rs 56 million in FY90 to Rs 417 in FY94 and witnessed a sharp decline to reach Rs 115 million in FY98. Although equity position slightly improved in last two years, it was far below the level achieved in FY94. The income

[16] Specifically, NIT was established in 1962, while ICP in 1966.

[17] The government notified Asset Management Rules in 1995 to promote open-end funds in the country. Following this, Unit Trust of Pakistan (an open-end fund) was established in 1997. As already mentioned, NIT holds over 98 percent of open-end funds, therefore, private open-end funds have yet to carve their niche.

of the company also followed almost the same pattern as that of equity and the size of open-end fund, indicating that management fee was the prime source of income for the company. Compared to income trend, the total expense of the company continued to increase upto 1996. After declining in 1997, an upsurge in FY98 occurred on account of Golden Handshake Scheme (GHS).

Investment Corporation of Pakistan (ICP) is managing closed-end funds. Upto June 2000, ICP has floated 26 closed-end mutual funds, whereas the first was launched in June 1967. ICP enjoyed monopoly status in the establishment of closed-end mutual funds until 1981 when the government allowed the private sector to establish and manage closed-end funds. The first closed-end fund in private sector named Golden Arrow was established in 1983. By FY00, the number of closed-end funds launched and managed by the private sector increased to 13. Contrary to this increase in number of funds, the share of private sector mutual funds remained very low, as the ICP-managed funds represent over 75 percent of total closed-end funds in Pakistan.

The performance indicators of closed-end funds are shown in **Table 4.11**, which shows that ICP managed funds performed relatively better compared to private sector. Net asset value of privately managed funds was as low as Rs 5.10 in FY99 against par value of Rs 10. However, the situation improved considerably in FY00. Besides other factors, the private mutual fund business did not commence at a favorable time, as most of the funds were established in second half of 1990s. Nevertheless, closed-end mutual funds managed by ICP remained financially viable, as the net asset value of these funds (in totality) was higher than the par value of Rs 10. Compared to this, the private mutual fund business is still in its infancy.

Table 4.11: Key Statistics of Closed-end Mutual Funds

	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Number of funds	23	25	29	37	39	39	39	39	39
Managed by ICP	21	23	23	26	26	26	26	26	26
Private	2	2	6	11	13	13	13	13	13
Dividend payouts by funds (Numbers)									
Managed by ICP	21	21	23	23	23	21	21	15	15
Private	2	2	0	0	0	2	2	4	6
Net asset value (Rupees)	121.27	92.34	77.15	77.46	46.95	28.65	9.11	9.22	13.86
Managed by ICP	129.58	97.85	91.20	103.56	66.22	39.67	10.96	11.36	17.07
Private	12.81	8.86	10.19	10.34	9.60	7.32	5.51	5.07	7.64
Listed capital (mln Rupees)	1,981	2,281	2,831	4,361	4,761	4,761	4,761	4,761	4,761
Managed by ICP	1,840	2,140	2,340	3,140	3,140	3,140	3,140	3,140	3,140
Private	141	141	491	1,221	1,621	1,621	1,621	1,621	1,621
Net assets (mln Rupees)	24,024	21,064	21,841	33,782	22,351	13,641	4,335	4,389	6,600
Managed by ICP	23,843	20,939	21,341	32,519	20,795	12,455	3,442	3,568	5,361
Private	181	125	500	1,263	1,556	1,186	893	821	1,239

In contrast with the performance of ICP-managed funds, ICP performed poorly. The total assets of ICP almost doubled from Rs 2.4 billion in FY90 to Rs 4.6 billion in FY97 but witnessed a sharp decline during the last three years reaching a level of Rs 2.6 billion in FY00. Following the same pattern, the equity of the company increased to Rs 613 million in FY97 as compared to Rs 280 million in FY90. In sharp contrast with the earlier performance, the ICP became technically insolvent in FY98, as it showed a negative net worth of Rs 633 million.

As already mentioned, the net asset value of closed-end mutual funds managed by ICP was higher than Rs 10 while dividend was also announced by 15 funds, indicating that mutual fund business of ICP seemed to be financially viable. Therefore, the poor performance of ICP could mainly be

attributed to its other business activities like project loan program, deposit schemes etc. Non-performing loans of ICP touched the level of Rs 1.5 billion in FY00 against Rs 0.8 billion in FY90, a further threat to ICP financial health.

Due to the poor performance of ICP and NITL, the government has ordered the proceedings for the winding up of ICP and the funds managed by ICP are being handed over to prospective buyers through privatization. Similarly, NIT is also expected to be privatized.

4.1.7 Discount Houses

Discount houses, which are only allowed to undertake discounting and related services in the country, hold a tiny share in overall business activities of NBFIs. Only three discount houses were in operation in FY00 and these jointly held assets of Rs 1.3 billion as compared to Rs 0.9 billion in FY90. **Table 4.12** shows that total assets of discount houses displayed a considerable variation over the period of analysis. The discounting activities also varied considerably along with the interest income. In spite of this erratic behavior, these institutions remained profitable. Discount houses are relatively new entrants in the market and still trying to position themselves. Their activities are likely to flourish with the passage of time.

Table 4.12 Discount Houses

million Rupees

	Assets	Discounting	Interest income	Net profit
FY90	929	11	74	4
FY91	1103	102	121	23
FY92	816	268	126	31
FY93	1276	691	162	49
FY94	778	344	126	56
FY95	812	445	63	26
FY96	976	568	152	57
FY97	1524	902	227	49
FY98	1603	808	270	94
FY99	1601	924	239	77
FY00	1312	713	218	78

4.1.8 Venture Capital Companies

Venture capital companies held less than one percent of total assets of NBFIs, being relatively new entrants in the market as compared to other NBFIs. Focused nature of their business activities, along with overall slower economic growth in late 1990s might have restricted the expansion of these institutions. Although VCCs could not increase their market activities as compared to investment banks and leasing companies, these institutions seemed to have performed prudently. Total assets of VCCs stood at Rs 105 million in FY92, which increased to Rs 1027 million in FY00, indicating healthy growth. **Table 4.13** depicts that investment activities of VCCs have also increased over the same period. However, net profit of these companies remained volatile from FY92 to FY00 indicating their vulnerabilities.

Table 4.13: Venture Capital Companies

million Rupees

	Assets	Investment	Net profit
FY92	105	70	-
FY93	121	105	11
FY94	137	86	26
FY95	134	97	0
FY96	133	106	5
FY97	629	570	20
FY98	1251	1036	9.2
FY99	1265	899	22
FY00	1027	743	-130

4.2 Performance of CDNS in 1990s

The National Savings Schemes (NSS) provided much needed receipts to bridge the gap between government expenditures and revenues (budget deficit), particularly from FY94. The receipts from NSS as percent of budget deficit ranged from 35.1 percent to 72.3 percent with an average of 43.6 percent[18], which implies that NSS were the major source of deficit financing (see **Table 4.14** and **Figure 4.17**). Higher reliance on NSS receipts for deficit financing is justified on grounds of being

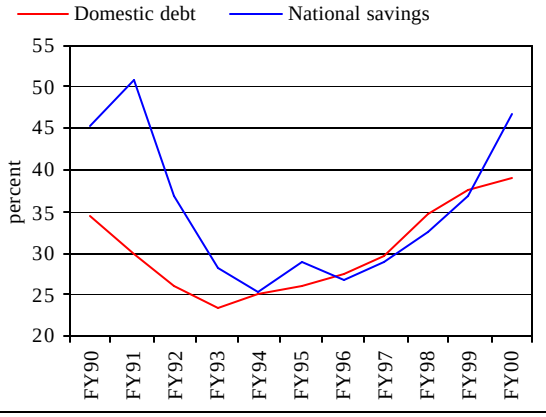
[18] Data from FY94 to FY00 are used to calculate the average.

less inflationary compared with other sources.[19] The National Savings Schemes also played a crucial role in generating savings in the economy. The share of NSS in national savings ranged from 1.9 percent to 39.9 percent, with an average of 15.7 percent.

Table 4.14: National Saving Schemes

	As Percent of			
	Domestic debt	**Budget deficit**	**National savings**	**GDP**
FY90	37.5	31.8	14.6	15.4
FY91	4.0	3.1	1.9	13.2
FY92	5.3	4.7	2.1	11.5
FY93	6.4	5.0	2.9	10.8
FY94	34.1	35.1	13.2	11.2
FY95	35.1	32.4	12.6	11.2
FY96	37.8	30.5	16.8	11.8
FY97	43.8	37.6	20.6	12.7
FY98	74.0	49.4	25.8	15.4
FY99	51.7	72.3	39.9	18.5
FY00	48.6	44.8	21.9	19.9

Figurte 4.17: Share of NSS in Domestic debt and National Savings



4.2.1 Savings Mobilization

Total outstanding amount in NSS stood at Rs 633.8 billion as on end June 2000 compared with Rs131.9 billion in 1990, showing a compound annual average growth rate of over 15 percent. This massive growth in NSS, except in FY91 and FY00, was the upshot of policy changes during the decade under review.

Amount received under NSS drastically declined in 1991 to Rs 2.8 billion as compared to Rs17.8 billion in 1990. This massive decline in NSS receipts was attributed to the discontinuation of Khas Deposit Certificates. Being the prime contributor to NSS receipts, Rs29.8billion maturity/ encashment of Khas Deposit Certificates in 1991 and in the following two years led to lower receipts in NSS in early 1990s. Furthermore, the receipts in newly introduced Special Saving Certificates (registered/bearer) could not offset the impact of the ban on Khas Deposit Certificates. In 1993, the CDNS introduced a new instrument named Regular Income Certificate to boost receipts from NSS. This newly launched instrument along with massive decline in maturity/encashment of Khas Deposit Certificates and better investment in SSCs contributed to upsurge in NSS receipts in 1994 (see **Table 4A.10** in **Annex 4**).[20] Besides, increased rate of profit also exerted a favorable impact on NSS. Later on, a substantial increase in NSS receipts in FY98 and onward was the result of increase in profit rates in FY97. However, increase in profit rates proved disastrous for domestic debt management as discussed in **Section 6.4**.

4.2.2 Yield Structure of National Savings Schemes

Yield structure of national savings schemes is reported in **Table 4.15**, which partially explains why people were investing more and more in these schemes. The profit rates on different savings schemes were totally administered and despite the efforts toward the end of decade to bring these rates in line with term structure of other interest rates, these remained very high. There was no mechanism to adjust these rates according to the determinants of overall interest rate structure in the economy. The intensity of high profit rates can be gauged from the fact that real profit rate (adjusted for inflation) on DSCs ranged from 2.9 percent to 11.4 percent, even higher than the weighted average lending rates on advances. The higher profit rates on NSS investment along with lower deposit rates in banking sector played a crucial role in diverting funds to NSS, which is known as the process of dis-intermediation.

[19] Other sources of financing include external and bank borrowing.
[20] Data on various National Saving Schemes are presented in **Table 4A.10** in **Annex 4**.

The role of NSS in increasing national savings in the economy and in generating less inflationary receipts for deficit financing seemed impressive. However, NSS created tremendous problems for the rest of the economy. The first and foremost area of prime concern is the profit structure of NSS.

Table 4.15: Interest Rate Structure in Pakistan

percent as on end June

	Deposit rates*	Lending rates*	T-bill rate	DSC	SSC-R	RIC	Saving accounts	Mahana amdani accounts
Nominal interest rates								
FY90	8.2	10.6	6.0	15.6	-	-	10.0	14.9
FY91	6.0	10.8	6.0	15.6	-	-	10.0	14.9
FY92	6.4	13.2	11.3	15.6	13.6	-	10.0	14.9
FY93	6.1	13.3	12.3	15.6	13.6	13.8	10.0	14.9
FY94	6.2	13.7	12.4	16.0	13.7	13.8	11.0	14.9
FY95	6.3	13.7	11.7	16.0	14.9	14.6	11.0	14.9
FY96	6.4	14.4	12.8	16.0	15.8	14.6	11.0	14.9
FY97	6.8	14.6	15.5	18.0	16.9	18.0	13.0	14.9
FY98	6.8	15.6	15.0	18.0	16.9	18.0	13.0	14.9
FY99	6.5	14.8	12.9	16.0	14.7	16.0	11.0	14.9
FY00	5.5	14.5	8.7	15.0	12.6	14.0	8.8	14.9
Real interest rates								
FY90	2.2	4.6	0.0	9.6	-	-	4.0	8.9
FY91	-6.7	-1.9	-6.7	2.9	-	-	-2.7	2.2
FY92	-4.2	2.6	0.7	5.0	3.0	-	-0.6	4.3
FY93	-3.7	3.5	2.5	5.8	3.8	4.0	0.2	5.1
FY94	-5.1	2.4	1.1	4.7	2.4	2.5	-0.3	3.6
FY95	-6.8	0.7	-1.3	3.0	1.9	1.6	-2.0	1.9
FY96	-4.4	3.6	2.0	5.2	5.0	3.8	0.2	4.1
FY97	-5.0	2.8	3.7	6.2	5.1	6.2	1.2	3.1
FY98	-1.0	7.8	7.2	10.2	9.1	10.2	5.2	7.1
FY99	0.8	9.1	7.2	10.3	9.0	10.3	5.3	9.2
FY00	1.9	10.9	5.1	11.4	9.0	10.4	5.2	11.3

*: Weighted average

The higher profit rates on NSS have diverted deposits from banking sector to these lucrative instruments and resulted in lower deposit base of the banks, particularly in late 1990s. This was in fact a reinvigoration of financial repression and went against the basic objective of financial reforms. The administered nature of profit structure of NSS was mainly responsible for distortion in the term structure of interest rates. Nominal returns offered on any instrument should depend on maturity period, the frequency of interest payments, degree of anonymity of ownership of instrument, rate of inflation, tax on interest payments and credit worthiness of issuer. Therefore, the differentials between NSS profit rates and banks' deposit rates should not be very high. The need to rationalize the profit structure of NSS in line with the banking sector of the economy was therefore imperative.

Several steps were, consequently, initiated in this direction. Rates of returns on various certificates were reduced in FY99 and again in FY00. The most important step was the introduction of a new long-term bond (Pakistan Investment Bond) in December 2000. The resulting yields on ten year PIB are being used to price long-term NSS instruments (especially Defense Saving Certificates) from January 2001. Furthermore, the government also imposed a 10 percent withholding tax on profits from NSS with effect from July 1, 2001, to bring uniformity in tax treatment of government securities.

Higher profit rates on NSS had negative implications for domestic debt servicing as shown in **Section 6.4**. No doubt, NSS provided much needed receipts to bridge the gap between government revenues and expenditures, but at a very high cost. Moreover, the downward rigidity of government expenditures is also mainly attributed to increasing debt servicing, which has emerged as the major macroeconomic imbalance in the economy.

Another problem generated by NSS is the difficulty in management of public debt. The tap nature of NSS along with early encashment facility reduced the government's control over flow of funds in these schemes. For example, higher amount in NSS as compared to budget estimates results in unnecessary realization of higher public debt. Similarly, lower mobilization in NSS against budget target leaves the government with no option but to resort to short-term borrowing at high interest rates. Needless to say, the higher borrowing cost of the government and lower deposit base of the banking sector along with debt management problems are not beneficial for long-term growth of the economy. Therefore, this should be an area of prime concern for policy makers.