8 PERFORMANCE AND RISK REVIEW OF THE NON-BANK FINANCE SECTOR

8.1 Overview

The key market players in the non-bank financial sector of Pakistan are Non-banking Finance Companies (NBFCs), mutual funds, modarabas and Development Finance Institutions (DFIs). As of the end of (financial year) FY06,[1] the size of the non-bank financial sector was Rs. 462.3 billion in terms of total assets and 188 in terms of the number of operative entities. Relatively, its assets were a mere 6 percent of GDP and constitute 7.9 percent of total assets of the financial sector, while its deposits formed 2.3 percent of the total deposits mobilized by the financial sector.

The major objective of the introduction of the concept of 'NBFCs' i.e. Non-Banking Finance Companies in 2002,[2] was to enable the existing (largely) single-product institutions serving specific market niches, to offer a whole variety and range of financial products through a one window operation akin to universal banking, subject to compliance with the prescribed progressively-tiered regulatory requirements. These financial products include: (i) investment finance services; (ii) leasing; (iii) housing finance services; (iv) venture capital investment; (v) discounting services; and (vi) investment advisory and asset management services. Previously, these various financial services were being offered by a number of small, fragmented companies. It was expected that consolidation of different financial services under one umbrella would lead to the emergence of stronger, well-capitalized entities, which will provide a fillip for the future development of the non-bank financial sector.

The emergence of the NBFC regime has, to a large extent, facilitated consolidation within the non-bank financial sector, in addition to cross-sectoral mergers with commercial banks, although there is still considerable scope for further amalgamation between smaller entities in the sector. However, the role of the NBFC model in shaping growth opportunities for non-bank financial services, particularly fund-based activities, has been rather debatable. The performance of the sector, other than that of investment advisory and asset management, has been meager and there are rising concerns about the viability of the leasing, investment finance and discounting services, as well as the under-performance of the housing finance and venture capital industries.

These concerns are particularly based on the stiff competition faced by NBFCs from the banking industry. Banks have access to low cost funds and a flexible operating environment, whereby they can offer, among a range of financial products, consumer finance products – in the shape of auto loans, personal loans, housing finance and credit cards – directly, and fund management indirectly through incorporated subsidiaries. As a result, banks have reported burgeoning growth from non-traditional activities. During FY06, banks' net investment in leasing was more than Rs. 80 billion, which surpassed the investment of leasing companies by Rs. 30 billion. Similarly, the banking sector had a mortgage loans' portfolio of Rs. 49.13 billion by the end of CY06 as compared to the outstanding housing finance facilities of Rs. 12.57 billion provided by NBFCs and House Building Finance Corporation (HBFC) together during FY06. Moreover, the operating environment for NBFCs has also become difficult due to the active involvement of brokerage firms in underwriting and capital market advisory activities.

Modarabas on the other hand have been in existence for more than two and a half decades and were the pioneer Islamic financial institution in the country. However, the sector has suffered from structural inefficiencies, constraints in resource mobilization and a proliferation

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[1] Financial year (FY) varies across the non-bank financial sector, whereas the financial year of the banking sector is based on the calendar year (CY). The term FY is used interchangeably for both Fiscal Year and Financial Year.

[2] Companies Ordinance, 1984 was amended in October 2002 (Companies (Amendment) Ordinance, 2002) to include Non-Banking Finance Companies in the definition of "financial institutions" and again in November 2002 (Companies (Second Amendment) Ordinance, 2002) to insert a chapter providing for establishment and regulation of NBFCs.

of small entities. On the product side, modarabas have not been innovative; instead, their funds are largely invested in leasing and lending activities, despite considerable flexibility available under the legal framework to engage in any form of business (financial or non-financial) as long as it is not opposed to the injunctions of Islam. While the sector managed to survive in a high growth, low interest rate scenario, there is concern about the future direction and role of modarabas, particularly in the face of rigorous competition from both Islamic and conventional banks and rising interest rates.

The issues surrounding NBFCs and modarabas pose significant challenges for sustaining growth in the non-bank financial sector, unless remedial measures are taken to enhance market outreach, promote product innovation, increase capitalization and restructure the under-developed segments. In the area of product development, the increasing focus of the Securities and Exchange Commission of Pakistan (SECP) to create an enabling framework for new financial products/structures is a positive step. In FY05, the Voluntary Pension System Rules were notified to provide for the introduction of private pension schemes in the country, under the management of professional fund managers.[3] SECP has also been working towards the introduction of Real Estate Investment Trusts (REITs)[4] and private equity funds through formulation of laws and rules, and addressing institutional constraints for these vehicles. In July 2007, SECP announced its intentions to establish a robust system of occupational savings in the country. The new financial products are expected to contribute to the growth and diversification of the financial system provided that the associated risks are properly managed.

This chapter provides an assessment of the performance of and key challenges for the non-bank financial sector and each of the financial services grouped therein. Section 2 provides an overview of the operating structure and environment of non-bank financial institutions (NBFIs)[5] while highlighting certain areas of concern. Section 3 provides a performance review of the sector during FY06 along with a detailed discussion of the performance and risk profile of each financial service group, followed by the conclusion in Section 4.

8.2 Operating Framework

Operating Structure:

The operating structure for each category of NBFIs has been carved out in the respective laws. NBFCs operate as public limited companies to undertake the businesses of investment finance, leasing, housing finance, venture capital investment, discounting, investment advisory and asset management. SECP grants a separate license for each financial service that an NBFC may provide.

NBFCs holding the license of investment advisory and asset management can offer mutual funds for public subscription. Mutual funds are generally constituted by way of trust deeds although a closed-end mutual fund may be set up as a company. The trust structure is predominant because of the flexibility it offers in laying down operational procedures and processes for mutual funds according to the requirements of the fund managers.

The modaraba is essentially formed as a two-tier fund structure to conduct business in line with the requirements of Shariah. A modaraba is floated by a modaraba management company with the prior permission of Registrar Modaraba (who functions under the administrative authority of SECP). For the purpose of floatation of a modaraba, the Religious Board – constituted by the Federal Government – must certify in writing that the business of the modaraba is not opposed to the injunctions of Islam.

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[3] In January 2007, SECP issued certificates of registration to four asset management companies to act as pension fund managers under the Voluntary Pension System Rules, 2005. Of these fund managers, three have launched pension funds by July 2007 while the fourth one is in the process of doing so.

[4] Latest draft of the Real Estate Investment Trusts Regulations, 2007 was notified for public opinion in July 2007.

[5] The term NBFIs is different from NBFCs in that it includes DFIs and modarabas.

All DFIs, except two, are joint ventures between the Government of Pakistan and foreign governments. They are registered as companies and are regulated by the State Bank of Pakistan (SBP).

Legal and Regulatory Framework

Since the emergence of NBFCs in 2002, SECP has substantially strengthened the legal framework for these institutions[6] although certain issues remain, as discussed in ensuing paragraphs. The Modaraba law, however, requires considerable improvements vis-à-vis the powers of the Registrar Modaraba and SECP to take immediate, remedial measures in cases of mismanagement of modarabas, restructure inoperative modarabas and sanction schemes of mergers and amalgamations in the sector (**Box 8.1**).

Box 8.1: Legal and Regulatory Framework for NBFIs

The concept of NBFCs was introduced in the year 2002 through amendments in the Companies Ordinance, 1984, prior to which these institutions were regulated by SBP. In order to provide a framework for the regulation and monitoring of NBFCs, the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules) were notified in 2003, following which SECP also issued Prudential Regulations for NBFCs. The NBFC Rules contain general provisions applicable to NBFCs as well as specific provisions dealing separately with each financial service, except discounting, that an NBFC may undertake. Detailed provisions for mutual funds have also been laid down in the NBFC Rules.

Modarabas operate under the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 and rules issued in 1981. SECP has also issued Prudential Regulations for the conduct of business of modarabas. A modaraba may be multipurpose (having more than one specific purpose or objective) or it may be a specific purpose modaraba and it may either be for a fixed period or for an indefinite period. The business that a modaraba engages in cannot be opposed to the injunctions of Islam.

The differences in the legal and regulatory framework for each category of NBFIs create distinct operating environments and challenges for them. A significant issue arises from low capital requirements for NBFCs and modaraba management companies, as compared to DFIs. **Table 8.1** shows that a modaraba management company may be set up with a capital base of Rs. 2.5 million only while an NBFC, which has a minimum equity of Rs. 30 million, can manage public money in the form of mutual funds. An additional equity of Rs. 100 million may enable the NBFC to provide housing finance, further equity of Rs. 200 million may allow the NBFC to undertake leasing and so on, such that an NBFC with minimum equity of Rs. 835 million can apply to SECP for licenses to undertake the entire variety of financial services permitted under the law. In contrast, SBP requires the minimum capital (net of losses) for DFIs to be Rs. 3 billion, which is to be raised in a phased manner by Rs. 1 billion annually to reach Rs. 6 billion by the end of December 2009, under a regulation which covers both banks and DFIs in its ambit.[7]

Table 8.1: Minimum Capital Requirements for NBFIs
million Rupees

DFIs	3,000
NBFCs engaged in:	
investment finance	300
Leasing	200
Discounting	200
Housing finance	100
Investment advisory and asset management	30
Venture capital investment	5
Modaraba Management Companies:	
Solely engaged in floatation of modaraba	2.5
Engaged in business additional to floatation of modaraba	7.5

The low capital base of NBFCs and modaraba management companies is a major challenge in mobilizing low cost funding, facing the stiff competition from banks and withstanding any

[6] The latest amendments in the Companies Ordinance, 1984, pertaining to SECP's powers for regulating NBFCs and their businesses, i.e. mutual funds and pension funds, have been made through the Finance Act, 2007.

[7] BSD Circular No. 6 dated 28 October 2005

exogenous shocks. It also creates a low barrier to entry, particularly in the case of the modaraba sector, which is characterized by a large number of small and weak market players, and concentration of business with a few large entities. Furthermore, in the absence of capital adequacy requirements for NBFCs and modarabas based on risk weighted assets, there are implications for the effective risk management of these institutions. DFIs, on the other hand, are required to maintain a minimum capital adequacy ratio of 8 percent. DFIs are also required to adopt Basel II in accordance with the timeframe prescribed by SBP.

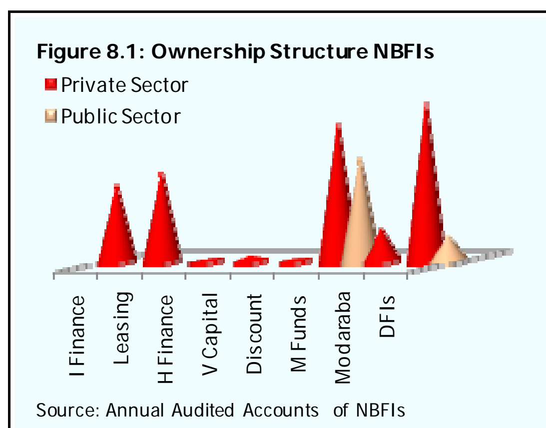
Another issue arises from the ability of modarabas and NBFCs engaged in investment finance, leasing and housing finance to raise deposits in the absence of a financial safety net for depositors' protection. As of the end of FY06, the outstanding deposits of modarabas and NBFCs amounted to Rs. 53.2 billion while those of DFIs were Rs. 26.1 billion. Effective financial safety nets generally have some or all of the following components: (i) a framework of prudential regulation and supervision; (ii) ability of the regulator to be the lender of last resort; (iii) deposit insurance; and (iv) a clearly defined resolution mechanism for financial institutions in distress.[8] SECP has, over the last two years, strengthened supervision through the on-site inspections of NBFIs while the laws administered by it are deficient with regard to its ability to act as the lender of last resort and a resolution mechanism for institutions experiencing insolvency.[9] The situation is aggravated in the absence of a deposit insurance scheme for financial institutions (including banks) in Pakistan. Due to the lack of adequate financial safety nets, there is a regulatory challenge in protecting the less financially sophisticated depositors of NBFCs and modarabas.

SECP is seeking to amend and update the legal framework for modarabas as well as to develop a separate law for NBFCs to address the challenges facing these sectors. SECP has also strengthened its monitoring and surveillance of NBFCs and modarabas in recent years and an on-site inspection function is now in place to carry out regular inspections of these entities. These measures should help to enhance the enforcement of laws, which has so far been lagging behind.

8.2.1 Ownership Structure

A noticeable trend within the non-bank financial institutions is the emergence of the private sector as the dominant owner of NBFIs. Between FY01 to FY06, private sector ownership of NBFIs has increased from 69.5 percent to almost 80 percent. This compares favorably to the banking sector where private sector ownership of assets had reached 77.7 percent by FY06. The ownership structure of the non-bank financial sector is shown in **Figure 8.1**.

Figure 8.1: Ownership Structure NBFIs



Source: Annual Audited Accounts of NBFIs

Among NBFCs, all institutions, except one, are now owned and managed by the private sector. The only public sector institution is National Investment Trust Limited, which manages the largest open-end mutual fund, National Investment (Unit) Trust (NIT), in the country. The government owns 8.33 percent of the shareholding in National Investment Trust Limited directly and 50 percent indirectly through government controlled entities. Privatization of NIT is imminent, at the conclusion of which the entire NBFC sector would stand transferred to private ownership. Modarabas are already 100 percent owned by the private sector. Among DFIs, HBFC has public sector ownership, with 62.5 percent of its capital held by the Federal Government and the remaining

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[8] General Guidance to Promote Effective Interrelationships among Financial Safety Net Participants, prepared by the Research and Guidance Committee, International Association of Deposit Insurers.

[9] SECP has only recently obtained the power to rehabilitate NBFCs that are facing financial or operational problems, through the Finance Act, 2007. This power is yet to be exercised by SECP.

37.5 percent by SBP. It is expected that the government would restructure the shareholding in HBFC to allow private sector participation.

The concentration of NBFIs' assets in the private sector has largely been the result of: (i) liberal entry of private sector institutions; (ii) transfer of closed-end mutual funds managed by Investment Corporation of Pakistan (ICP), a public sector company, to private sector investment advisers; and (iii) closure/merger of certain DFIs in the public sector. The liberalization and privatization of the non-bank financial sector has resulted in a relatively more competitive operating environment for NBFIs that promotes efficiency and good corporate governance.

8.2.2 Consolidation

Another factor that has a significant bearing on the competitiveness and soundness of the non-bank financial sector is consolidation through mergers and amalgamations. Consolidation results in the emergence of relatively stronger, well-capitalized entities that are better placed to compete and grow in the financial sector.

Table 8.2: Mergers in the NBFC and Modaraba Sectors from CY02 to CY06

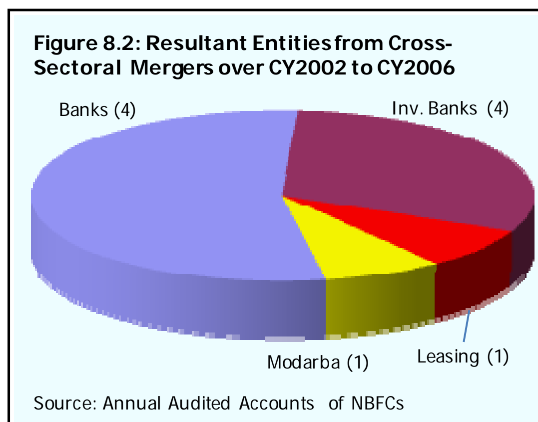
	Name of NBFC/ Modaraba	Name of Company/Modaraba Merged with	Date of Merger
1	Al-Faysal Investment Bank	Faysal Bank Limited	10-01-2002
2	Ghandhara Leasing	Al-Zamin Leasing Modaraba	01-02-2002
3	Atlas Lease	Atlas Investment Bank Limited	15-03-2002
4	Pakistan Industrial Leasing Corporation Limited	Trust Investment Bank Limited	22-07-2002
5	Second Prudential Modaraba	First Prudential Modaraba	26-08-2002
6	Third Prudential Modaraba		
7	First Crescent Modaraba	Altowfeeq Investment Bank	21-05-2003
8	First Professionals Modaraba	Al-Zamin Leasing Modaraba	30-06-2003
9	Crescent Investment Bank Limited	Mashreq Bank Pakistan Limited	09-07-2003
10	Industrial Capital Modaraba	Dawood Leasing Company Limited	
11	First General Leasing Modaraba		
12	Trust Investment Bank Limited	Trust Commercial Bank Limited	30-04-2004
13	Fidelity Investment Bank Limited		
14	Pacific Leasing Limited	First Standard Investment Bank Limited	18-06-2004
15	Paramount Leasing Limited		
16	First Leasing Corporation Limited		
17	First Hajveri Modaraba	First Fidelity Leasing Modaraba	22-10-2004
18	First National Modaraba	First Paramount Modaraba	11-09-2004
19	Ibrahim Leasing Limited	Allied Bank Limited	31-05-2005
20	Second Tri-Star Modaraba	First Tri-Star Modaraba	24-02-2006
21	Modaraba Al-Tijarah	Modaraba Al-Mali	06-12-2006
22	First Allied Bank Modaraba	Allied Bank Limited	07-12-2007
23	Atlas Investment Bank Limited	Atlas Bank Limited	26-07-2006
24	Jahangir Siddiqui Investment Bank Limited	JS Bank Limited	30-12-2006

Source: SECP

Since CY02, mergers involving as many as 24 NBFCs and modarabas have taken place, as shown in **Table 8.2**. Initially, the major impetus for consolidation came from the introduction of the minimum capital requirements for NBFCs, which drove smaller companies towards mergers and amalgamation in a bid to raise their equity base. In more recent years, however, the trend has been largely market-driven to enhance economies of scale, operational efficiencies or switch over to another line of business (cross-sectoral mergers). An additional authority obtained by SECP in 2002 to sanction schemes of amalgamation of NBFCs – in line with the already available SBP directive in case of banks and DFIs – along with the existence of tax incentives for merging financial institutions since 2002, has also helped to facilitate the process of consolidation in the financial sector.

As shown in **Figure 8.2**, a noticeable feature of mergers in the NBFC and modaraba sectors has been the tendency of amalgamation with and into commercial banks. Over the last five years, there were 13 cross-sectoral mergers, of which seven resulted in banks as the emerging entity. These cases of mergers involved seven NBFCs, with the predominant majority of those engaged in investment finance services, and one modaraba.

Figure 8.2: Resultant Entities from Cross-Sectoral Mergers over CY2002 to CY2006



Source: Annual Audited Accounts of NBFCs

The tendency of banks to take over NBFIs has significant bearing on the dynamics of the financial sector. Banks have adequate liquidity, capital, human resources and organizational infrastructure, and most importantly, profitability, in comparison to NBFIs. By directly competing with NBFIs in providing financial services that were traditionally within the domain of the latter, banks have squeezed the revenue streams for the non-bank financial sector. With the acquisition of viable NBFIs, the ability of the non-bank financial sector to withstand competition from the banking sector would be further constrained.

8.3 Performance Review

The composition of the non-bank financial sector as of the close of FY06 is indicated in **Table 8.3**. There were 6 DFIs, 58 NBFCs and 44 mutual funds in operation. An NBFC may hold multiple licenses under the NBFC Rules. Hence, the 58 operational NBFCs held 93 licenses for financial services permitted to them under the law. As of the close of FY06, there were 51 modaraba management companies while the operational modarabas were 29.

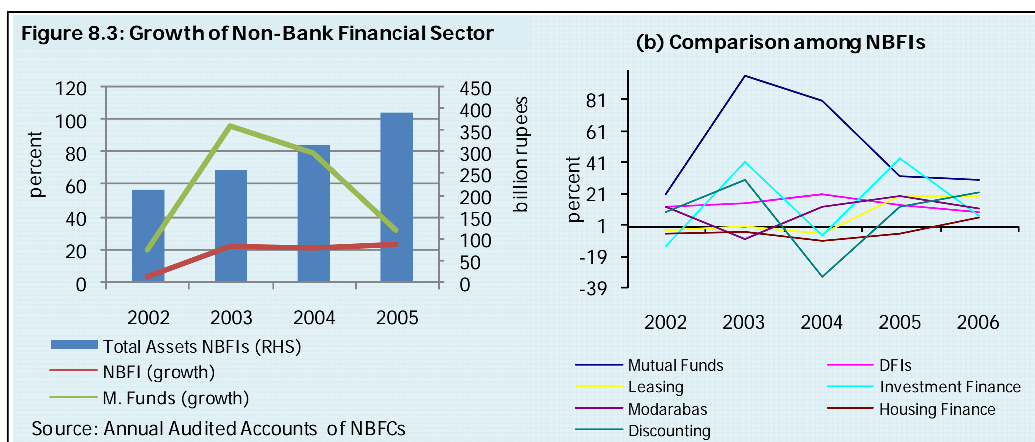
Table8.3: Composition of the NBFIs

NBFI	Number of Operational Entities	Number of Licenses
DFIs	6	
NBFCs	58	
- Investment Finance		13
- Leasing		19
- Housing Finance		6
- Venture Capital Investment		3
- Discounting		1
- Investment Advisory and asset management		51
Mutual Funds	44	
Modaraba Management Companies	51	
Modarabas	29	
Modarabas	29	

Source: SECP

During the year, mutual fund management was the most active component of the non-bank financial sector as SECP granted 21 new licenses for investment advisory and asset management. Two new licenses each were awarded for investment finance, leasing and housing finance to existing NBFCs. Subsequent to the re-appointment of the Religious Board after a lag of almost three years, renewed interest in modarabas was evident and the Registrar Modaraba authorized floatation of six modarabas during FY06, although none of the new modarabas commenced business during the year.

The non-bank financial sector has gradually expanded its asset base in recent years to reach Rs. 462.3 billion by the close of FY06. The growth has been largely spurred by a buoyant mutual funds industry that has swelled enormously since FY02, with its growth rate going up as high as 96.53 percent in FY03. As shown in **Figure 8.3**, the growth in mutual funds has consistently outpaced the growth in the non-bank financial sector taken as a whole; the gap between the two reached 12.65 percentage points in FY06 after growing to 74.20 percentage points in FY03. However, it is likely that the gap will widen again on account of: (i) persistent interest in the mutual funds industry, evident from the high number of entrants; (ii) introduction of pension funds and REITs as a sub-class of collective investment schemes; and (iii) dwindling growth rates of investment finance, modarabas and DFIs.



Source: Annual Audited Accounts of NBFCs

During FY06, the non-bank financial sector grew at 17.43 percent, the slowest growth rate in the last four years. Growth was dragged down by the meager performance of investment finance companies, modarabas and DFIs. Consequently, their share in the non-bank financial sector deteriorated further during the year, with DFIs registering the largest share reduction of 2.09 percentage points during the year (**Box 8.2**). The mutual fund was the best performing industry and strengthened its share to 38.34 percent of NBFIs' assets by the close of FY06. There was a nominal increase in the shares of leasing and venture capital sectors in the total assets of NBFIs. **Table 8.4** sets out the asset share of each component of the non-bank financial sector over FY02 to FY06. A detailed performance review of each component is covered later in this section.

In terms of the composition of assets, the share of advances in total assets of NBFIs (excluding mutual funds and venture capital) was 51.28 percent during FY06, largely on account of the 22.73 percent growth in advances of the leasing companies. Advances of modarabas also showed a reasonable growth of 10 percent as lease financing and lending under murabaha and musharika transactions remained a sizable proportion of their assets. The share of investments in the total assets of NBFIs (excluding mutual funds and venture capital) continued to be significant at 27.10 percent, primarily as the stock market remained lucrative. Collectively, earning assets constituted 84.50 percent of total assets during the year.

Table 8.4: Assets of NBFIs

billion Rupees , share in percent

	FY02	FY03	FY04	FY05	FY06
Assets	213.5	261.1	318.1	393.7	462.3
Growth rate	3.9	22.3	21.8	23.8	17.4
			Share in Assets		
Mutual Funds	13.6	21.9	32.4	34.6	38.3
DFIs*	32.2	30.2	29.8	27.4	25.3
Leasing	22	17.9	14.1	13.6	13.8
Investment Finance	12.6	14.5	11.2	13	11.8
Modarabas	8.2	6.1	5.7	5.5	5.2
Housing Finance*	10.5	8.3	6.1	4.7	4.3
Venture Capital	0.1	0.3	0.3	0.8	0.9
Discounting	0.7	0.8	0.4	0.4	0.4

*Assets of HBFC, a DFI engaged in providing housing finance, have been clubbed under 'Housing Finance' for better comparison

Gearing of non-bank financial sector (other than mutual funds and venture capital) has steadily risen from 250.13 percent in FY04 to 298.65 percent in FY06, reflecting increased reliance on borrowings and deposits for funding business activities. The average cost of borrowings and deposits has also increased in recent years, reaching up to 7.58 percent in FY06, due to the rise in interest rates. As shown in **Table 8.5**, NBFIs have been relying on borrowings more than deposits, with the deposits to liability ratio reaching 36.18 percent in FY06 and borrowings to liability ratio rising to 54.0 percent. This was largely due to the higher borrowings and lower deposit mobilization by DFIs during the year. Investment finance companies, on the other hand, registered a modest increase in the deposit to liability ratio with a corresponding decline in the ratio of borrowings to total liabilities.

Box 8.2 Development Finance Institutions

Development Finance institutions (DFIs) date back to 1957, when 'Pakistan Industrial Credit and Investment Corporation limited' (PICIC) was established to finance medium to large industrial projects and to mobilize funds from international financial intuitions (IFIs) for industrial development. More DFIs were established in the 1960s and 1970s to provide investment capital for state enterprises, develop capital markets and other priority sectors. Besides these government sponsored organizations, there are also a few DFIs that were jointly sponsored by the governments of Pakistan, Kuwait, Libya, Saudi Arabia and Oman.

These DFIs played an active role in accelerating the pace of industrialization during the early years of their establishment, especially in the 1960s and the 1970s. However, political influence and interference in their lending decisions and other operational aspects impacted the financial health of these organizations. Poor recovery rate, failure to develop domestic sources of funding (deposit mobilization) and significant depreciation of the rupee are some of the factors which had a negative impact on their operations. The business activities of DFIs were further impacted by competition from Investment Banks and Leasing companies.

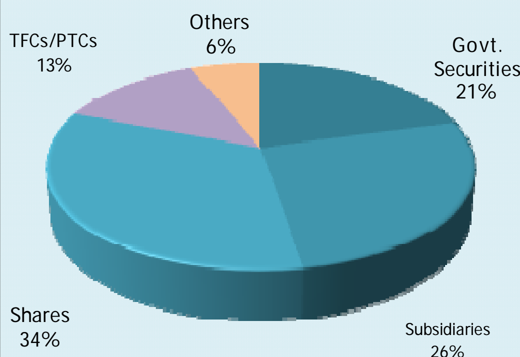
Since then, DFIs have under-gone a broad-based restructuring program since the late 1990s. One DFI was liquidated; others have been part of the M&A wave in the financial sector. As a result, the asset share of the DFIs in the overall assets of the financial sector has declined to 2.0 percent in FY06 as compared to 3.3 percent in FY00. DFIs have even lost their dominant share among NBFIs to mutual funds in the process, as their share in overall assets has reached 25.3 percent as compared to 38.3 percent for the latter.

Table 1: Composition of Assets

percent

	DFIs	Banks
Lending to FIs	14.5	4.9
Investments	32.4	19.2
Loans	35.2	55.8
Other assets	17.8	20.1

Figure 1: Composition of Investments



At present, there are five DFIs, four of which are jointly sponsored by other countries' governments. These DFIs are gradually diversifying their lines of business in repose to stiff competition from other financial institutions, especially from the commercial banks.

Figure 2: Liability Structure of DFIs

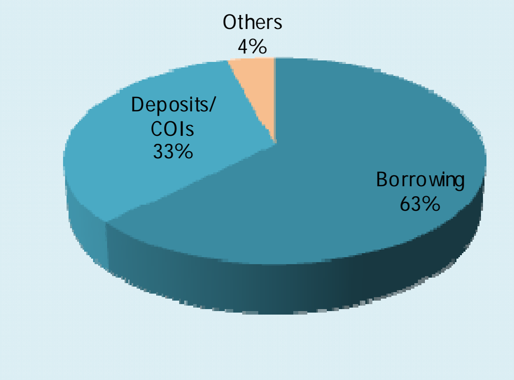


Table 1 shows that in case of DFIs, the share of the loan portfolio accounts for only 35.2 percent of total assets, which is substantially lower than the 55.8 percent share for the banking sector. Another notable point is the share of investments, which is over 30 percent of the total assets of DFIs. Further break up of investment indicates that 21 percent of the total investments are in government securities. The most notable point is the share of TFCs/PTCs,[1] both medium to long-term instruments, the share of which is only 13 percent (**Figure 1**). It may be noted that a quarter of overall investments are invested in subsidiaries and associated institutions. This is largely attributed to acquisition of commercial banks by two DFIs. In sum, the asset composition of DFIs indicates that these institutions are not actively involved in project (long term) financing: a core business activity for the DFIs.

[1] Term Finance Certificates / Participation Term Certificates are generally medium to long term financial instruments.

On the other hand, liability structure of the DFIs reveals that 63 percent of their liabilities constitute of borrowings and deposits constitute only 33 percent (**Figure 2**). This liability structure clearly suggests that DFIs have been unable to develop their own sources of funds. In sharp contrast to this, deposits of the banking sector form 82.5 percent of total liabilities, while the share of borrowing is only at 11.0 percent. This liability comparison indicates that DFIs are at a disadvantageous position, as the cost of mobilizing funds for DFIs is higher than banks. Specifically, the average cost of funds for DFIs is more than twice (8.6 percent) the cost of the banking sector (3.9 percent).

In sum, the balance sheet structure of DFIs indicates that these institutions are unable to perform their basic function of providing long term financing. On the other hand, a heavy share of borrowing in their liabilities keeps the cost of funding significantly high as compared to the banking sector. With the advent of universal banking in the financial sector, the DFIs model is less likely to succeed in the future. While some of the DFIs have already diversified their businesses by acquiring commercial banks, the rest need to re-assess their competitive strength in line with market dynamics.

Table 8.5: Key Performance Indicators of NBFIs (excluding Mutual Funds and Venture Capital)
percent

	FY02	FY03	FY04	FY05	FY06
Advances to assets ratio	43.7	42.9	46.9	51.8	51.3
Investments to assets ratio	28.8	36.6	33.3	30.5	27.1
Earning assets to total assets	75.8	83.9	84.9	85.6	84.5
Debt to equity ratio	290.5	259.2	250.1	281.6	298.6
Borrowings to liability ratio	57.2	54.7	55.0	49.0	54.0
Deposits to liability ratio	29.7	31.1	33.4	40.9	36.2
Return on advances and investments	15.3	11.4	9.0	8.8	10.6
Cost of deposits and borrowings	9.0	6.1	3.9	5.7	7.6
Average spread	6.3	5.3	5.0	3.1	3.0
Net interest margin	7.2	6.6	5.9	4.1	4.3
Income to expense ratio	134	156.6	159.4	144.3	123.6
Return on average assets (after tax)	3.0	4.3	3.5	2.7	1.7
Return on average equity (after tax)	14.3	17.7	13.5	10.4	7.2

Source: SECP

With rising interest rates, there has been a squeeze on the spread and interest margin of NBFIs (excluding mutual funds and venture capital), which declined to 3.04 percent and 4.31 percent, respectively, by FY06. The non-bank financial sector has taken a larger hit than the banking sector whose spread was 6.2 percent and net interest margin was 5.2 percent for FY06. The deteriorating earning ratios of NBFIs are a cause of concern in a high interest rate scenario.

The profitability indicators of leasing companies, modarabas and DFIs also worsened during FY06. Overall, the return on assets and return on equity of NBFIs (other than mutual funds and venture capital) have declined to 1.73 percent and 7.18 percent by FY06 from their peak in FY03. It is worth noting that the venture capital industry has been continuously in loss since FY03 and if its operating results are considered, the return on assets (RoA) and that on equity (RoE) would further reduce to 1.65 percent and 6.70 percent for FY06. NBFIs' indicators are weak when compared to the banking sector that reported an RoA of 2.12 percent and RoE of 24.25 percent for FY06.

A detailed discussion of performance and challenges for each financial service group among NBFIs is provided in the ensuing sections.

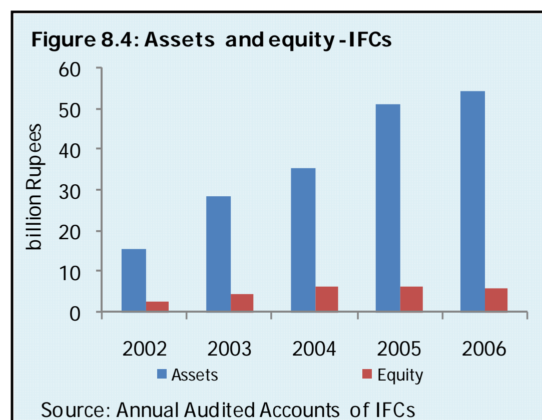
8.3.1 Investment Finance

Traditionally, investment banking involves a range of activities from underwriting, selling, and trading securities (stocks and bonds), to providing strategic advisory services, credit lines and portfolio management. In Pakistan, NBFCs, duly licensed by SECP, provide investment finance services. Beside NBFCs, banks and brokerage firms are actively engaged in money market,

capital market, corporate finance and project finance activities synonymous to investment banking.

As of the close of FY06, there were ten operative investment finance companies, with a share of 11.79 percent in the aggregate assets of the non-bank financial sector. The asset and equity base of investment finance companies was Rs. 54.53 billion and Rs. 5.92 billion, respectively (**Figure 8.4**). During FY06, assets increased by Rs. 3.49 billion or 6.83 percent while equity eroded by Rs. 0.74 billion or 11.09 percent over the previous year. The decline in equity was due to the huge losses of Crescent Standard Investment Bank Limited (CSIBL) of Rs. 2.12 billion in FY05 and another Rs. 1.12 billion for nine months ended 30 September 2006. In October 2005, SECP had unearthed massive financial irregularities in CSIBL, including illegal maintenance of parallel accounts, concealment of assets, unauthorized massive funding of group companies and unlawful investments in real estate and stock market. By end-September 2006, CSIBL had a negative equity of Rs. 1.69 billion. CSIBL was amongst the largest NBFCs, holding more than 25 percent of total assets of the investment banking sector prior to the discovery of its financial irregularities in 2005. As a result, depletion of its equity distorted the growth parameters of the investment banking sector. Excluding CSIBL, the assets and equity of the remaining investment finance companies grew satisfactorily by 25.7 percent and 17.8 percent during FY06.

Figure 8.4: Assets and equity - IFCs



Source: Annual Audited Accounts of IFCs

Table 8.6: Key Performance Indicators of Existing Investment Finance Companies

percent

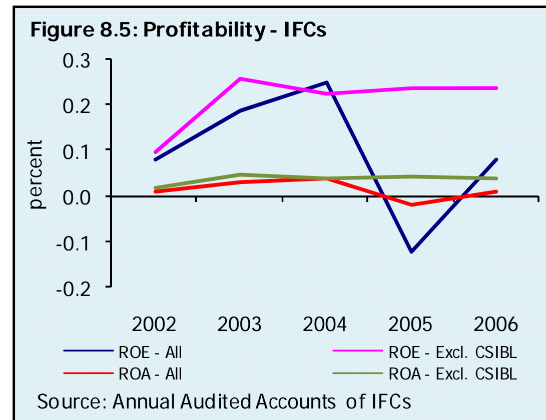
	FY02	FY03	FY04	FY05	FY06
Lease finance to total assets	16.1	24.9	23.1	24.0	25.2
Investments to total assets	34.9	38.7	29.1	27.1	22.5
Placements to total assets	9.1	10.9	19.9	13.9	21.6
Term finance to total assets	21.5	14.8	15.0	17.7	16.1
Earning assets to total assets	81.7	89.3	87.1	82.7	85.5
Debt to equity ratio	454.7	467.3	399.3	614.8	759.5
Average spread	4.2	3.5	5.6	0.2	2.9
Net interest margin	8.1	5.3	7.1	2.0	4.3
Income to expense ratio	113.9	144.0	187.2	106.9	127.4
Return on average assets (after tax)	1.3	3.1	4.4	-1.9	1.0
Return on average equity (after tax)	7.8	18.9	25.0	-12.2	8.5

Source: Annual Audited Accounts and SBP calculations

The proportion of total debt to equity indicates that the sector is highly geared. As of the close of FY06, the gearing ratio of existing investment finance companies was 759.53 percent, the highest over the last five years. Excluding CSIBL, the gearing ratio of other investment finance companies was still high at 487.43 percent for FY06. **Table 8.6** indicates that with the rise in interest rates, the average spread of investment finance companies has declined from the peak of 5.58 percent in FY04 to 2.87 percent in FY06. Similarly, net interest margin has reduced from 7.07 percent to 4.34 percent over the period. Higher financial charges during FY06 caused a significant jump in the expenses of investment banks that resulted in a lower income to expense ratio of 127.36 percent in FY06 as compared to 187.17 percent in FY04.

The profitability indicators of investment banks deteriorated in FY05 and FY06, largely on account of the losses reported by CSIBL. By FY04, the sector boasted return on average assets of 4.44 percent and return on equity of 25.02 percent. As financial irregularities at CSIBL were revealed, return on average assets of investment banks worsened to -1.88 percent in FY05 with a slight improvement to 1.01 percent by FY06. Likewise, return on equity fell to -12.21 percent in FY05 and then increased to 8.49 percent the next year. However, as **Figure 8.5** illustrates, return on assets and that on equity of investment finance companies, excluding CSIBL, hovered around 4.0 percent and 23.5 percent, respectively, for FY05 and FY06.

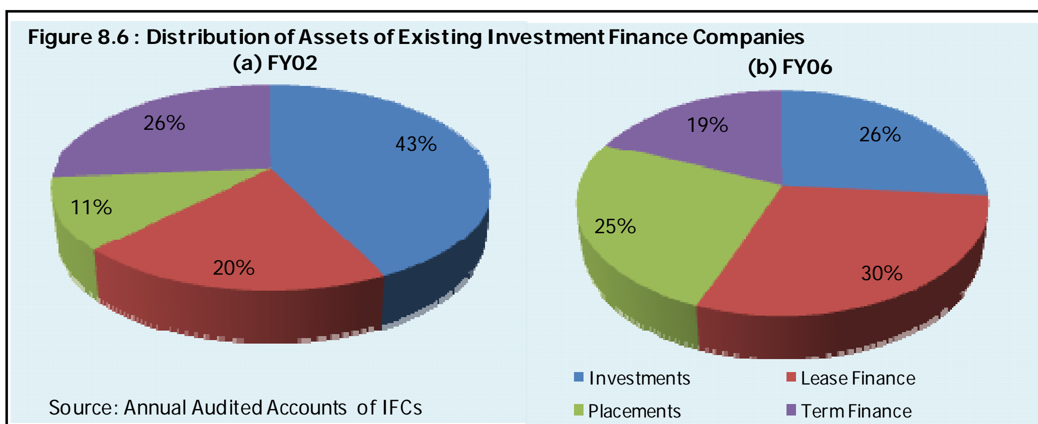
Figure 8.5: Profitability - IFCs



Source: Annual Audited Accounts of IFCs

The financial irregularities at CSIBL and its deteriorating financial situation led SECP to issue a directive to the investment bank in June 2006 to cease issuance of new deposits. By then, a run on the investment bank had triggered as news of financial chaos at CSIBL had become public, albeit worsening liquidity and extensive losses meant that CSIBL was unable to meet its obligations to depositors and institutional lenders. As of end-CY05, CSIBL had customers' deposits of Rs. 6.71 billion which had slightly reduced to Rs. 5.48 billion by end-September CY06. SECP took a number of steps to redress the situation including appointment of an Administrator through superseding the Board of directors and management of CSIBL in August 2006, and facilitating the merger of the investment bank subsequent to the close of FY06. Given its hectic efforts, SECP was successful in arranging a buy-out of CSIBL, subsequent to the close of FY06, to enable staggered repayment of depositors' money. In contrast to SECP's successful endeavor in the case of CSIBL, the risk of fallout to depositors from lack of adequate safety net is evident in case of other failed investment banks where financial collapse of the institutions and the move to wind them up meant that the less financially sophisticated depositors lost their money.

Figure 8.6 : Distribution of Assets of Existing Investment Finance Companies

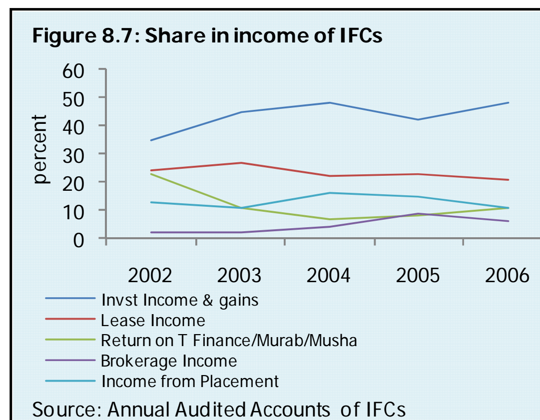


Source: Annual Audited Accounts of IFCs

The financial difficulties faced by a number of investment banks, together with acute competition from banks and brokers, have significantly altered the dynamics of the investment banking sector and the need for survival led them to diversify their business activities. Firstly, this is evident from the multiple licenses held by most of the existing investment finance companies under the NBFC regime. Of the ten operative investment finance companies, as many as five had additional licenses for leasing and housing finance in FY06. Also, the asset composition of investment finance companies reflects the increasing reliance on lease financing. As shown in **Table 8.6** and **Figure 8.6**, share of lease finance in the total assets of existing investment finance companies was the largest at 28.19 percent

during FY06 and had increased by 9.0 percentage points since FY02. The other notable shift was towards placement of funds, whose share in total assets increased by 13.0 percentage points over the period FY02 to FY06.

Secondly, investment finance companies are now increasingly providing brokerage services. There are six investment finance companies which are registered brokers of the Karachi Stock Exchange.



As may be seen from **Figure 8.7**, the income from brokerage activities has steadily risen over the last five years, with a dip in FY06. Investment income and gains retain the largest share in the total income of existing investment finance companies over the period, increasing to 47.57 percent in FY06. During the year, share of income from interest-bearing activities, i.e. lease financing and placements, declined.

The changes in asset portfolio, income composition and structure of investment banks strongly indicate that investment finance service is no longer viable as a stand-alone activity for NBFCs. Investment banks have not been able to carve out a niche for themselves, and the requirements of customers for investment finance services in the areas of money market, capital market, corporate finance and project finance are being taken care of by banks and brokers. Simultaneously, the ability to offer other financial services under the NBFC Rules and to act as registered brokers has opened up other, profitable avenues for NBFCs with investment finance licenses. There is inherently nothing wrong in this structure as long as risks from a universal NBFC structure are properly managed. However, as discussed earlier in section 2.2, major implications for risk management could arise from the lack of capital adequacy requirements for NBFCs and weak enforcement of laws.

Finally, a look at the pattern of mergers and acquisitions in the sector may lead to the observation that investment banking has been a move in transition to commercial banking in many cases. Over CY02 to CY06, six investment finance companies merged with commercial banks. The latest in this series has been the merger of Jehangir Siddiqui Investment Bank Limited with American Express Bank Limited, for forming a new banking company, namely, the JS Bank Limited, and merger of Atlas Investment Bank Limited with and into Atlas Bank Limited. In terms of asset base, the two merging investment finance companies, i.e. Jehangir Siddiqui Investment Bank Limited and Atlas Investment Bank Limited, together accounted for 24.8 percent of the total assets of the sector as of the close of FY06. As strong institutions exit the investment banking sector to join the more profitable and lucrative banking sector, it reinforces the likelihood of investment banking shrinking in prominence and structure from a separate, distinct category of financial institutions to a department/segment within banks and universal NBFCs.

8.3.2 Leasing

The leasing sector in Pakistan has played a catalytic role in capital formation since the establishment of the first leasing company, National Development Leasing Corporation in 1984. Leasing companies meet the short to medium term funding requirements of businesses and provide a flexible, tax efficient and economic mode of raising funds. As of the close of FY06, the share of leasing companies in the asset base of the non-bank financial sector was 13.84 percent.

There are a number of players actively engaged in providing lease financing in Pakistan, i.e. NBFCs with the license to undertake leasing, modarabas, commercial banks and DFIs. The

competition has intensified as the demand for lease finance has increased on account of: (i) high economic growth in recent years that raised the demand for credit, including lease finance; (ii) low interest rates (till FY05) that enhanced the affordability of leasing as a mode of financing for small enterprises as well as individuals; and (iii) introduction of shariah-compliant leasing, i.e. Ijarah to satisfy the financing needs of customers in accordance with Islamic principles. The competition for leasing companies is particularly severe from commercial banks that have extensive branch networks and distribution channels, higher equity base and access to low cost funds.

Within such a competitive operating environment, leasing companies have undergone significant transformation. Most visible are structural changes in the leasing sector on account of mergers and amalgamations and regulatory efforts to 'clean up' the sector through suspension of licenses of unprofitable/insolvent companies and moving the courts for their winding up. As a result, the size of the sector has shrunk in terms of the number of operative companies to 13 by FY06 from 29 in FY02. Despite consolidation, however, fragmentation still abounds and the leasing sector comprises mainly of small, low capitalized companies. As **Table 8.7** indicates, only one leasing company, i.e. Orix Leasing Pakistan Limited is well capitalized, with an equity base of Rs. 2.33 billion as of end-June FY06. Four companies are modestly capitalized, with equity in the range of Rs. 500 million to Rs. 1.0 billion. The remaining eight companies have a low equity base and one is acutely falling short of the minimum capital requirement of Rs. 200 million, as laid down in the NBFC Rules. These small companies together account for only 20.0 percent of the total assets of the sector in FY06. The five largest companies hold 80.0 percent of the assets with the largest chunk of 37.0 percent with Orix Leasing (**Figure 8.8**). The proliferation of small companies raises significant challenges for the growth of the leasing sector as rising interest rates and severe competition from banks could threaten the financial viability of these companies and dampen the performance of the sector.

Table 8.7: Equity of Leasing Companies

Equity	Number of Companies
Over Rs. 2 billion	1
Between Rs. 1 – 2 billion	0
Between Rs. 0.5 – 1 billion	4
Between Rs. 0.2 – 0.5 billion	7
Less than Rs. 0.2 billion	1

Figure 8.8 – Concentration in Leasing Sector

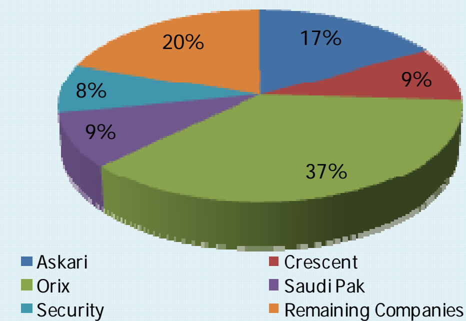
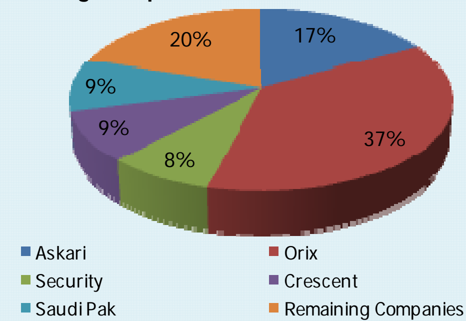


Figure 8.9: Growth and Profitability of Operative Leasing Companies



Source: Annual Audited Accounts of LCs

The assets of the leasing sector have grown to Rs. 64 billion by the close of FY06, as depicted in **Figure 8.9**. The growth rate has been encouraging, shooting up to 29.30 percent in FY05 and then declining to 21.85 percent in FY06. The major factor behind the growth in assets has been higher demand for lease finance in the country.

In terms of composition of assets, lease finance constitutes the bulk of assets at 78.17 percent while investments account for only 7.11 percent of total assets. Together, the earning assets were 87.86 percent of the asset base in FY06 (**Table 8.8**). It is encouraging

that the proportion of earning assets has been consistently high since FY03. Riding the wave of high demand, the core business of leasing companies has grown at an average annual rate of 27.51 percent over the period FY02 – FY06, albeit high interest rates in FY06 have reduced the demand and, consequently, growth of lease financing to 24.41 percent during the year.

Table 8.8: Key Performance Indicators of Existing Leasing Companies
percent

	FY02	FY03	FY04	FY05	FY06
Lease finance to total assets	56.9	74.6	77.1	76.6	78.2
Investments to total assets	4.6	9.0	11.0	10.1	7.1
Earning assets to total assets	62.9	86.3	89.6	89.3	87.9
Growth rate of lease finance	13.2	52.2	19.2	28.5	24.4
Debt to equity ratio	594.4	530.3	549.0	634.5	676.7
Average spread	10.1	4.8	4.8	3.6	2.3
Net interest margin	6.7	6.0	5.6	4.1	3.1
Income to expense ratio	107.2	120.6	128.2	126.2	112.0
Return on average assets (after tax)	0.8	1.9	2.2	2.0	1.0
Return on average equity (after tax)	5.9	13.6	15.6	14.8	8.2

Source: Annual Audited Accounts of Leasing Companies

The leasing sector is highly geared as depicted by the debt to equity ratio of 676.73 percent for FY06. As the high interest rate regime gradually set in, there has been a consequent squeeze on the spread and interest margin of leasing companies from 10.1 percent and 6.69 percent, respectively, in FY02 to 2.34 percent and 3.05 percent, respectively, in FY06. This is largely an outcome of the sector's reliance on borrowings at floating interest rates – in a high interest rate scenario, such borrowings lead to a high cost of funds – while most of the earlier leases were provided at low, fixed rates of interest. The thinning of spread of leasing companies has adversely affected the profitability indicators. As shown in **Figure 8.9** and **Table 8.8**, return on assets has decreased to 1.0 percent in FY06 from its peak in FY04. Similarly, return on equity has dipped to 8.17 percent in FY06 from a high of 15.56 in FY04. This has exposed the vulnerability of the sector and is a cause of serious concern for leasing companies, particularly the small ones. The interest rate risk has manifested itself in the case of Network Leasing Corporation Limited – a small company with equity of Rs. 258 million in FY05 and Rs. 50 million in FY06. The sharp erosion in equity took place on account of: (i) a hike in the financial charges of the company of Rs. 63.8 million during the year that raised the cost of borrowings; (ii) bulk of leases being at fixed rate of interest; and (iii) impairment of Rs. 86.06 million in the value of Pakistan Investment Bonds (of which Rs. 18.56 million was recognized subsequent to the close of FY06) as interest rates shot up. Due to the precarious financial condition of Network Leasing, its management was taken over by another financial institution subsequent to FY06 with a view to restructure/merge the operations of the company.

Given the stiff competition from commercial banks, leasing companies have sought to diversify their businesses. Of the 13 leasing companies, three have obtained multiple licenses under the NBFC Rules to undertake investment finance/housing finance services in addition to leasing. Moreover, there have been targeted efforts by companies for the diversification of their lease portfolio into new market segments, particularly by offering operating leases, as well as improved customer services. The proposed amendments in NBFC Rules to allow NBFCs to undertake leasing of commercial buildings and shops would augur well for the growth of the sector.[10]

The outreach of leasing companies is expected to expand with the increased focus on micro and rural leasing, and expansion of branches across the country. Micro and rural leasing is at a nascent stage and only four leasing companies are so far engaged in this area of financing. There is considerable scope for expansion given the enormity of the potential client base, government's focus on promoting small and medium enterprises, availability of financial and technical support from multilateral agencies, and proven feasibility of this line of business.

[10] SRO 959(I)/2006 dated 11 September 2006.

Community-based micro and rural leasing will not only help to diversify the portfolio of leasing companies but will also contribute towards the socio-economic development of Pakistan (**Box 8.3**).

Box 8.3.: A Case for Rural Lease Finance

Farms and other rural enterprises often lack access to the long-term credit needed to acquire equipment. Most assets that rural enterprises own cannot be used as collateral: titles to land are often non-existent and movable assets such as livestock and warehouse receipts are not legally permissible as collateral. Leasing is a financing tool that overcomes this constraint. In leasing, the provider (lessor) owns the equipment and permits the client (lessee) to use it in exchange for periodic payments (lease payments). For most rural enterprises, leases are also a means of acquiring equipment (and not just its use) and ownership is transferred to the lessee at the end of the lease period, either automatically or at a token price.

Leasing offers several advantages over loans, both to the lessees and to the lessors. For lessees, the most important benefit is access to a source of finance. For farms and other rural enterprises with no access to bank loans, this could be their only means to acquire funding. In addition to access, leases may be more affordable than loans because down payments are lower than bank requirements and additional collateral is seldom required. From the lessor's perspective, the lessor has a stronger security position compared to that of the lender.

The case studies of three leasing companies reinforce the feasibility of leasing as a profitable rural financing tool. All the case-firms report their rural portfolio performance to be as good as or slightly better than their urban portfolio. In two of the three case-firms, a significant proportion of clients were accessing finance from a formal financial institution for the first time. And several have obtained more than one lease from the case-firms, suggesting that the access is not a one-time event.

Five lessons specific to rural leasing are drawn from the case studies:

- In rural areas, leasing is a means to acquire productive assets: all rural leases provided by the leasing companies studied are finance leases. The lease is primarily a means to finance acquisition of an asset (in contrast to renting an asset under operational leases).

- Rural enterprises of different sizes benefit from leasing but a provider may not be able to serve enterprises of all sizes: the reason appears to be differences in skills and capacities that staff requires when catering to enterprises of different sizes. While the categories of enterprises served by the companies studied overlap, each focuses on one or the other.

- Non-farm enterprises account for a significant proportion of rural leases: in the case of two of the three case-firms, leases to non-farm rural enterprises accounted for a larger proportion of the rural portfolio than leases to farming enterprises.

- Rural leasing can be profitable, but jump-starting rural leasing may require government and donor support: all three case-firms are profitable. However, they all have benefited from access to government or donor funds, particularly to expand their rural operations.

- A rural leasing company may not be viable: in two of the three case-firms, the larger proportion of clients is urban. Because leasing is a specialized financial activity, economies of scale, cost, and risk factors may require that, in most economies, leasing companies have larger urban operations.

The three case studies show that rural leasing – particularly finance leasing – can be a useful tool to finance the acquisition of a broad range of rural assets, particularly in economies in which rural credit markets do not function well.

Source: The World Bank, Agriculture and Rural Development, Discussion Paper No. 7 (2004) and 28 (2006)

8.3.3 Housing Finance

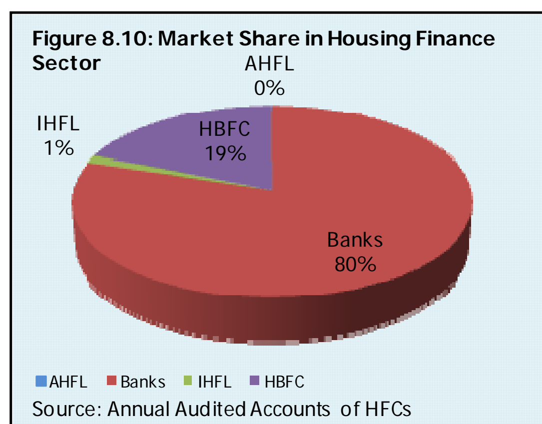
The growth of the housing finance sector has wide developmental and social implications in any country. An effective housing finance system mobilizes savings by providing access to affordable housing and, hence, capital accumulation. Furthermore, investments in the

housing sector catalyze economic activity in other sectors. It has been estimated that there are about 40 industries in Pakistan that have links to the housing market. A stimulus to the demand for housing will have a direct or indirect stimulatory impact on all of these industries, which are often labor-intensive. This helps in significant job creation and spurs economic growth.

The housing finance sector in Pakistan is underdeveloped and, until recently, has shown insipid performance despite massive housing backlog. Over the last few years, some growth has been witnessed, largely owing to macroeconomic stability, rising incomes, increasing level of foreign remittances and low interest rates (till last year). However, at 0.8 percent of GDP, the housing finance sector is small as compared to 4.0 percent for India and 15-20 percent for South East Asian countries. The penetration level is miniscule when compared with the shortage of housing units; the Karachi Chamber of Commerce and Industry has estimated that Pakistan has a current deficit of 6.1 million housing units with an annual deficit of additional 300,000 units. In addition, concerns about the growth momentum in the housing finance sector have arisen as prices of land and construction materials, as well as interest rates, have shot up. There also remain significant legal and structural constraints to the development of the housing sector in Pakistan, including poor record keeping, titling and ownership laws that make land transactions a complex and risky business.

During FY06, housing finance provided through banks, NBFCs and the state-owned HBFC aggregated to Rs. 61.7 billion. Commercial banks have recently entered the housing finance sector as part of a broader strategy of providing consumer financing. Within a span of few years, banks dominate the sector, accounting for the largest share of 80.0 percent of housing finance provided in the formal sector during FY06. Flushed with liquidity, banks started with purchase or renovation loans, targeting mainly the upper income groups in the country. Gradually, they widened the scope of housing finance to include construction finance as well as to target middle income groups. As shown in **Figure 8.10**, the enlarged portfolio has allowed banks to surpass the market share of HBFC, which was 19.0 percent for FY06. The two NBFCs engaged in housing finance, namely, Asian Housing Finance Limited (AHFL) and International Housing Finance Limited (IHFL) cumulatively accounted for only 1.0 percent of the housing finance sector in FY06.

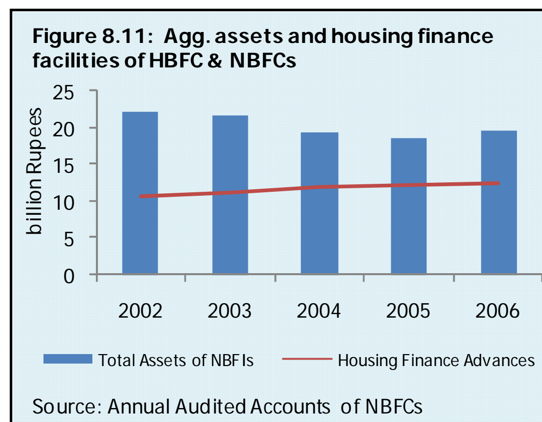
Figure 8.10: Market Share in Housing Finance Sector



Source: Annual Audited Accounts of HFCs

Taken together, HBFC and NBFCs engaged in the business of housing finance had aggregate assets of Rs. 19.7 billion as of the close of FY06; of this amount, HBFC accounted for 93.06 percent. Their total share in the asset base of the non-bank financial sector was only 4.26 percent. During FY06, aggregate assets of HBFC and NBFCs providing housing finance, grew at the rate of 5.6 percent, having declined over the previous two years (**Figure 8.11**) on account of huge provisioning against non-performing loans and suspended income and relief packages provided by HBFC. It was, however, encouraging to note a sustained increase in

Figure 8.11: Agg. assets and housing finance facilities of HBFC & NBFCs



Source: Annual Audited Accounts of NBFCs

housing finance facilities at an annual average rate of 2.18 percent over FY02 to FY06. In FY06, housing finance was 63.79 percent of total assets while earning assets improved to 86.67 percent of total assets of both HBFC and the NBFCs providing housing finance.

Gearing ratio for HBFC together with the two NBFCs undertaking housing finance business remained, on average, at around 300 percent over FY02 to FY06 (**Table 8.9**). HBFC has huge, but low-cost, borrowings from SBP and the government, in addition to borrowings from financial institutions. As a result, its gearing was higher at 328 percent than the sector average. However, the low financial charges on its borrowings have enabled housing finance companies to record an increase in spread from 7.35 percent in FY02 to 8.59 percent in FY06. Similarly, net interest margin has risen to 8.81 percent by FY06. However, huge provisioning by HBFC against its non-performing portfolio caused the earnings indicators, i.e. spread, net interest margin and income to expense ratio to dip sharply in FY04. In subsequent years, the level of provisioning and expenses declined as income levels shot up, thereby boosting the income to expense ratio from 57.36 percent in FY04 to 110.57 percent in FY05 and further to 176.59 percent in FY06. For similar reasons, return on assets and return on equity of HBFC and NBFCs providing housing finance bounced back to 0.72 percent and 3.2 percent, respectively, in FY06 after hitting its low in FY04.

Table 8.9: Aggregate Performance Indicators of HBFC and NBFCs providing Housing Finance

percent

	FY02	FY03	FY04	FY05	FY06
Housing finance to total assets	47.3	51.6	61.5	65.4	63.8
Investments to total assets	22.4	20.2	9.4	19.0	22.6
Earning assets to total assets	69.8	71.8	70.9	84.5	86.7
Growth rate of housing finance	-7.0	5.3	7.8	1.8	3.0
Debt to equity ratio	327.8	295.7	310.3	280.7	279.7
Average spread	7.4	7.5	6.9	8.3	8.6
Net interest margin	7.4	7.5	6.9	8.4	8.8
Income to expense ratio	154.3	142.6	57.4	110.6	176.6
Return on average assets (after tax)	1.4	0.9	-3.3	-1.5	0.7
Return on average equity (after tax)	7.2	4.0	-14.7	-6.8	3.2

Source: Annual Audited Accounts and SBP Calculations

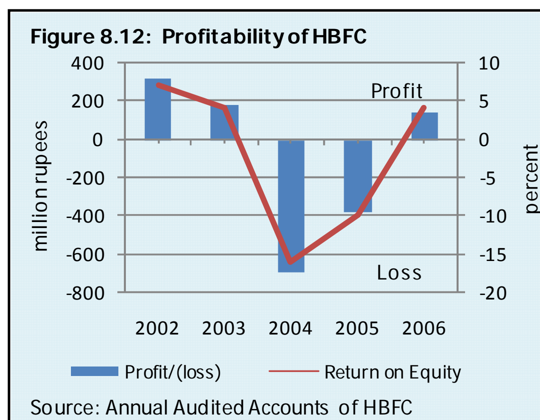
HBFC is the single largest provider of housing finance in Pakistan. Established in 1952, it provides financing for the construction, restoration, and purchase of houses to the low to middle income market segment. Nearly 85 percent of HBFC's clientele is from the low-income group, whose housing loan amount is less than Rs. 100,000, while nearly 98 percent of the clientele has per party loan below Rs. 500,000. To ensure enhanced access, HBFC has expanded its outreach to smaller cities and towns, increasing its presence in the country from 55 to 80 cities. Given the competition from commercial banks, HBFC is attempting to enhance product innovation, market development and market penetration. At present, it offers two Shariah-compliant housing finance schemes along with the facility for mortgage loan transfer. HBFC is also seeking to develop housing schemes comprising of small and medium units, based on horizontal and vertical housing solutions. Recently, it undertook to finance and develop a low-cost housing scheme in the port city of Gawadar. Floatation of REITs is also under active consideration.

HBFC is currently being restructured and recapitalized with the aim to convert it from a government program to a proactive, independent and self-sustained commercial mortgage lender. In FY06, it raised its paid-up capital to Rs. 3.0 billion through the issuance of bonus shares by capitalization of its reserves. HBFC intends to raise the paid-up capital gradually to Rs. 6.0 billion in accordance with SBP's directive to banks and DFIs. A number of reforms are underway, including an aggressive recovery plan that yielded Rs. 7 billion in FY05 and FY06 from current and non-performing loans. Targeted efforts have enabled HBFC to earn a net profit after tax of Rs. 144.31 million during FY06 after consistently being in loss for the

previous two years, as shown in **Figure 8.12**. Its return on equity also jumped back to 4.07 percent in FY06 after hitting the low of -16.33 percent in FY04.

HBFC has, in the past, financed its operations mainly from credit lines obtained from SBP. As of end-CY06, the outstanding credit lines from SBP were Rs. 11.24 billion. HBFC also received a loan of US$ 158.24 million from International Development Association (IDA) through the Government in 1984. As fresh SBP credit lines were no longer available from 1992 onwards, HBFC has since then largely relied on loan recoveries to finance additional lending. It has also repaid over Rs. 5 billion since 2002, pursuant to SBP's decision not to roll-over outstanding credit lines. Another Rs. 1.4 billion were repayable to SBP in June 2006 but the payment was not made as HBFC requested SBP to partially adjust its liabilities against HBFC's receivables from Government and reschedule the remainder amount. The matter is currently under consideration by the SBP.

Figure 8.12: Profitability of HBFC

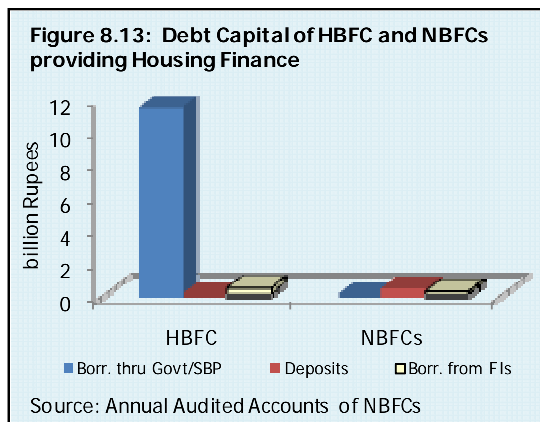


Source: Annual Audited Accounts of HBFC

Notwithstanding the decision to reschedule SBP's credit lines, HBFC must identify alternate, long term sources of financing. As the entity is planned to be run on a commercial basis, it will need to tap the securities market for raising funds rather than relying on borrowings from the government/SBP or funds from operating activities. In this regard, HBFC is considering securitization of mortgages, floatation of corporate bonds and issuance of certificates of investment to strengthen and diversify its debt capital.

Taking a closer look at NBFCs providing housing finance, i.e. IHFL and AHFL, it is apparent that they have been in a disadvantageous position as compared to banks and HBFC. The biggest constraint is the relative difficulty for these NBFCs to arrange long-term funding for their operations in order to remain competitive. As illustrated in **Figure 8.13**, NBFCs raise funds mostly from mobilizing deposits. During FY06, the aggregate deposits of AHFL and IHFL were Rs. 355.45 million as compared to borrowings from financial institutions of Rs. 190.26 million. Of the total borrowings and deposits, close to 45 percent were payable within one year.

Figure 8.13: Debt Capital of HBFC and NBFCs providing Housing Finance



Source: Annual Audited Accounts of NBFCs

Given the rate sensitivity of NBFCs/HFCs' liabilities, it becomes difficult to price long-term housing finance loans. While in most cases, these loans are provided at adjustable rates of interest, they can only be re-priced at intervals. As interest rates have started climbing up since FY05, NBFCs have witnessed narrowing spread and net interest margin. As a result, net interest margin of both the NBFCs reduced from 6.79 percent in FY04 to 4.65 percent in FY06. The lack of long-term funding instruments does not augur well for the sustainability of housing finance services by NBFCs.

Besides financing issues, operational problems for NBFCs emanate from: (i) limited outreach of NBFCs, as both banks and HBFC have an extensive branch network across the country; (ii)

inability to tap a niche market when the high-end of the market is largely served by banks and the low-end is served by HBFC; and (iii) complex and ineffective property titling and land registration systems which do not reliably guarantee or enforce property rights. Another area of significant concern is the weak equity base of AHFL at Rs. 145.88 million and IHFL at Rs. 642.75 million as of the close of FY06. In contrast, equity of HBFC was Rs. 3.62 billion as at end-CY06.

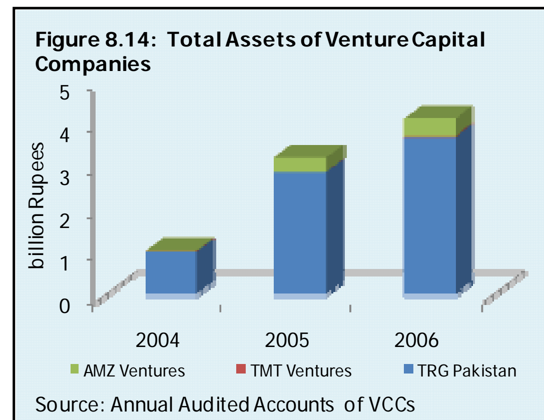
Given the challenges faced by housing finance companies, in particular NBFCs engaged in this line of business, development of long-term financial instruments for mortgage backed lending and secondary market for mortgage backed securities appear to be a plausible solution. Mortgage securities help manage the liquidity risk of making long term housing loans, increase their affordability and increase the flow of funds to the housing sector. However, this will have to be a well-structured process that takes into consideration the impediments to development of mortgage securities.

8.3.4 Venture Capital Investment

Venture capital is critical to the development of high-growth companies. It is typically provided for financing new, growing, or struggling businesses. Due to the highly risky nature of their investments, venture capital companies expect a high rate of return along with some measure of control over management/strategic planning of the investee companies. In addition, venture capitalists exit from the project after a relatively short period of time, usually within three to seven years, when the equity is either sold back to the client company or offered on a second-tier stock exchange.

The NBFC Rules provide that an NBFC may itself undertake the business of venture capital investment (called a venture capital company), or through a fund (called a venture capital fund) floated for the purpose and managed by the NBFC.

Figure 8.14: Total Assets of Venture Capital Companies



Source: Annual Audited Accounts of VCCs

The venture capital sector is at a nascent stage in Pakistan (**Box 8.4**). As of the close of FY06, the sector accounted for a mere 0.89 percent of aggregate assets of the non-bank financial sector. During the year, there were only three licensed companies, namely, TRG Pakistan Limited, TMT Ventures Limited and AMZ Ventures Limited in the sector. TMT Ventures Limited has launched the pioneer venture capital fund in the country – the TMT-PKIC Incubation Fund Limited – which provides financing at the start-up stage for businesses in the telecom, media and technology sectors. The other two venture capital companies are mainly involved in business process outsourcing (BPO). The principal activity of TRG Pakistan Limited is to acquire, manage and/or maintain the business of telephone answering services and call centers, mainly located in North America and Europe, through its subsidiary, TRG International Limited (TIL). Similarly, AMZ Ventures Limited has used the BPO structure to conduct data production and processing activities (mainly for healthcare and financial sectors) in Pakistan while the business is sourced in the US.

During FY06, the assets of venture capital companies registered a growth of 29.0 percent to reach Rs. 4.13 billion as of the close of the year (**Figure 8.14**). The increase was registered primarily on account of a surge of Rs. 795.47 million in the total assets of TRG Pakistan Limited during the year as the company increased shareholding in TIL – a Bermuda based corporation – by US$ 12.75 million or Rs. 764 million. TIL has been following an aggressive strategy for acquisition of call centers with a view to enhance their margins by pairing them up with low cost offshore service delivery centers located in Asia and Africa. The additional

Box 8.4: Impediments to Growth of Venture Capital Industry in Pakistan

Complex legal framework: The limited-liability partnership (LLP) structure, which is globally favored for venture capital deals, does not exist in Pakistan. Instead, venture capital funds are required to be incorporated as companies in terms of the NBFC Rules. As a result, a plethora of legal requirements applicable to companies in general, and NBFCs in particular, become applicable to venture capital funds. Minimum capital requirements and rules on valuation of intangible assets are some of the barriers faced by investors. Resultantly, the legal framework does not only become complex, as compared to international norms, but also takes away substantial operational flexibility from venture capital firms. Successful growth and development of a domestic venture capital industry in Pakistan will require a much more friendly and supportive legal and regulatory environment than that which exists today. SECP has already started preparation of a revised legal framework for venture capital and private equity funds in Pakistan to address these issues.

Lack of appropriate tax incentives: The venture capital industry requires suitably designed tax incentives to give tax pass-through status to venture capital funds, exemption of capital gains tax on sale of unlisted investments (in line with the exemption available on the sale of listed securities), appropriate tax treatment of interest carried forward and so on. A rather simplistic approach is currently in use whereby profits and gains of licensed venture capital companies/funds are tax-exempt up to June 30, 2014, under the Income Tax Ordinance, 2001. A structured approach to devising a favorable tax policy for venture capital funds is needed in order to boost this sector.

Limited exit options: Offer of shares on over-the-counter (OTC) or second-tier market is the most likely exit route for venture capital funds the world over; being costly and cumbersome, listing on the stock exchange is in most cases not feasible for small firms. The OTC market in Pakistan is, however, non-functional and has failed to take off due to a variety of reasons, including absence of market makers and other infrastructure. It is essential that the OTC market be made operational to ease listing of smaller companies and their eventual IPOs, which would widen the exit channels for venture capital funds.

Restriction on institutional investors to participate in venture capital funds: Currently, the legal framework prevents provident funds, pension funds and insurance companies from investing in venture capital funds due to the high risks involved. International examples, however, reveal evidence of tremendous growth in venture capital investments once institutional investors are allowed to participate in this sector. These investors not only bring in the much-needed capital but also the oversight of fund managers in prudently managing the risks involved. In order to boost the venture capital sector in Pakistan, barriers to entry should be lowered for institutional investors and sophisticated, high net worth individuals (who understand and accept the risks of long-term unmarketable investments) in accordance with a clear cut eligibility criteria based on international best practices.

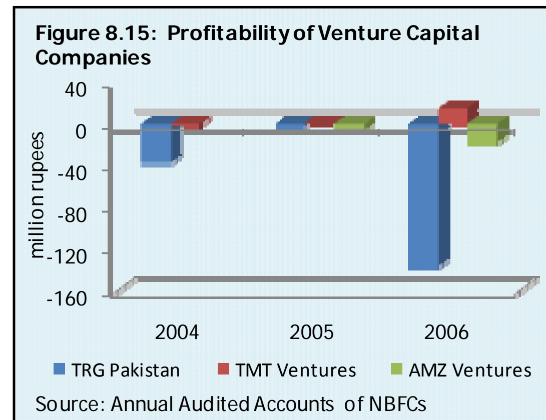
Unavailability of data on foreign funds' participation in local firms: There is little information available about the extent of investment of foreign venture capital and private equity funds in Pakistani companies. In the absence of requisite data and feedback, it is difficult to address bottlenecks faced by off-shore funds or provide them specific incentives for deepening their investments in promising enterprises in the country. This issue needs prompt attention since global trends indicate that venture capital funds, all over the world, now take the idea of global investing more seriously than ever before! The Global Trends in Venture Capital 2006 Survey, sponsored by Deloitte Touche Tohmatsu, indicates that more than half of the surveyed venture capitalists would like to expand their investment focus internationally within the next five years. Pakistan and the region have a tremendous opportunity -in-waiting that must be adequately tapped.

Inadequate institutional support: Until recently, this was a major stumbling block in the growth of the venture capital industry. The government has a key role in encouraging the availability of risk capital in any country. This may be in the form of: (i) creation of equity guarantees for domestic institutional investors; (ii) creation of a government backed seed fund; (iii) creation of national and provincial level business angle networks linked to emerging venture capital funds; or (iv) co-financing ventures with international investors. The Government support would speed up the progress towards creating a sustainable venture capital market in Pakistan.

investment by TRG Pakistan Limited into TIL during the year was to enable the latter to finance its acquisitions.

The performance of venture capital companies over FY04-06 is displayed in **Figure 8.15**. As may be seen from the chart, the venture capital sector has been consistently in loss. The reported loss for FY06 was Rs. 139.28 million as compared to the preceding year's loss of Rs. 9.02 million. The sector's performance sharply deteriorated due to losses of Rs. 135.91 million by TRG Pakistan Limited whose financial charges, amounting to Rs. 139.02 million in FY06, were five times the charges incurred during FY05. The financial charges increased due to the bridge loan of Rs. 1.4 billion taken to finance past acquisitions, and was repaid from the proceeds of the second rights issue in August 2006. TRG Pakistan Limited, as the largest venture capital company in the country, has had a dampening effect on the sector performance. By end-June FY06, the accumulated losses of TRG Pakistan Limited were Rs. 236.48 million while those of TRG Group, on a consolidated basis, were Rs. 1.05 billion.

Figure 8.15: Profitability of Venture Capital Companies



Source: Annual Audited Accounts of NBFCs

It is apparent that the performance of the venture capital industry has been lackluster despite the phenomenal growth in the size of the global outsourcing market, low labour cost and leveraging opportunities in Pakistan and keen Government interest in recent years. There are a number of factors impeding the growth of this sector, which should be addressed on priority basis to provide an enabling environment for venture capital investment in the country.

8.3.5 Discounting:

Discount houses are responsible for generating market liquidity and creating a secondary market for debt securities issued by government and corporate entities. The discounting industry has remained an under-developed segment of the non-bank financial sector in Pakistan, constituting less than 0.01 percent of GDP for FY06 and only 0.4 percent of the total assets of the non-bank financial sector.

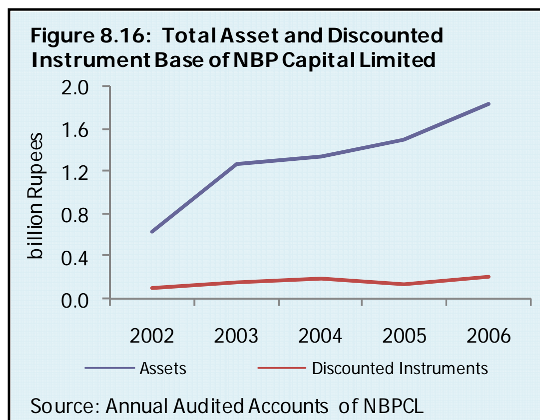
Over the last twenty years, only four discount houses were set up. All, but one, have ceased discounting business. First Credit and Discount Corporation (Pvt) Limited (FCDC) was the first discount house in the country. It was established in 1989 to provide a secondary market for the trading of bonds issued by the Water and Power Development Authority (WAPDA) as well as those of Civil Aviation Authority (CAA). In 2004, FCDC obtained from SECP the license to undertake investment finance services and did not seek renewal of the license for discounting services. The company now operates as an investment bank under the name of 'First Credit and Investment Bank Limited'. In the case of two other discount houses, namely, Prudential Discount and Guarantee House Limited and Speedway Fondmetal (Pakistan) Limited, SECP has moved the Court for their winding up in terms of the Companies Ordinance, 1984.

There remains now only one operational discount house, i.e. NBP Capital Limited. NBP Capital Limited was incorporated in 1995 as a wholly owned subsidiary of National Bank of Pakistan. It is engaged in discounting of suppliers' invoices, lease receivables, bankers' acceptance for bills of exchange and demand promissory notes. The discount rate ranges from 13 percent to 19.11 percent per annum. The discounted instruments are secured, with recourse, against hypothecation of trade receivables of borrowers. Besides license for discounting services, the company has obtained licenses from SECP for leasing, investment advisory and asset management to diversify its business activities. The leases executed by the company are for a

term of three to five years and the fixed implicit rate of return ranges from 10.75 percent to 18 percent per annum. NBP Capital Limited did not commence investment advisory or asset management services during the year and the respective licenses were subsequently withdrawn by SECP.

Diversification into financial services beyond discounting has enabled the company to strengthen its asset base, which increased by 22 percent over the year to reach Rs. 1.83 billion as of end-CY06. The asset growth was spurred by a surge of 173.64 percent in the lease portfolio of NBP Capital Limited during the year.

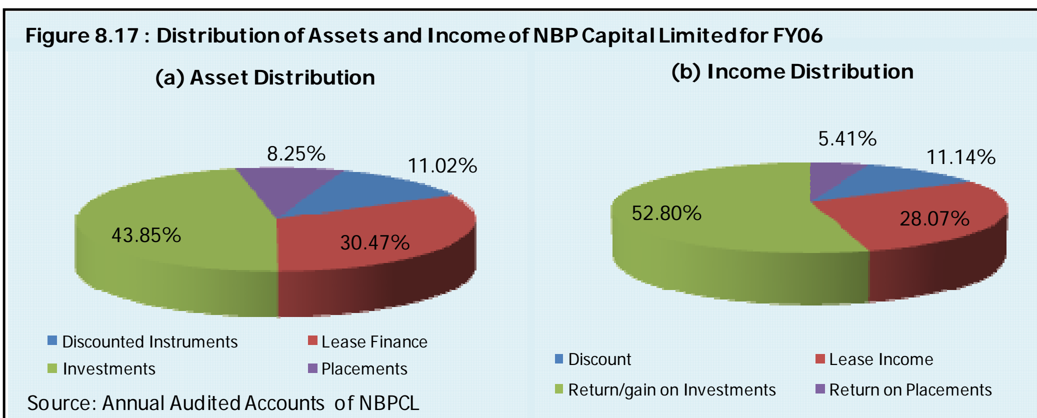
Figure 8.16: Total Asset and Discounted Instrument Base of NBP Capital Limited



Source: Annual Audited Accounts of NBPCL

Figure 8.16 shows the growth in the assets of NBP Capital Limited in comparison to the growth in discounted negotiable instruments held by the company over FY02 to FY06. The wide gap between the two is indicative of the nominal investment of NBP Capital Limited's resources in discounting services over time. For FY06, investments in securities and lease financing comprised 43.85 percent and 30.47 percent, respectively, of the asset base of the company, whereas discounted instruments were a mere 11.02 percent of the total assets or Rs. 202.15 million as of end-CY06, generating only 11.14 percent of the total income for FY06.

Figure 8.17 : Distribution of Assets and Income of NBP Capital Limited for FY06



Source: Annual Audited Accounts of NBPCL

Discounting has not only become non-existent as a stand-alone, exclusive financial service, but the marginal contribution of discounting services to total assets and total income of NBP Capital Limited – as illustrated in **Figure 8.17** – raises doubts about discounting being a financially viable activity for NBFCs. This concern emanates, in particular, from commercial banks holding a major proportion of debt securities issued in Pakistan and being engaged in discounting services and repo transactions involving debt instruments. The issue becomes peculiar since NBFC Rules do not contain any specific provisions for NBFCs holding license for discounting services. It is imperative that SECP carves out the role of discount houses in promoting a secondary market for government and corporate debt instruments for sustaining this activity within the non-bank financial sector or otherwise consider the possibility of clubbing discounting services with another permitted activity of NBFCs.

8.3.6 Mutual Funds

A mutual fund is a vehicle for pooling together savings of diverse investors – individuals as well as institutions – to collectively invest those savings in stocks, bonds and/or money market instruments. It offers several advantages to investors, particularly retail investors,

overtaking a direct exposure in capital and money markets. The expertise and resources of the fund manager in identifying and selecting investment options is the most important incentive for investing in mutual funds. Besides professional management, mutual funds offer a diversified investment portfolio that helps to reduce exposure risks for individual investors and allow sharing of transaction costs among all investors.

The mutual funds sector is rapidly growing in Pakistan and accounted for the largest chunk of 38.34 percent in total assets of the non-bank financial sector in FY06. Between FY02 to FY06, net assets of mutual funds have grown by more than 6 times to reach Rs. 160 billion by the close of FY06. The average payout of the mutual funds industry also grew to 21.13 percent in FY06, as illustrated in **Figure 8.18.** The total market capitalization of the sector was Rs. 162 billion as on end-June FY06 (representing around 6 percent of total market capitalization of the Karachi Stock Exchange) as compared to 26 billion as of close of FY02. Despite these developments, the size of mutual funds industry is still very small in international comparison (**Table 8.10**).

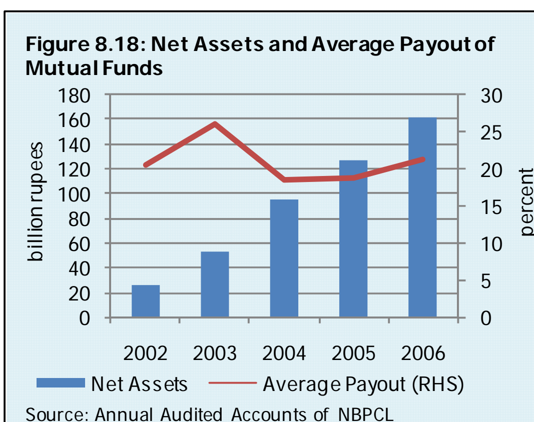
Table 8.10: Worldwide Net Assets of Mutual Funds

billion US Dollars

	2006
Americas	11,486
United States	10,414
Europe	7,744
Africa	78
Asia and Pacific	2,457
Australia	864
Hong Kong	631
Republic of Korea	252
India	58
Pakistan	2
Philippines	1
World	21,765

Source: Investment Company Institute

Figure 8.18: Net Assets and Average Payout of Mutual Funds



Source: Annual Audited Accounts of NBPCL

The growth in mutual funds in Pakistan is attributable to: (i) liberalization of the sector; (ii) economic growth and macroeconomic stability that attracted investors, including foreign investors, to the stock market; (iii) increased liquidity with institutional investors, which was channelized into the stock market and mutual funds; (iv) high corporate earnings that increased the earnings potential for mutual funds; and (v) a buoyant stock market that provided mutual funds with good returns in the form of capital gains. Liberalization has helped to facilitate entry of the private sector in the mutual funds industry. Historically, the industry was dominated by public sector funds. However, creation of an enabling legal framework to allow mutual funds to be set up in the private sector and transfer of ICP-managed closed end funds to two private sector investment advisers in FY03 boosted the number and size of funds under the management of the private sector, increased competition and efficiency of the sector and enhanced the quality of fund management. It also provided opportunity to financial institutions, like banks and brokerage firms, to diversify into fund management through subsidiaries and associated companies. As may be seen from **Table 8.11**, the share of private sector funds in the sector has grown from 10 percent to 60 percent over the last five years. While the public sector open-end mutual fund, NIT, by its sheer size continues to have a significant share of 40 percent in net assets of the sector, its privatization has been announced by the Government.

As of end-June FY06, the mutual funds sector comprised of 27 open-end funds and 17 closed-end funds. Open-end funds dominate the sector, as shown in **Table 8.11**, due to investors' preference for the flexibility to enter or leave open-end funds at any time at the prevailing value of net assets per unit. In FY06, the share of open-end funds in the net assets

of the mutual funds sector was 72.7 percent as compared to the share of closed-end funds at 27.3 percent. Closed-end mutual funds are suitable for long-term investors. In the absence of continuous sale and redemption of certificates by a closed-end fund, investors can only exit the fund at the market price of shares/certificates on the stock market, which is generally at a discount to net assets value per share/certificate. However, lack of redemption pressure has its advantages for the closed-end fund, particularly with respect to the ability to invest in illiquid, but high-potential small and medium-sized companies to earn high returns, optimizing investment of assets by maintaining low liquidity and saving on marketing and distribution costs. Given the usefulness of closed-end funds, necessary mechanisms may be introduced to facilitate investors who wish to exit a closed-end fund in order to address their primary concern about investing in the closed-end mutual funds. Internationally, buy-back of shares/certificates of a closed-end fund by its fund manager, prompted by trading of shares at a certain discount to net assets value, is widely used to minimize the difference between the market price of shares/certificates on the stock market and their net asset value (NAV), so that the secondary market price is not disadvantageous to investors exiting the closed-end fund.

Table 8.11: Structure of Mutual Funds
Rupees in billion and share in percent

	FY02	FY03	FY04	FY05	FY06
Net Assets	24.8	51.6	93.7	125.8	159.9
Share by Ownership (in percentage)					
Public Sector	89.6	78.5	52.8	48.5	40.2
Private Sector	10.4	21.5	47.2	51.5	59.8
Share by Type (in percentage)					
Open-end Funds	78.1	78.2	73.6	70.1	72.7
Closed-end Funds	24.9	21.8	26.4	29.9	27.3
Share by Category (in percentage)					
Equity Funds	92.2	81.2	76.5	72.8	63.0
Income Funds	0.0	6.6	6.4	6.2	10.6
Money Market Funds	0.0	4.6	3.6	3.9	7.3
Balanced Funds	6.7	5.8	10.3	9.0	7.2
Islamic Funds	1.1	1.8	3.2	4.7	5.6
Tracker Funds	0.0	0.0	0.0	0.0	0.6
Fund of Funds	0.0	0.0	0.0	0.4	0.5
Asset Allocation Funds	0.0	0.0	0.0	3.0	5.2

Source: Annual Audited Accounts of Mutual Funds

An encouraging development in the mutual funds sector is the increasing diversity of categories of funds offered for public subscription, as also evident from the variety of entrants in the sector during FY06 (**Box 8.5**). By the close of the year, equity funds constituted 63 percent of the mutual funds sector, income funds constituted 10.6 percent, money market funds were 7.3 percent, balanced funds were 7.23 percent, Islamic funds were 5.62 percent and asset allocation funds were 8.16 percent, while tracker funds and fund of funds were also available. Equity funds have the largest share in the mutual funds sector in terms of the number of funds as well as the net assets under management. However, the large assortment of options for investors is a reflection of the ability of fund managers to meet the investment needs and risk

Box 8.5: Mutual Funds Offered During FY06
During the year, the following twelve new mutual funds were offered:

i. AKD Index Tracker Fund
ii. AKD Opportunity Fund
iii. Al-Falah GHP Value Fund
iv. AMZ Plus Income Fund
v. Askari Income Fund
vi. KASB Liquid Fund
vii. NAFA Cash Fund
viii. Pakistan International Element Islamic Fund
ix. PICIC Energy Fund
x. United Growth and Income Fund
xi. UTP A30+ Fund
xii. UTP Fund of Funds

Three funds namely, ABAMCO Capital Market Fund, ABAMCO Stock Fund and ABAMCO Growth Fund were merged to form UTP – Growth Fund.

Source: SECP

profile of a variety of investors.[11]

A significant regulatory development during FY06 was the discontinuation of SECP's requirement for asset management companies to seek foreign collaboration in managing open-end funds.[12] The condition had been imposed at the initial stage of development of the mutual funds industry in Pakistan to facilitate transfer of technical knowledge and expertise from overseas fund management companies to local fund managers. It was considerably successful in enabling local asset management companies to obtain training, know-how and resources from their international affiliates. The condition was removed once SECP was satisfied with the pace of development of the mutual funds sector and the abilities of the asset management companies to manage their respective funds professionally and proficiently. On the positive side, removal of the condition for mandatory foreign affiliation has helped to lower barriers to entry of new fund managers. However, a greater responsibility now lies with SECP in strengthening its licensing criteria for fund managers, monitoring their performance and taking appropriate enforcement actions in order to prevent market abuse. In discharge of this responsibility, SECP – since August 2005 – requires asset managers and investment advisers to obtain from credit rating agencies in Pakistan ratings

Box 8.6: Conditions on International Investments of Mutual Funds

Generally, asset managers and investment advisers are required to fulfill the following conditions while investing mutual funds abroad, in terms of the offering documents:

- While investing in international equities, international profit-bearing securities and international money markets, the asset manager/investment adviser will only invest through its foreign counterpart or the following avenues unless it has built in-house capacity to manage international investments and provided evidence of the same to the trustee: (i) mutual funds; (ii) index funds or securities that give exposure to international equity indices; (iii) managed accounts with a reputable international fund manager; or (iv) directly invested after acquiring the services of a reputable international fund manager through a joint venture or a service agreement.

- Any advisory, management or consultancy fee charged directly by an international fund manager on mutual fund's investments abroad will be the responsibility of the asset manager/investment adviser. Any fees paid out of the mutual fund's property will be netted-off from the fees paid to the asset manager/investment adviser.

- The asset manager/investment adviser will reduce its own fee by up to 50 percent on the mutual fund's property invested in international mutual funds managed by third party.

- Associated companies and companies in parent-subsidiary relationship shall be treated as group companies, even if registered/ listed in different countries and any prescribed limit on group exposure shall apply to such companies.

- Direct investments of mutual funds in debt securities will only take place in 'investment grade' securities and 'sovereign risk' securities. Only up to 50 percent of the allowed limit of international investments shall be placed in sovereign risk securities of countries outside Pakistan and only up to 20 percent of the allowed limit of international investments in sovereign risk securities of any one country with the sovereign risk portion, if fully invested, divided among five different countries. The above limit will be applicable only to direct investments by the Fund.

- Not more than 50 percent of allowable limit of international investment will be placed in any one country.

Source: Offering Documents of Pakistan International Element Islamic Fund and AKD Income Fund

[11] Between July 2006 and June 2007, 25 new mutual funds were offered, of which four belonged to a new category of mutual funds, i.e. capital protected funds.
[12] SECP's announcement of 2 November 2005.

specific to their fund management quality as well as ratings specific to the performance of the mutual funds managed by them.[13] The ratings must be disseminated for public information and disclosed in the accounts and advertisements of mutual funds and fund managers. SECP has also started inspections of fund managers, focusing on the quality of their systems and procedures, subsequent to the close of FY06.

During FY06, SBP allowed mutual funds to make overseas investments up to 30 percent of the aggregate funds mobilized (including foreign currency funds) subject to a cap of US$ 15 million, whichever is lower.[14] Prior approval of SBP is required by a mutual fund seeking to invest outside Pakistan. In order to manage associated risks, SECP generally requires fund managers to observe certain conditions vis-à-vis international investments. The permission to invest abroad has been welcomed by the mutual funds sector as it would enable them to diversify investments outside Pakistan. As many as four mutual funds have availed the opportunity to invest in foreign portfolios.

The mutual funds industry is gradually moving towards a wider concept of collective investment schemes (**Box 8.6**). With the Voluntary Pension System Rules in place since FY05, asset managers are exploring the opportunity to manage private pension schemes in the country. There is a business case for fund managers to strengthen their risk management systems and investment expertise in order to manage pensioners' money. Once operational, pension fund managers will be responsible for managing an enormous pool of funds. Moreover, SECP's current initiative to develop a legal and regulatory framework for REITs and occupational savings schemes will open up another lucrative market for fund managers.

Developments in the regulatory and operating environment indicate a strong potential for the mutual funds sector to continue its growth momentum albeit the challenges faced by the sector need to be addressed expeditiously (**Box 8.7**).

Box 8.7: Challenges for the Mutual Funds Sector

The significant challenges for the mutual funds industry are:

- restrictions on institutional investors, such as provident and pension funds to invest in mutual funds;
- availability of national savings schemes for institutional investors;
- inadequate mobilization of investments from retail investors due to lack of financial literacy in the country, low savings rate and concerns about protection of minority shareholders' rights;
- lack of depth in the domestic securities market that constraints investment decisions;
- the need to introduce stringent fit and proper test for fund managers and intermediaries, including their sales force;
- ·the need to implement international best practices across the sector and improve fund governance, transparency and disclosure; and
- limited institutional capacity to act as trustees of funds, particularly REITs.

8.3.7 Modarabas

Modaraba is an Islamic mode of doing business and implies a contract between two parties: one party, the Rab-ul-mal entrusts money to the other party called the Mudarib, who puts in its management expertise and utilizes the capital in an agreed manner. Profits of the

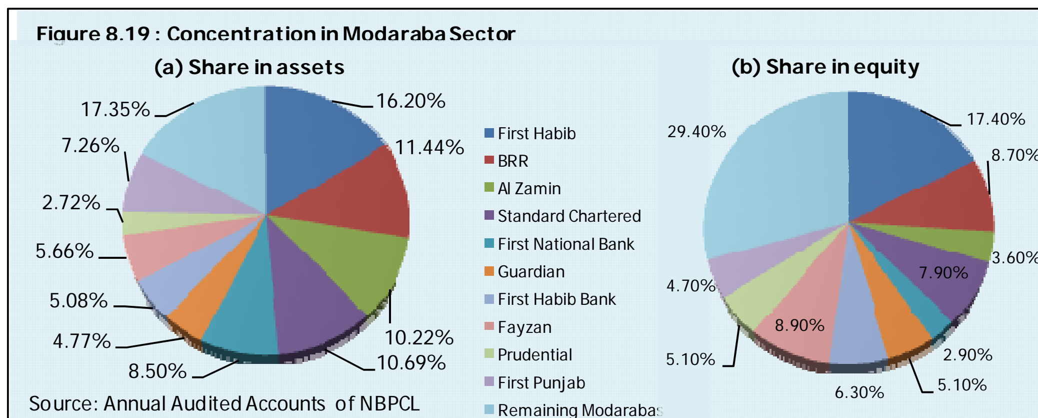
[13] SECP's Circular No. 11 dated 19 August 2005.
[14] FE Circular No. 11 dated 12 August 2005.

modaraba are shared in a pre agreed ratio and losses in the proportion of the capital invested.

Modaraba, as a concept, was introduced in Pakistan in 1980 upon promulgation of the Modaraba Companies and Modaraba (Floatation & Control) Ordinance. The law provides that a modaraba can be floated by a modaraba company, which is registered with the Registrar of Modaraba Companies. Modarabas can be either for a specific purpose or can be multipurpose. Similarly, they may be floated for a limited period or for perpetuity. Considerable flexibility is available to modarabas regarding the nature of business that they may conduct, with the only restriction being that the nature of business should be according to the injunctions of Islam. The Religious Board, constituted by the Federal Government, issues a certificate to this effect. Currently, the activities of modarabas are focused on lease financing (Ijarah), lending (Murabaha and Musharika), investing in securities markets and, in some cases, trading and manufacturing. Also, if 90 percent income of a modaraba is distributed among certificate holders, the entire income of the modaraba is exempt from income tax.

The modaraba sector experienced an initial boom in the 1980s and registered a mushroom growth in the number of entities. The sector suffered a major setback when the income tax exemption was withdrawn in 1993 (although the exemption was restored for non-trading modarabas in 1999). Economic sluggishness and slump in the stock market adversely affected the growth and performance of modarabas. Having been hit by falling share prices in the stock market, most of the modarabas focused on the more profitable leasing business. However, in doing so they faced stiff competition from banks and leasing companies. The situation became worse due to lack of access of modarabas to low cost funds.

Figure 8.19 : Concentration in Modaraba Sector



Source: Annual Audited Accounts of NBPCL

In recent years, modarabas have benefited from economic growth, low interest rates and a buoyant equity market. As of the close of FY06, they had a share of 8.18 percent in the asset base of the non-bank financial sector. Structural improvements, particularly through mergers and amalgamation, have also improved the performance of the sector. In particular, mergers within and across sectors have helped to reduce fragmentation to some extent. However, the sector is still the largest among NBFIs – after mutual funds – in terms of the number of entities. During FY06, there were 29 modarabas but only a handful dominated the sector. As shown in **Figure 8.19**, the ten largest modarabas together accounted for 82.65 percent of the total assets of the sector for FY06. The remaining modarabas held only 17.35 percent of total assets. However, even the larger modarabas were not well-capitalized, with the exception of First Habib Modaraba whose equity base was close to Rs. 1.8 billion as of end-June FY06. All the rest of the modarabas had equity below Rs. 1 billion. Overall, as many as 18 modarabas had equity below Rs. 500 million, of which 7 had equity less than Rs. 100 million as of the close of FY06. The ten largest modarabas accounted for only 70.6 percent of the aggregate equity base. The low equity of modarabas is largely on account of: (i) huge losses suffered by the modaraba sector in previous years; and (ii) distribution of 90 percent profits by modarabas in order to claim tax exemption.

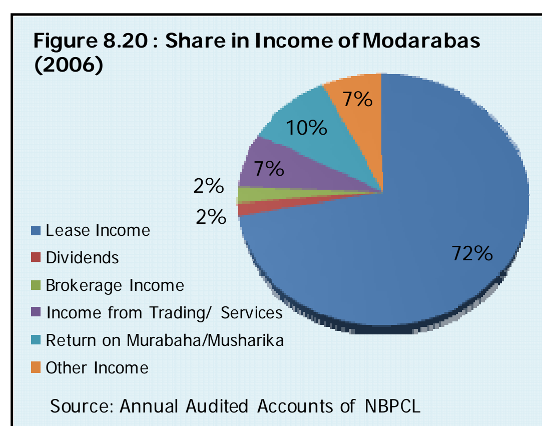
Table 8.12: Key Performance Indicators of Existing Modarabas
percent

	FY02	FY03	FY04	FY05	FY06
Total assets (Rs. in billion)	12.9	13.4	15.4	19.6	23.9
Growth rate of assets	6.9	4.6	14.1	27.5	22.3
Lease finance to total assets	48.3	51.4	50.7	50.9	46.8
Investments to total assets	16	12.3	17.1	17.6	17.2
Murabaha/ musharika to total assets	17.7	20.6	15.3	16.6	15.8
Earning assets to total assets	81.9	84.3	83.1	88.1	79.9
Debt to equity ratio	91.9	79.5	96.5	111.3	118.2
Income to expense ratio	125	131.5	137.1	125.9	121.1
Return on average assets (after tax)	6.3	7.8	6.7	4.7	3.6
Return on average equity (after tax)	13.8	16.5	14	10.2	8.4

In terms of growth of assets, the modaraba sector has registered annual average growth rate of 15.08 percent over FY02 to FY06. As of the close of FY06, the assets of existing modarabas had reached almost Rs. 24 billion, growing at a rate of 22.3 percent during the year. As shown in **Table 8.12**, lease financing constituted almost half of the total assets of modarabas over the last five years, with its share dipping slightly to 46.8 percent in FY06. Modarabas also provide lending as murabaha and musharika facilities besides investing in the securities markets. During FY06, share of murabaha/musharika in the total assets of modarabas was 15.8 percent while that of investments was 17.2 percent.

In line with the asset composition, the largest share of 72 percent in the total income of modarabas was earned from leasing activities for FY06, as shown in **Figure 8.20**. This proportion was consistent with previous years' results. Another 10 percent was contributed by returns on murabaha and musharika financing. Trading activities of modarabas yielded income to the tune of 7 percent of the total income during the year. Some of the modarabas also undertook brokerage functions, with brokerage fee and commission accounting for 2 percent of the total income. However, the sector suffered capital losses of Rs. 124 million on stock market investments during the year, primarily on account of poor results reported by First Equity Modaraba for FY06. The capital losses of First Equity Modaraba amounted to Rs. 292.8 million that wiped away the meager capital gains made by the rest of the modarabas. The matter is being looked into by the Registrar Modaraba in view of requirements of the Prudential Regulations for Modarabas and Modaraba law and rules.

Figure 8.20 : Share in Income of Modarabas (2006)



Source: Annual Audited Accounts of NBPCL

Capital losses, together with high depreciation/amortization costs and high financial charges, dampened the income to expense ratio for the modaraba sector to 121 percent in FY06, from its peak of 137 percent in FY04. The higher expenses reduced the net profit of the modaraba sector to its lowest level in four years. As a result, return on assets and return on equity receded to 3.6 percent and 8.4 percent, respectively, in FY06.

As compared to NBFCs undertaking investment finance, leasing or housing finance services, modarabas have been the least geared throughout the last five years. In fact, modarabas were not previously allowed to raise debt capital, which was a huge constraint in financing their operations and activities. The gravity of the problem was substantially reduced when SECP allowed modarabas to raise funds through issuing certificates of musharika (similar to certificates of investments issued by NBFCs) and musharika-based term finance certificates. However, the persistently low gearing ratio for modarabas, which reached 118.2 percent by

FY06, reveals that they have not successfully tapped debt capital, particularly through deposits.

Another issue for modarabas on the financing side is the requirement to distribute 90 percent of their annual net profits in order to claim tax exemption. This restricts building up of equity by modarabas since most modarabas prefer to distribute profits among certificate holders to avail the exemption. The result is evident in the form of the low equity base of modarabas. In order to enable modarabas to accumulate their profits, the Registrar Modarabas, in July 2006, raised the upper limit from 30 percent to 50 percent of profits required to be taken to a statutory reserve. This should, to some extent, help to strengthen the equity base of modarabas albeit the issue of low equity should require a well-considered policy intervention. One possibility could be for SECP to encourage mergers of small modarabas so that only well-capitalized, profitable entities continue to operate in the sector.

As a result of tax exemption for modarabas paying 90 percent of profits among certificate holders, the payout ratio of the modaraba sector is comparatively higher than many other sectors listed on the Karachi Stock Exchange (KSE). However, certificates of most modarabas are being traded at below par value. As of end-June FY06, certificates of only 3 modarabas were trading on KSE at more than their par values while the rest were at a discount. This effectively restricts the possibility for certificate holders to exit a modaraba. The situation is analogous to that of closed-end funds but the modaraba structure suffers from certain rigidities, by virtue of the legal framework, that puts them at a disadvantage. Firstly, the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 requires the government to set up a Religious Board. The Religious Board is authorized to determine whether or not the business of a modaraba is in line with the Shariah principles. Such a broad power means that a modaraba cannot commence or diversify its business unless it has obtained a certificate from the Religious Board. This not only reduces operational flexibility for modarabas if there is a lag on part of the government to constitute the Religious Board – as was experienced for three years from April 2002 to March 2005 due to expiry of the term of the previous Board – but no fresh activity can take place in the sector. Another major drawback of the Modaraba law is that it does not empower certificate holders to review the performance of the management company on the basis of annual accounts of a modaraba or change the management company on specific grounds.

Despite their long standing presence, modarabas have not been able to establish their niche market. As discussed earlier, most of the funds of the modarabas are deployed in leasing and lending. Intense competition, particularly with banks, makes it impracticable for modarabas to continue to focus activities on these areas. While some modarabas have started exploring other business activities, including housing finance, real estate investments, and trading and services, it is critical for the sector to develop new, innovative products. Rural and SME financing particularly merit attention, given the considerable scope for expansion in these areas.

The modaraba sector lags behind other players in the Islamic financial market, i.e. Islamic banks and Islamic mutual funds. As of the close of FY06, assets of modarabas were a mere one-fifth of the total assets of Islamic banks despite the fact that modarabas were the pioneer Islamic institution in Pakistan's financial sector. This is largely due to the modaraba sector concentrating on ijarah, murabaha and musharika without exploring other Islamic financial instruments, including diminishing musharika, istasna and salam. There is also limited research, at both entity and industry levels, in structuring Islamic products as well as in standardizing contracts of Islamic modes of finance. If the modaraba sector is to make a meaningful contribution to the financial sector, it must address the challenges in product development and innovation.

8.4 Conclusion

The non-bank financial sector plays an important role in the mobilization and channeling of savings in the financial system. The NBFIs have, in recent years, benefited from a low

interest rate, high economic growth environment but have been unable to create an impact as well-functioning, specialized financial intermediaries. As banks have made rapid inroads into business segments traditionally serviced by NBFIs, market share of NBFCs and modarabas has eroded considerably, so much so that Investment finance and discounting are likely to disappear as stand-alone activities in the non-bank financial sector while leasing and modaraba sectors are faced with the dilemma of 'diversify or die'. Furthermore, housing finance and venture capital industries have failed to take off despite significant demand potential. The only success story among NBFIs is that of mutual funds.

In such a scenario, further growth of the non-bank financial sector is highly dependent on providing a conducive environment for growth of promising segments (collective investment schemes, including mutual funds), creating niche markets and products for mature industries (leasing and modarabas) and restructuring the under-developed components of the financial sector (housing finance and venture capital). While SECP has initiated activities for developing new products, like pension funds, master trusts for occupational savings scheme and REITs, and encouraging private equity and venture capital industries, focus on other issues facing the NBFI sector appears to be missing.

A thorough examination of factors affecting commercial viability and risk profile of NBFIs is needed. A significant factor impeding development of NBFCs and modarabas is the low capital base of these entities. Low regulatory thresholds and abundance of small institutions are the root cause. Continued consolidation in the sector, through mergers and amalgamations as well as through raising the minimum capital requirements, is desirable in order to provide NBFCs and modarabas a level playing field in the financial sector.

NBFCs and modarabas have also suffered from a dearth of funding sources and high reliance on borrowings. It is essential to enable these institutions to diversify funding avenues at lower cost of funds. This may be possible through providing flexibility in accepting deposits, generating long term and overnight borrowings from the money market and development of attractive corporate debt instruments.

On the regulatory side, risk management of NBFCs and modarabas merit attention. Major differences in regulatory approach towards banks and NBFIs can lead to regulatory arbitrage, which can pose challenges to financial sector stability. A risk-based approach to oversight and effective enforcement of laws is particularly important in the case of deposit-taking institutions, to avoid the social implications of excessive risk-taking and poor performance. In the absence of a financial safety net framework and insolvency regime in Pakistan – to provide for an orderly exit of institutions that have become inoperative, unprofitable or illiquid – protecting depositors' interest is a paramount issue.

With the increasing convergence of product lines between banks and NBFIs, a notable feature within the financial sector in Pakistan has been the emergence of financial conglomerates. As a result, banks, along with group companies, are now involved in NBFI, brokerage and insurance businesses. As a universal financial regime is setting in, issues regarding the capital and corporate structure for NBFCs and modarabas and regulatory approach to consolidated supervision become even more crucial. In addition, the relationships and overlaps between the banking sector, securities markets, and non-bank financial sector need to be examined in depth to identify the risks and opportunities, failing which it will be particularly difficult for small institutions to survive.