Chapter 6 Non-Bank Financial Institutions[41]

NBFIs asset base surged by 22.6 percent at the back of phenomnal growth in mutual funds industry while some of the NBFI-subsector struggled for survivial. Borrowing remains the major funding source for NBFIs, which in wake of challenging enviornment, continues to shrink. Improved performance of Modarbas and leasing boosted overall profitability of the system, which marginally improved the capital base of NBFIs. However, a number of NBFIs still fail to meet the minimum equity requirement (MER) which keeps the option of further consolidation of NBFIs open.

Overview[42]

NBFIs asset base surged at the back of phenomenal growth in Mutual funds industry.

After declining for two consecutive years, NBFIs' assets surged by 22.6 percent, duirng the year under review **(Table 6.1)**. This increase was mainly driven by a phenomenal 29 percent growth in mutual funds over the year(16 percent over the half year), duly supported by increase in assets of Modarabas and DFIs by 8 percent and 10 percent respectively. On the other hand, Investment Finance Companies (IFCs), leasing companies and venture capital continued to struggle for existence **(Figure 6.1)**. Despite healthy growth, the overall size of NBFIs in the financial sector remains small; with assets of Rs 517.4 billion, NBFIs represent 2.7 percent of GDP[43] of the country.

Figure 6.1
Growth Trend in Non-bank Finance Sector

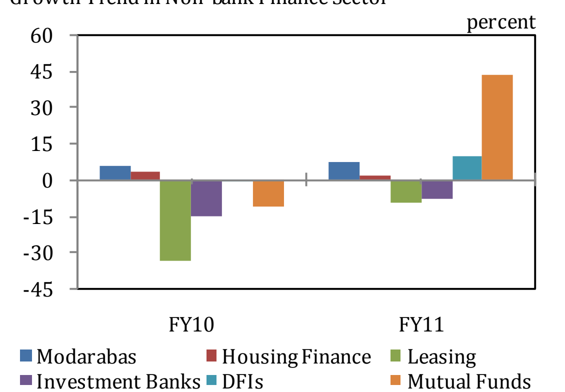


Table 6.1: Profile of NBFIs

	FY04	FY08	FY09	FY10	FY 11
Assets (Rs. Billion)	318.1	585.6	470.1	421.9	517.4
Growth rate	22.7	3.28	-19.72	-10.25	22.62
Share in Assets (percent)					
Mutual Funds	32.4	58.5	47.9	47.6	55.7
DFIs	29.8	14.5	24.2	26.8	24.1
Leasing	14.1	11	11.9	8.8	6.5
Investment Finance	11.2	7.4	6.6	6.2	4.7
Modarabas	5.7	5.1	4.9	5.8	5.1
Housing Finance	6.1	3.1	4	4.6	3.8
Venture Capital	0.3	0.3	0.5	0.3	0.2

Source: Annual Accounts of NBFIs and MUFAP
DFIs and Mutual funds data is as of December 2011
*Assets of HBFC, a DFI engaged in providing housing finance, have been included in the Housing Finance category however for analysis purpose we have included HBFC under DFI category.

Mutual funds sector, which experienced a major setback after imposition of floor on KSE-100 index in FY09, managed to recover the lost value in FY-11 on the back of increased investments in money market funds. As a result mutual funds now constitute 56 percent of the assets of NBFIs **(Table 6.1)**. Growing fiscal deficit and tax arbitrage on investment in mutual funds proved major factors behind the growth of mutual fund industry. All other sectors saw contraction in their respective shares, with major drop in leasing and IFCs. Moderate increase in the asset base of DFIs and Modarabas was overshadowed by healthy growth in mutual fund, which lead to marginal drop in their share in the asset base of NBFIs.

...while other subsector of the NBFIs struggle for survival.

The sector, though has seen continuous consolidation over the years, the trend is making survival of some sub-sectors difficult.

[41] Non-Bank Financial Institutions (NBFIs) include Non-Bank Finance Companies (NBFCs), Modarabas and Development Finance Institutions (DFIs)where NBFCs include Investment Finance Cos.(IFCs), Leasing Cos., Mutual Funds, Venture Capital Cos.(VCCs). and Housing Finance Cos.
[42] The analysis of NBFCs and Modarabas is based on Annual Statements as of June 30, 2011, whereas DFIs' and Mutual Funds data is as of December 31, 2011.
[43] Average GDP at market price.

Table 6.2: Number of NBFIs

	FY08	FY09	FY10	FY11
DHs	1	0	0	0
VCCs	4	3	4	3
HFCs	2	1	1	1
DFIs	6	8	8	8
IFCs	11	9	8	7
Leasing	12	11	9	9
Modarabas	27	27	26	26
M. Funds*	95	102	135	144
Total	158	161	191	198

Source: SECP and MUFAP and for analysis purpose, 7 IFCs are used for FY10 analysis as 1 IFC is under winding up.

Table 6.3 Key Performance Indicators of NBFIs*

percent (unless mentioned otherwise)

	FY08	FY 09	FY 10	FY 11
Capital to Assets	35.2	35.9	36.2	35.4
Advances to Assets**	52.5	47.7	41.4	38.7
Investments to Assets**	28.6	34.0	39.2	46.8
Earning Assets to Total Assets**	82.6	85.6	80.7	85.5
Debt to Equity Ratio (Times)	2	2.1	1.8	1.8
Borrowings to Liabilities**	61.1	58.1	60.0	66.7
Deposits to Liabilities**	25.2	28.7	27.8	21.5
Income to Expense	111.3	92.5	102.5	112.9
Return on Average Assets (after tax)	0.9	-1.6	-0.1	0.6
Return on Average Equity (after tax)	3	-5.1	-0.3	1.7

*Excluding Mutual Funds and Venture Capital

** Modarabas are not included for these ratios

Excluding mutual funds, number of NBFIs stood at 54 in FY11, down from 56 in FY10. Among the sub sectors, IFCs performance saw further deterioration duirng the year, amid their inability to generate fresh funds to do business, though competition from banks and challenging economic enviornment. With expected merger transaction of largest IFC(holding 36 percent share), the sector is expected to loose substantial ground. With already small number of firms, further deterioration of performance and closure/consolidation of NBFIs, particularly IFCs and leasing companies, will further decline the role of NBFIs sector and need urgent measures to make this sector sustainable **(Table 6.2).**

In line with the overall slow down in busines and economy, the share of advances in total assets[44] decreased to 38.7 percent **(Table 6.3).** The contraction, was observed all around as financing became more risky and funding sources remain limited. The exposure of banks on NBFIs, their main financing source, declined by 6 percent over the year. In the meantime, investment mainly in risk free secutiries increased as instituition opted flight to safe haven. DFIs, with 27 percent increase in investments provided boost to 23 percent increase in overall investments**.**

Borrowing remains the major funding source for NBFIs

On the funding side, NBFIs reliance on borrowing from financial institutions increased with a concomintant drop in deposits. Borrowing saw a substantial surge over the year, which enahnced its share in total liabilities to 67 percent in FY11, up from 60 percent in FY10. Most of the borrowing was concentrated in DFIs, while the drop in deposits is observed all aorund. Particulaly the leasing companies not only shed their borrowings but also their deposits and utilized their recoveries from leases for filling up the funding gap **(Table 6.3)**.

Improved performance of Modarabas and leasing boosted profitability of the system

NBFIs posted profit after tax of Rs 1.3 billion against losses booked during FY09 and FY10. As a result, the ROA and ROE of NBFIs turned positive in FY11. Decrease in provisions across the NBFIs remains the key factor in improving the performance, in addition to overall risk averse attitude. The profitability of the sectors resulted from improved performance of Modarabas and leasing companies, while profitability of DFIs remained below the level achieved in FY10. Further analysis show that profitability is mainly attributed to a few institutions in each of the sub-sector and exit of any of these institutions will significantly decrease share of NBFIs sector in the financial system and adversely impact the performances of the specific sub-sector. Improved profitability, marginally improved the capital base of NBFIs, however, a number of NBFIs still fail to meet the minimum equity requiremt(MER).

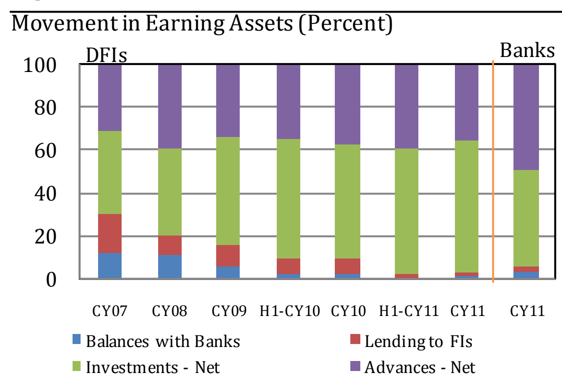
[44] Excluding Mutual funds and Modarabas

Development Finance Institutions (DFIs)[45]

Strong lopsided growth in investments provided boost to assets base of DFIs.

Figure 6.2

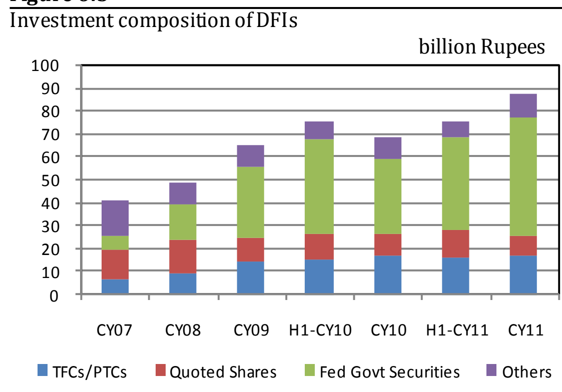
Movement in Earning Assets (Percent)



The asset base of DFIs, which remained stagnant for last couple of years, saw a modest growth of 7 percent during the half year under review. Like banks, increase came from rising investment portfolio, which now constitutes 57 percent of the asset base and 62 percent of the earning assets. Institution wise analysis shows that increase in assets and investment was contributed by a few DFIs. Advances, on the other hand, saw a contraction of 1.8 percent, which decreased their share in asset base to 32 percent (**Figure 6.2**). Lending to financial institution which almost dried up during the first half of the year, saw improved activity; with most of the increase taking place in last quarter of the year.

Figure 6.3

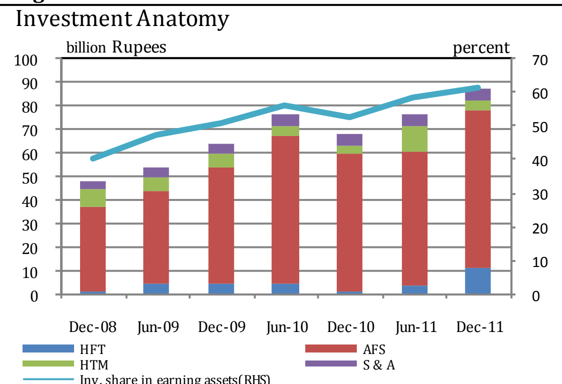
Investment composition of DFIs



Investments surged by 15.5 percent over the half year due to 28 percent increase in short term government securities. As a result, the share of, Federal Government securities increased to 59.4 percent of total investments (**Figure 6.3**). However this growth was not broad based, as increase was driven by a couple of DFIs. With deterioration of capital market[46], DFIs shed their investment in shares, mutual funds etc. by 9 percent. The value of investments in subsidiaries and associates (S&A), which mainly constitute Mutual Funds, Leasing and Takaful, further declined due to continuing losses particularly in the later two segments (see later section of this chapter).

Figure 6.4

Investment Anatomy



Due to stressed money market, DFIs opted to enhance their asset based liquidity. Accordingly, their holding of AFS and HFT securities further increased and count for 76.8 percent and 12.9 percent of DFIs investment portfolio respectively in H2-CY11 **(Figure 6.4).**

[45] DFIs include House Building Finance Company Limited(HBFCL); a DFI engaged in providing housing finance

[46] See chapter 5 Financial Markets.

Figure 6.5

Advances Compositon (flow)

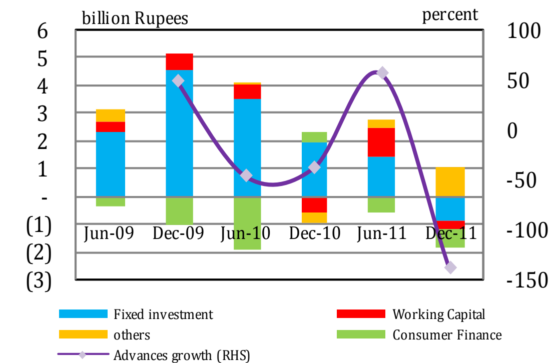


Figure 6.6

Flow of fresh loans and NPLs in H2-CY11

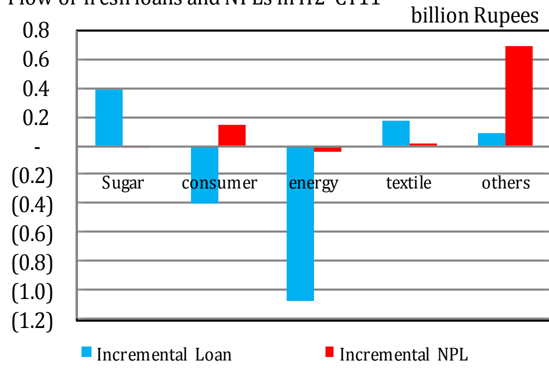
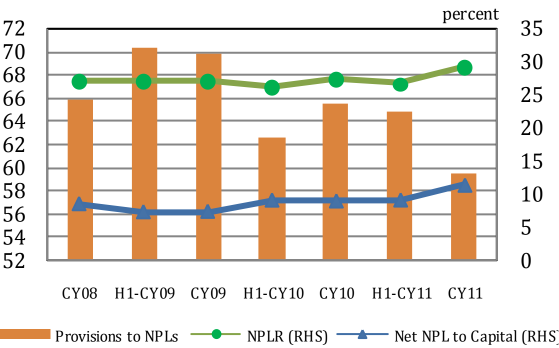


Figure 6.7

Asset quality of DFIs



...while advances saw all around decline

Amid increased risk aversion, DFIs shed their lending portfolio during H2-CY11. Breakup of incremental advances[47] reveals decline in all categories of advances with major drop in corporate advances in fixed investment category. Consumer finance, the second largest segments in DFIs loan portfolio, further decreased its shares due to 5.3 percent decline in mortgage financing (**Figure 6.5**). Only positive development during the half year remains the increase in commodity finance, where couple of DFIs started taking exposure. Sector-wise analysis show healthy growth in advances to sugar and electronics & appliances sector, with marginal increases in Textile and Chemicals. However, significant reduction particularly in energy and transportation sector led to overall decline in the advances of DFIs during H2-CY11 (**Figure 6.6**).

Asset quality indicators deteriorate due to rise in NPLs, amid fall in advances

With a smaller loan portfolio and due to sluggish growth over the last couple of years, the credit risk of DFIs, on aggregate basis, kept a contained profile. However, the asset quality saw deterioration, during the half year under review, leading to worsening of credit risk indicator. NPLR increased to 29.34 percent (highest in last three years) on the back of 8 percent growth in NPLs and overall contraction in advances. Excluding, housing finance company, NPLR increased to 20 percent; a rise of one percentage point over H1-2011, conspicuouously indicating that rising NPL in special mortgage finance institution contributed to rising overall infection of DFIs.

Major chunk of NPLs fall under loss category (requiring higher provisions), which saw further increase of 14.4 percent during H2-CY11. Provisions coverage ratio, however, deteriorated to 59.4 percent due to lower provisions charge on account of enhanced FSV benefit. Corresponding increase in Net NPLs led to increase in Capital impairment ratio (Net NPLs to capital) ratio to 11.3 percent **(Figure 6.7).**

[47] Sectoral and segment based analysis of advances in this section is based on Un-audited quarterly data.

Figure 6.8
Funding strcuture

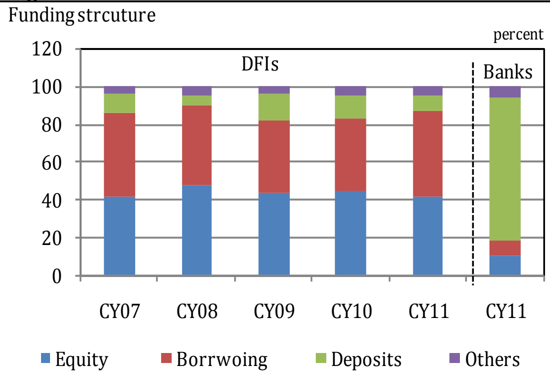


Figure 6.9
Proftability of DFIs

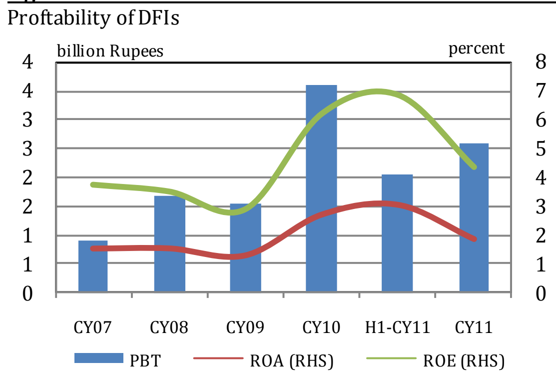
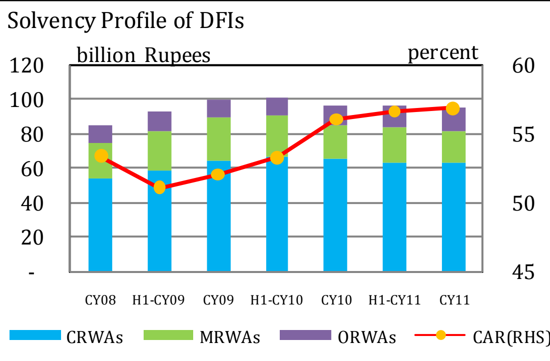


Figure 6.10
Solvency Profile of DFIs



Funding structure remained heavily reliant on equity and costly borrowings

Funding structure of DFIs remained reliant on capital and borrowings which jointly fund 86 percent assets of DFIs (**Figure 6.8**). Equity usually remained the mainstay of the funding strucutre of DFIs, however, during the half year under review, borrowing saw a substantial jump particularly in secured repo borrowing, which increased by 58 percent. This increase like overall increase in assets was quite lop sided and limited to a few DFIs.

Operating performance of DFIs weakened during H2-CY11

Operating performance weakened during second half of 2011 as pretax profit declined by 74 percent compared to the first half. While net interest income increased by 12.4 percent, the gain was offset by increase in provisions charge, losses in dealing in foreign currencies and surge in other expenses. Accordingly, the ROA dipped to 1.9 percent in H2-CY11, from 3.1 percent in the first half (**Figure 6.9**). Again decline in profits resulted from a lop-sided performance of a couple of DFIs, a persistent feature of the sector.

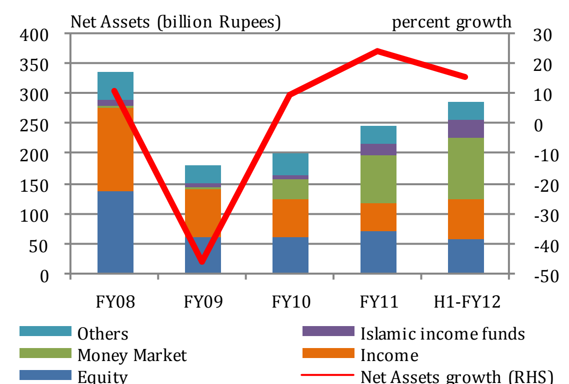
Solvency though strong but excessive suggesting ineffective utilization of capital

Solvency of DFIs remained quite strong. Due to stangnancy in risk based activity, oveall strucutre of RWA assest and capital remained stable over the half year. As a result CAR, with a marginal increase of 20 bps, remained steady at 56.9 percent (**Figure 6.10**). This development, consistent with overall change in asset mix of the DFIs, should be seen with caution as very high CAR is mainly driven by strong capital with low investment in risky assets, indicating less than optimum utilization of capital. Such a high CAR coupled with low leverage of the sector, highlights the need for DFIs to broaden and diversify their exposures.

Mutual Funds

Figure 6.11

Profile of Mutual Funds Industry



Structural shift seen both in funding structure and investment strategy

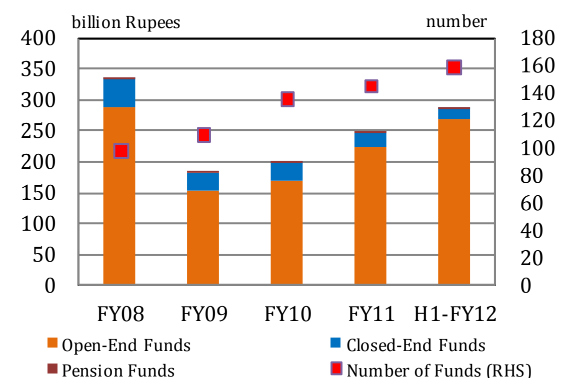
Mutual fund industry has undergone major structural shift in the last decade due to changing maket dynamics and economic conditions. In terms of funding structure, open end funds now lead the market compared to close end funds. In terms of investment strategy, industry once driven by equity funds, shifted to money market and income funds; amid increased safe haven demand in line with overall risk averse enviornment. With the increasing demand for Islamic financial products, Islamic funds have gained substantial share over the last 3 years.

Net assets surged at the back of growing investment in open end funds …

Although mutual fund sector experienced major setback after imposition of floor on KSE-100 index in first half of FY-09, yet it managed to substantially recover the lost value in FY-11. Over the half year under review, net assets of the mutual fund industry expanded by 15.7 percent(24 percent in first half) to reach Rs 288 billion (**Figure 6.11**). Among the mutual fund categories, open end funds grew by 20 percent during second half of CY11, while close end funds diminished by 22.7 percent. Number of Mutual funds increased to 144 **(Figure 6.12)**.

Figure 6.12

Performance of Mutual Funds



….while in terms of investment strategy, MMFs outpaced all other instruments available

Money market funds (MMF) continued to attract more funds due to their risk free competitive return with safety of capital. With a 33 percent growth over the half year, MMFs remained the main growth driver for the industry. Similarly, income funds, with an invesment mix of governemnt securties, debt instruments of fiancial instituions and banks deposits, posted a phenomenal 35 percent growth. As a result, the share of MMF and income funds surged to 39 and 32 percent respectively of the total net assets. In contrast, equity funds and close end funds continued on the contraction path both in terms of value and overal share due to jittery stock market (**Figure 6.13**). The net assets of equity funds saw a decline of 5.21 percent as KSE-100 index lost 9.2 percent during H2-CY-11, decreasing its over all share to 23 percnt of total net assets(92 percent in 2002 and 54 percent in 2007).

Figure 6.13

Mutual funds and equity market

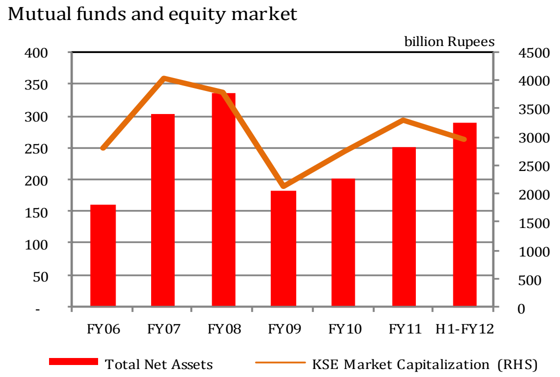


Figure 6.14

Profile of Islamic Mutual Fund Industry

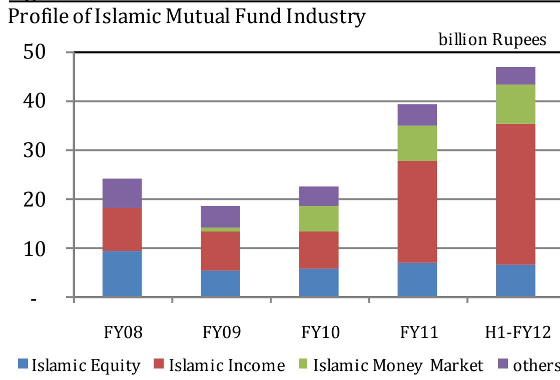
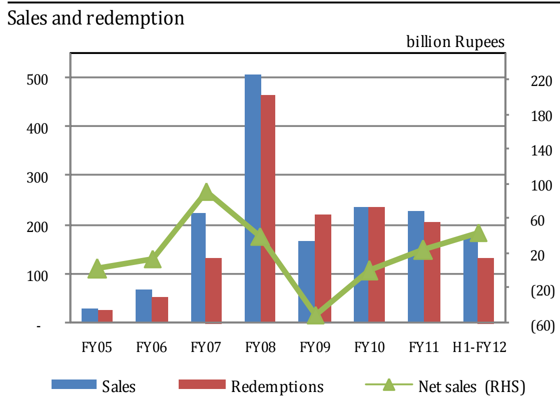


Figure 6.15

Sales and redemption



Islamic Mutual funds continue to capture a considerable share of mutual fund industry on the back of growth in Islamic income funds

With the growing demand for shariah compliant products, the offering of Islamic Mutual Funds(IMFs) is also increasing, though pattern remains more or less in line with the industry trend. The net assets of IMFs surged to Rs 47 billion at 31st December, 2011 from less than a billion rupees in 2003, representing Compound Annual Growth Rate(CAGR) of 48 percent.The IMFs have seen increased divesity over time. Starting from equity funds in 2002, their pool now contains all categories including, income, money market, balanced, capital protected and pension funds. As of the end H2-CY11, the net assets of IMFs represent 17 percent of the overall market, with major concentration in Islamic income fund(10 percent) followed by Islamic money market funds(3 percent) and Islamic equity funds(2 percent). A full year growth of 62 percent in net assetsof IMFs compares well with 7.6 percent growth in the Islamic fund industry globally[48] **(Figure 6.14)**.

Although Islamic mutual funds are exhibiting healthy growth, SECP is working for improving cohesion in policy and framework. In this regard, a specialized unit is being set up at the SECP to review the existing and proposed Islamic products to cater to investors' needs[49].

Sales and redemption of the mutual funds over the last 6 years show that mutual funds have generally seen net sales except for net redemptions in 2008 due to liquidity crunch faced by the mutual funds in the aftermath of freezing of stock exchanges. The trend continued in the period under review as industry attracted Rs 24 billion of new investment in FY-11 on the back of major investment in Money market funds(Rs 34.2 billion) and pension funds (Rs 10 billion). All the other funds experiended net redemption **(Figure 6.15)**. Favourable enviroment in money maket funds on the back of Government demand and investors' risk averse sentiment is a major factor behind growth of mutual fund indsurty.

[48] Islamic Funds & Investment Report 2011, Ernst & Young.

[49] Securities and Exchange Commission of Pakistan (SECP) Annual Report, 2011.

Banking industry remains the major player in Mutual fund industry due to tax advantage…

On the funding side, the growing interest of banks in mutual funds due to tax incentive[50] and low capital charge proved a major impetus behind the growth of mutual fund industry in 2011. As a result, the banks' investment in Mutual funds grew to 33 percent of the total size of fund industry.However, this development should be seen with caution as mutual funds industry needs diversity of investors for sustainable development in the long run.

Further, in the absence of any specific instruction to categorize mutual fund investments, banks' growing exposure to mutual funds attracts less risk weight as banks prefer to place these investments on the banking book. This approach ignores the market risk component of mutual fund portfolio for capital adequacy purpose. Going forward, any change in regualtory instructions on Basel capital accord for Collective Investment Schemes like 'look through approach[51] may impact applicable capital charge on mutual funds investments. In the absence of any tax and capital advantage, banks may pull off their investments from mutual funds and devise other investment strategies for enhancing returns.

Although growth in mutual funds is a positive development but growth is concentrated both in terms of funding and investement strategy. With the proposed changes in tax regime and expected changes in regulatory framework for banks, regulators and fund managers need to give due consideration to these developments while devising overall future starategy for the industry. Particullary the Asset Management Companies (AMCs) will have to revisit their approches and offer new products and avenues for investment to cater to the diverse class of investors.

[50] The income of banks is presently taxed as per the corporate tax rates i.e., @35% of income before tax. However, the income generated by banks from investment in mutual funds was taxed at 10%. Finance bill 2012 has proposed gradual elimination of this tax incentive over the next two years.

[51] Under look through approach, banks are required to calculated capital charge on their mutual fund investments as if the underlying exposure/asset class is held by the banks themselves.

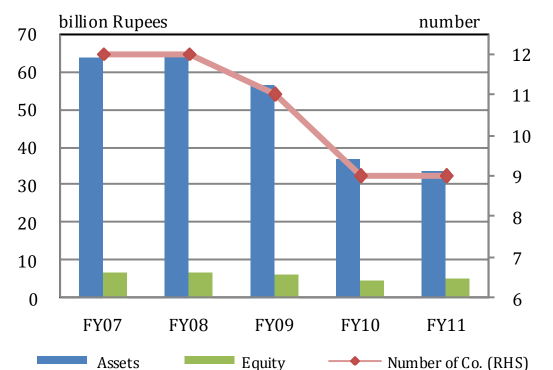
Leasing

Marginal improvement in performance with shrinking assets base and high concentration

The performance of the leasing sector marginally improved in FY-11 in the backdrop of challeging business, economic and social enviornment. The sector posted profits, after making substantial losses in last two years, on the back of expense control and lower provisions charge. As a result, return indicators turned positive. However, due to on going consolidation, shrinking funding resources and competition from commercial banks and other NBFIs, the sector shed 9.5 percent of assets base. Overall sector continued to be dominated by few companies

Figure 6.16

Profile of Leasing sector



During FY11, industry continued consolidation as assets of the sector shrank further (**Figure 6.16**). Most of the decline was contributed by 8 percent reduction in advances and 22 percent in investments. Though lease finance remained the major financing activity representing 74 of the total assets, however, it observed a drop of 6.7 percent over the year. Analysis of lease finance show that major focus of the sector remained on car financing followed by manufacturing. Sector-wise composition shows that leases are quite diversified, with major concentration in textiles, sugar and individuals. Given high non-performing loans, focus of the sector has remained on limiting the credit risk, improving recoveries and restructuring activity; as a result provisions charge for FY11 remained 26 percent lower than the previous year.

Table 6.4 : Leasing sector performance indicators

amount in milion Rupees, ratio in percent

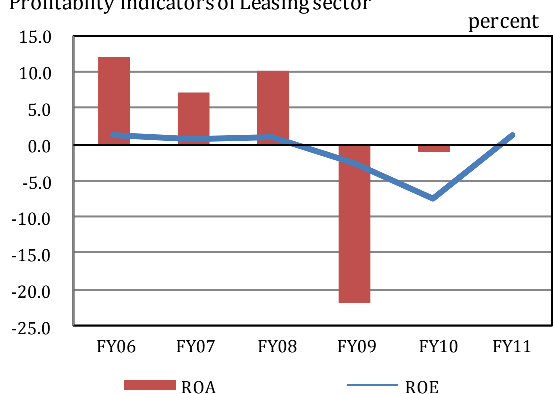
	FY07	FY08	FY09	FY10	FY11
Profit after tax	303	551	(1,522)	(336)	65
Income from lease operations	4,349	4,518	4,346	3,501	3,447
Income from investment	24	47	(24)	26	2
Expense	786	884	1,189	5,053	3,724
Expense to income	91.8	90.3	174.7	107.8	88.7
Financial expense to income	86.8	83.0	175.0	64.7	53.5

Funding constraint remained the key issue facing leasing industry...

Funding constraints remained the key issue facing the leasing sector. As borrowings dropped by 18 percent, leasing companies utilized the lease rentals for repayment of borrowed funds. Similalry the deposits of the leasing sector saw a decline of 14 percent. Though decline in funding mobilization was a sector wide phenomenon, it was more pronounced for companies facing financial stress.

Figure 6.17

Profitablity indicators of Leasing sector



...yet sector posted earnings

During the year under review, leasing sector posted profit after tax of Rs 64.6 million (**Table 6.4**). Due to deline in lease finance activity, lease income saw a marginal drop, however, substantial drop in financial charges and allowances for lease losses provided boost to the net earning of the leasing sector. As a result expense to income ratios declined while return indicators turned postive; ROA imporved to 0.2 percent in FY11 from negative 1 percent in FY10 and ROE improved to 1.4 percent from negative 7.5 percent a year earlier (**Figure 6.17**). Also 5 out of 9 firms posted profits and most of the loss making firms curtailed their losses.

Figure 6.18

Capital of leasing companies during FY11

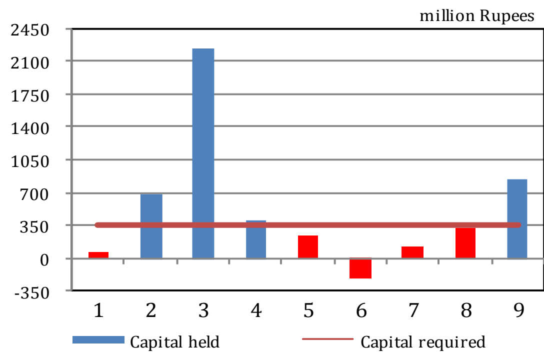
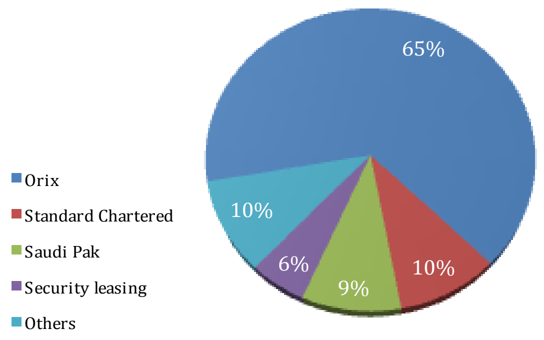


Figure 6.19

Asset concentration in Leasing sector during FY11



This improved performance resulted in marginal strengthening of solvency profile due to buildup of statutory reserves. However, majority of the firms remained undercaptialized with 5 of the 9 companies were non-compliant with the Minimum Equity Requirement(MER) set forth by SECP[52] (**Figure 6.18**) . Keeping in view the challenging economic environment, SECP has allowed the leasing sector to meet minimum equity requirements of Rs700 million by 2013 (previouly required to be meet by 2011).

Leasing sector continued to shrink due to a host of challenges. Sector though exhibited improved performance during the year, however, its performance remained lopsided in favour of few firms with major concentration of industry assets (**Figure 6.19**). Additionally, non-compliance of a number of firms with MER kept the chances of further consolidation open, which will further reduce the number of firms in the indutry . Keeping in view the role of leasing sector in SME financing, serious efforts are needed to keep the leasing sector afloat. Leasing companies should focus on diversifying their funding, product and customer base to take benefit of their niche[53]. On the other hand regulator needs to take measures for facilitating the growth of sector. To this end, SECP has proposed amendments in NBFC Regulations 2008 to allow shorter lease contracts for leasing companies, which is expected to enhance business prospects of the leasing industry[54].

[52] Non-Banking Finance Companies and Notified Entities Regulations, 2008 (amendment vide SRO 764, Dated September 2nd 2009) require fresh licensed leasing companies to hold Rs700 million capital while existing companies to maintain Rs350 million by June 30,2011 , Rs500 million by June 30,2012 and Rs700 million by June 30,2013).

[53] In FY-11, Orix has issued TFCs of Rs4.3 billion to financial institutions, corporate and trusts.

[54] Annual Report 2011-Securities & Exchange Commission of Pakistan.

Figure 6.20
Assets and Equity IFCs

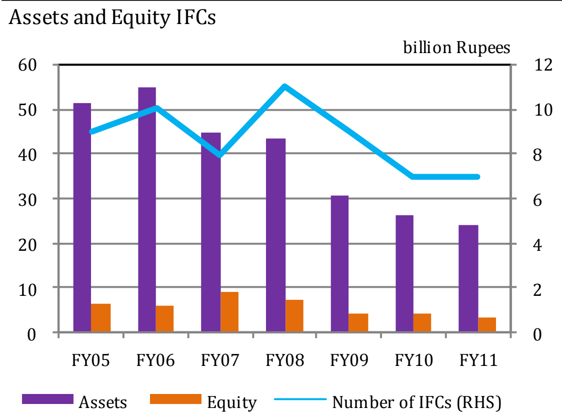


Figure 6.21
Profitability Indicators and Asset growth

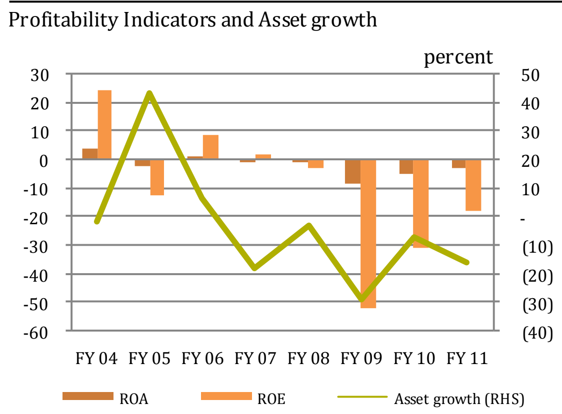
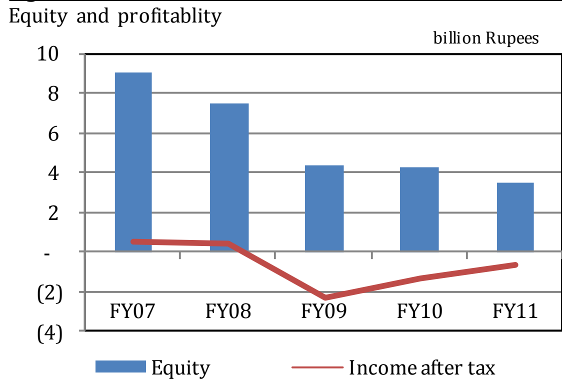


Figure 6.22
Equity and profitablity



Investment Finance Companies

IFCs in Pakistan are facing severe competition from commercial banks. They were doing well till late 80's however, after initiation of financial sector reforms in early 90s and entry of new banks in the market, competition in banking sector heightened. This forced banks to explore new business avenues other than traditional intermediary role. Given the leverage available in the legal framework[55] of Banking Companies, some banks entered in investment advisory business, project finance and underwriting ventures. Further, some banking groups opted to merge group IFCs with banks to meet capital requirements, which also enhanced banks' capacities in investment finance services and at the same time made it quite challenging for the remaining IFCs to compete with banks.

Sector faced continuous shrinkage in terms of number of operative institutions resulting in declining asset base….

Above trend continues, as number of IFCs came down substantialy from 12 in FY03 to 7 in FY11[56]. During the period under review, performance of Investment Finance Companies further deteriorated, as asset base of IFCs declined by 8.2 percent to Rs 24 billion (**Figure 6.20**). This contraction was mainly contributed by decline in asset base of 3 IFCs on account of reduction in advances. On the funding side IFCs reliance remained on borrowing from financial instituions which inceased by 23 percent over the year. Most of these funds were used to enhance investment activity of the IFCs as well as to manage shortfall in funding resulting from 20 percent decline in deposits.

…and murky performance and solvency picture

Performance indicators also show dismal picture (**Figure 6.21**). Due to curtailed financing activity gross revenues declined by 11 percent over the year. Overall expenses also observed substantial drop due to decrease in deposit and administrative cost control measures. As a result, IFCs managed to limit the overall losses for the year to Rs 689 million compared to losses of Rs 1.8 billion in FY10 **(Figure 6.22).**

Although paid-up capital of IFCs improved after FY08 in line with the increase in the minimum equity requirements (MER), continuous accumulation of losses over the last three years led to substantial decline in equity of the IFCs. As of end FY11, four institutions failed to meet the minimum equity requirement of Rs500 million (**Figure 6.23**). Small capital base with limited capacity to absorb shocks is a major impediment in the growth of this sector.

[55] Banking Companies Ordinance ,1962
[56] Innovative Housing Finance which was operational till 2010 went into liquidation, which led to decline in number of IFCs to 7. Number of IFCs is expected to decrease further as a major IFC holding 36 percent share of industry is contemplating with a commercial bank.

Figure 6.23

Minimum equity required and maintained

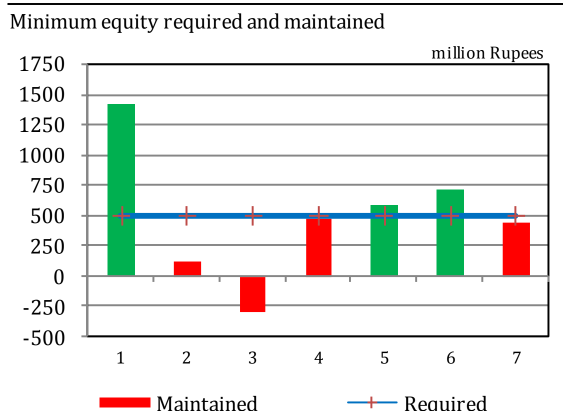


Figure 6.24

Profile of Modaraba sector

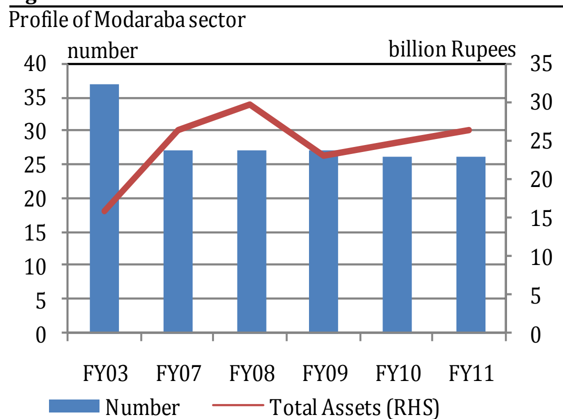


Table 6.5: Concentration in Modaraba business

in percent

	FY08	FY09	FY10	FY11
Top 3	42.0	42.3	45.0	42.5
Top 5	64.0	65.8	63.0	61.0
Top 10	86.0	83.3	83.0	84.0
Rest of firms	14.0	16.7	17.0	16.0

Going forward, existing IFCs need to realign their business strategies with the financing needs of the economy. In the face of large potential of debt and equity market development in the economy,SECP is striving hard to revive this sector.To encourage investment banks to enhance scope of non-fund based services, SECP has allowed investment banks to undertake brokerage business from their own platforms instead of establishing a separate company[57]. Apart from these incentives, both regulators and market participants need to devise a sustainable business model for IFCs if these specialized institutions are to remain commercially viable in an increasingly competitive financial sector.

Modarabas

Sector is among the one of the three NBFIs showing growth in current period despite facing competition from Islamic banks

Modaraba companies[58] perform sharia-compliant business under the provisions of *Modaraba Companies and Modaraba (floatation & Control) Ordinance' 1980 (the Modaraba Ordinance)*. The legal framework provided them flexibility to involve in financial and non-finanical business; a comparative advantage over banks. However, islamic banks with similarlity in product offering remains their major competitor.

Currently there are 26 Modaraba companies out of which 23 are in financial services, 2 in manufacturing/trading and one is equity Modaraba[59]. In terms of number, modaraba sector is the second largest sector after mutual funds; however the size of the modaraba sector, in term of its share in total NBFI assets is relatively small and stands at 5.6 percent at end FY11 **(*Figure 6.24*)**.

Modaraba is one of the three NBFIs sub-sector which registered growth in FY11. During the period under review, Modaraba sector registered growth of 7.6 percent. This growth though commendable in the highly competitive and difficult economic environment, was mainly contributed by top ten Modarabas representing 84 percent of total assets. Concentration in Modaraba Companies is also an indication of widespread fragmentation as is evident from large number of small and weak entities, with limited market share **(Table 6.5)**.

Major funding source of modarabas include floatation of modaraba in the form of equity Musharaka certificates and financing facilities from banks and other financial institutions in the form of various Islamic financing arrangements. These funds were largely utilized in the form of shariah compliant financing agreements, namely

[57] Amendment made in Non-Banking Finance Companies (Establishment and Regulation) Rules 2003 through S.R.O. 271(I)/2010 dated April 21,2010

[58] Modaraba industry structure consist of modaraba management comapines which float Modarabas. There are two types of Modarabas ; (i) Multipurpose (ii) Specific purpose.Currently all modarabas are listed on stock exchange.

[59] NBFI & Modaraba year book 2011

Ijarah,Musharika, Murabaha, with ijarah being major financing mode. Industry has exposure to wide variety of sectors ranging from food and beverages, construction, sugar, chemical andtextile sector.

Performance of the sector improved on the back of lease finance income

Performance of the Modarabas further improved over the year. The performance of the sector in terms of profitability was best among the financial institutions after banking sector. The profit after tax jumped to Rs 1.1 billion in FY11 from Rs 0.78 billion in FY10. Income from lease finance formed the major part of income of Modarabas. As a result, ROA and ROE improved to 4.4 percent and 9.4 percent in FY-11 (**Table 6.6**). Earnings of the sector were broad based as 21 modarabas posted profit. Size wise analysis show that top ten Modarabas augmented the overall profitability, with most of them owned by strong groups involved in banking and finance, and manufacuring.

Table 6.6: Performance Indicators of Modarabas

billion Rupees

	FY08	FY09	FY10	FY11
Profit after tax	*0.8*	*-0.1*	*0.8*	*1.1*
Income	*5.5*	*6.9*	*7.9*	*8.8*
Expenses	1.8	6.5	7.1	7.6
ROA (percent)	3.6	-0.6	3.3	4.4
ROE (percent)	8.7	-1.4	7.0	9.4

Source: Annual Audited Reports

Going forward, major challenge faced by Modaraba sector is from Islamic banking institutions providing similar products. To increase their customers, they needs to focus on customized services and build their niche. To sustain in long term, Modaraba industry strongly need to focus on those segments which are still untapped by banks including SME, agriculture, real estate and small infrastructure projects. The sector needs serious efforts towards improving and strengthening governance framework. for which industry driven steps with activie involvment of regulator is needed.

Venture Capital

Private equity/venture capital accounts for a nominal share of 0.2 percent in overall NBFCs market. Venture capitalists provide funds to new projects with high potential of growth and exit after five to seven years. Due to the high risk nature of start up businesses, venture capitalists desire commensurated returns along with management control and startegic interest holding. To develop enterpreneurship in country, SECP is revisiting the regualtory framework for private equity to make it conducive for both investors and enterpreneurs. The relative size of sector is negligible comprising three institution; out of those, one is effectively inactive for the last three years. The financial position of sector is given in **Table 6.7**.

Table 6.7: Profile of Venture Capital

million Rupees

	FY08	FY09	FY10	FY11
Equity	1,714	2,497	1,028	961
Liabilities	267	66	65	77
Income	-2,403	823	134	14
Expense	91	85	1,620	72
Assets	1,981	2,563	1,093	1,038