During the period under review, the asset base of the Developments Finance Institutions (DFIs) managed to grow marginally. Share of advances in total assets remained intact (around 35 percent), though at significantly lower level than what DFIs' nature of business would warrant. DFIs' strong solvency ratios suggest ineffective utilization of their capital base. The leasing sector has kept on shrinking amid strong competition from the banking sector. In contrast, the mutual funds industry witnessed its revival as the money market investments improved the net assets of the industry by 24 percent in H1-CY11. Finally, the insurance industry witnessed a growth of 16.6 percent in its asset base with the life business experienced a much strong growth[1] (24 percent). On the contrary, the nonlife insurance has been affected by a significant drop in the consumer finance activities and a higher claims ratio, though it has managed to post reasonable profits from rising investment income.

Figure 6.1

Movement in Earning Assets(Percent)

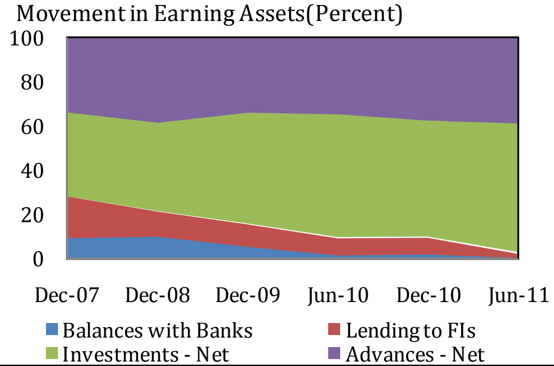


Figure 6.2

Investment composition of DFIs (Percent)

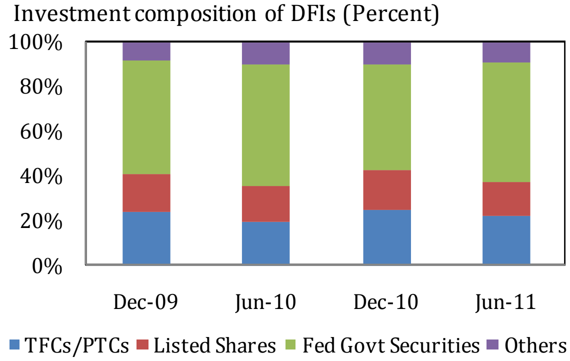


Table 6.1

Investment by type (Share in percent)

	Jun-10	Dec-10	Jun-11
HFT	5.6	1.6	4.0
AFS	82.3	85.7	75.7
HTM	5.1	5.0	13.5
S&A	7.0	7.6	6.8

Development Finance Institutions (DFIs)

Growing investment portfolio takes up lending to FIs……..

Similar to banks, DFI's investments over the last few years have also been on a continuously rising trend and now constitute around 59 percent of their assets. Contrary to common perception, surge in investments has not crowded out the private sector credit. Rather, it is the lending to financial institutions (FIs) that has practically disappeared in the process *(Figure 6.1)*. With ample opportunities to invest in government papers offering attractive returns, DFIs find little incentive for lending to other financial institutions.

During the period under review (H1-CY11), investments grew by 11.9 percent on the back of 26 percent growth in government securities, particularly the short term MTBs. Within investments, Federal Government securities constitute 54 percent of total investments, followed by 22 percent in TFCs/PTCs (Term Finance Certificates/ Participating Term Finance Certificates) *(Figure 6.2)*. With rising exposure to government papers over the period, DFIs have reduced their exposure to risky investments like listed shares, mutual funds and commercial papers, etc. While this trend of increasing investments in safe and liquid government papers augurs well for both liquidity and profitability of the DFIs in the short run, it is likely to reduce

the risk management capabilities of DFIs going forward.

In terms of maturity profile, while Available-for-Sale (AFS) securities still accounts for bulk of DFIs investment portfolio, its share has declined from 85.7 percent to 75.5 percent during H1-CY11 *(Table 6.1)*. High share of AFS securities is in line with industry's strategy of keeping the investment

[1] This analysis is based on published annual audited accounts of 24 private non life insurance having 88 percent share in total assets for year 2009, 6 life insurance and a reinsurance company that were available with the SBP.

management flexible which also improves their liquidity position. On the contrary, there has been increasing trend in DFIs' Held-to-Maturity (HTMs) and Held-for-Trading (HFT) portfolio. Specifically, share of HTMs has more than doubled during the same period, suggesting DFIs' lower expectations of liquidity stress in near future.

....but share of advances uphold, though at traditionally lower level

With around 35 percent share in total assets, advances have been traditionally at lower level than the nature of DFIs' business would warrant. However, rising investments in recent years have not led to a further drop in advances *(Figure 6.3).* During H1-CY11, advances posted a growth of 4 percent, marginally increasing the share of advances from 37.8 to 38.4 percent. However, relatively small share of advances in DFIs portfolio mix, particularly when even banks have advances around 44 percent of their assets, exhibits the reluctance of DFIs in extending private sector credit and playing an active role in project finance. Breakup of advances reveals that loans to corporate sector, which constitutes around three quarters of DFIs advances, exhibited a growth of 6.7 percent. Within corporate sector loans, around 88 percent were extended for fixed investment purpose.

In terms of sector wise advances, energy, textile and chemical sector accounted for around 40 percent of DFIs total advances *(Figure 6.4).* During H1-CY11, advances to chemical sector grew by 15 percent, followed by 11 percent growth in credit to energy sector. The consumer finance, which is the second largest segment in DFIs advances portfolio and mainly finances housing mortgage further declined from 26 percent to 24 percent during H1-CY11.

NPLs continue to rise, though concentrated in few DFIs

During the period under review, Non-Performing Loan Ratio (NPLR) of DFIs (excluding HBFC) increased from 18 to 19 percent, as 12 percent growth in NPLs outpaced the 7.7 percent growth in advances. Inclusion of HBFC in our analysis pushes up the NPLR of DFIs to a staggering 26.7 percent, much higher than banking industry average of 15.3 percent *(Figure 6.5).* Segment wise analysis of the NPLs shows that major chunk is in consumer finance category (47 percent), largely contributed by a single mortgage financing institution. Further, the coverage ratio (provisions to NPLs) has deteriorated during the period under review, from 66.2 percent to 64.7 percent as 4.4 percent growth

Figure 6.3

Advances Compositon

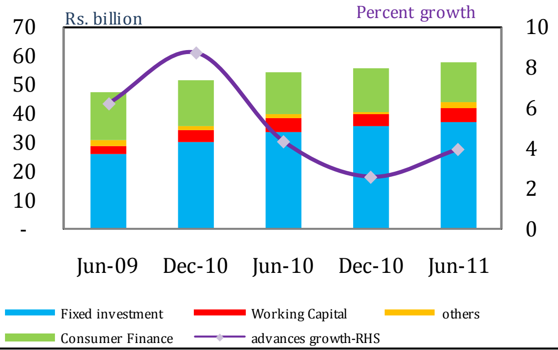


Figure 6.4

Concentration of loans and NPLs(share in percent)

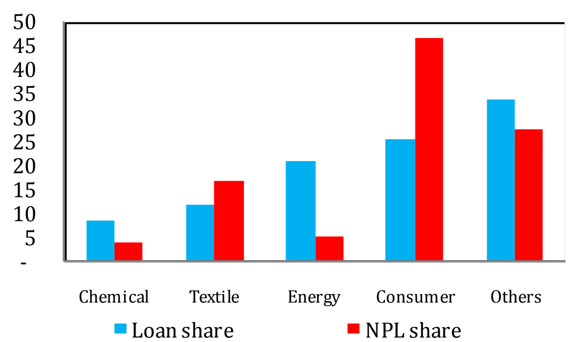


Figure 6.5

Asset quality of DFIs(Percent)

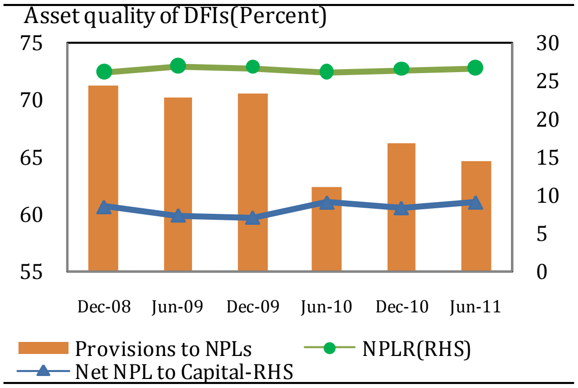


Figure 6.6

Composition of mark-up income(Billion Rupees)

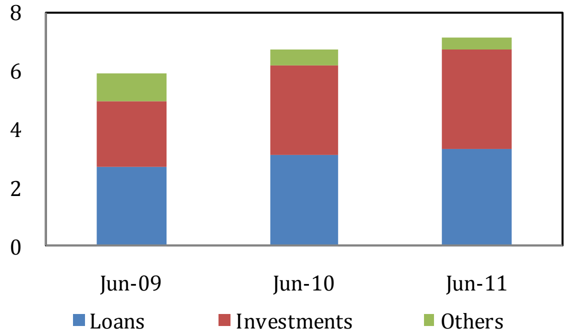


Figure 6.7

Solvency Profile of DFIs

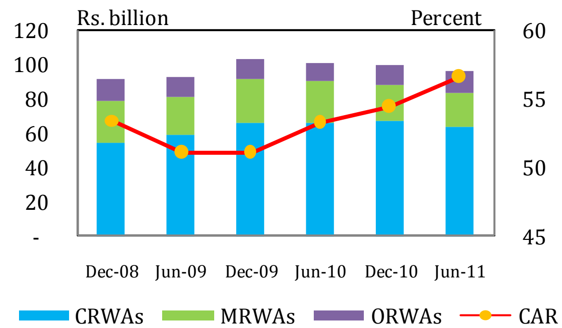
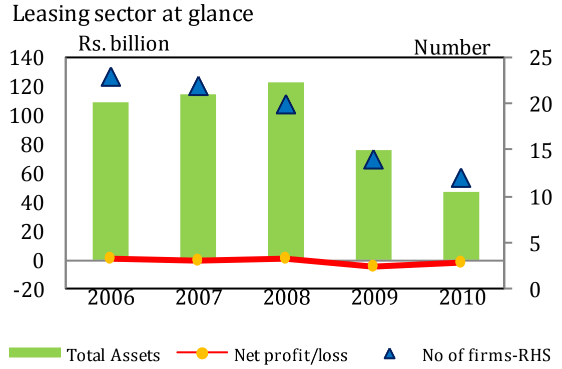


Figure 6.8

Leasing sector at glance



in NPLs outpaced 2 percent growth in provisions. This also led to a rise in capital impairment ratio (Net NPLs to capital) from 8.3 percent to 9.1 percent.

Operating performance marginally weakens during H1-CY11

During the first half of 2011, DFIs witnessed weak operating performance on YoY basis. The profit before tax of the DFIs dropped to Rs. 2 billion from 3.1 billion during the corresponding period last year, largely because of increase in loan loss provisioning. Share of interest income from advances has remained unchanged at around 46 percent in last three years while share of income from investments has grown substantially from 37.8 to 47.9 on the back of changing portfolio mix, as discussed above *(Figure 6.6).*

Strong solvency indicators suggest ineffective utilization of capital

An already strong solvency position of DFIs witnessed further improvement during H1-CY11. While the capital base marginally reduced, retained earnings alongside share of risk free assets enhanced the Capital Adequacy Ratio (CAR) of DFIs to an impressive 56.7 percent, compared with 14.1 percent for banks *(Figure 6.7).* The improvement was widespread as six out of eight DFIs registered a rise in their respective CARs.

Low share of credit risk weighted assets[2] on the back of relatively small loan book contributes towards this significantly high CAR of DFIs compared to banks. It also indicates the selective business activities of DFIs with fairly limited risk taking, suggesting a grossly sub-optimal utilization of their strong capital base.

Leasing[3]

Presence of leasing sector is fleeting amid competitive pressures

In recent years, leasing sector has undergone structural changes, with number of leasing firms significantly dropping on account of their mergers with investment and commercial banks. Competitive pressures from the banks, offering similar products at attractive rates amid their lower costs of raising deposits, have posed a challenge of survival to many leasing firms. Unsurprisingly, the number of leasing firms has reduced

[2] Share of credit risk weighted assets of DFIs is 66 percent, compared to 79 percent for banks, as on June 30, 2011.

[3] Leasing sector review is based on data provided by NBFI and Modaraba Association of Pakistan year book 2010 and Pakistan Leasing Year Book 2008.

Figure 6.9

Profitablity indicators of Leasing sector(Percent)

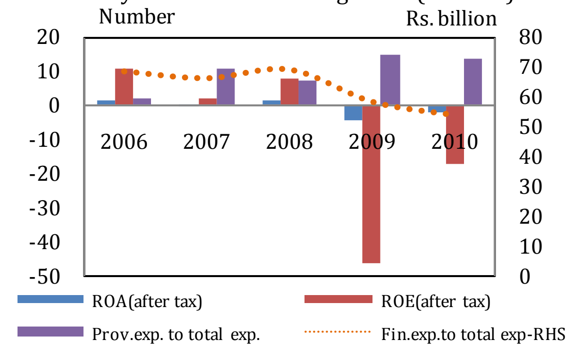


Figure 6.10

Concentration of Assets in Leasing Sector(FY-10)

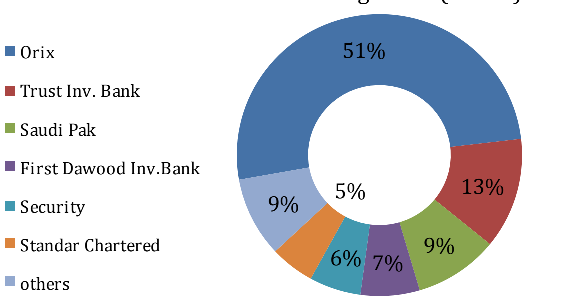
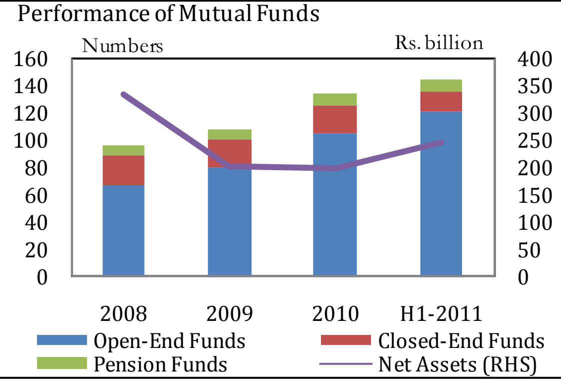


Figure 6.11

Performance of Mutual Funds



from 20 in FY08 to 12 in FY10, with their total assets plummeting from Rs 110 billion to Rs.47 billion during the same period *(Figure 6.8).* The focus of firms has been on lease finance which forms 68 percent of their total assets at end FY-10. Category wise asset break up shows that 45 percent of leasing business is concentrated in plant and machinery and 49 percent in private and commercial vehicles.

....with seven of the twelve firms in red

Profitability of the leasing sector is continuously on declining trend since FY08. Impact of weak performance of the industry is evident from the profitability indicators, as both ROA and ROE turned negative in FY10 *(Figure 6.9).* Out of twelve firms, seven are incurring losses. High financial expenses on the back of heavy reliance on bank borrowing and provisioning costs are the key reasons behind poor performance of the leasing sector. Specifically, provisioning expense now stands at around Rs.1 billion much higher than in FY06 figure of Rs.0.1 billion[4]. High provisioning cost calls for enhanced risk management and improved credit standards on part of leasing industry.

Equity position has also deteriorated over the period on account of contraction in industry as well as lower capital maintained by leasing firms. In FY10, 3 out of 12 companies are non-compliant with the minimum equity requirement for the leasing companies set forth by SECP[5] .

....further increasing the industry concentration

Leasing sector is highly concentrated, with four companies holding 81 percent share of total assets (68 percent in FY08)[6] *(Figure 6.10).* Out of these four firms, Orix alone holds 57 percent of industry assets.

Despite shrinking role of leasing industry in overall financial sector, its implications for overall financial stability was extremely limited as leasing industry is a miniscule 0.5 percent of overall financial sector.

Mutual Funds

Mutual Funds' net assets exhibit strong recovery

Since CY08, the mutual funds industry witnessed a significant

[4] To make objective comparison of provision expense to total expense ratio, data have been used for twelve firms that survived in FY10.
[5] Non-Banking Finance Companies and Notified Entities Regulations, 2008 require fresh licensed leasing companies to hold Rs. 700 million capital while existing companies to maintain Rs. 350 million by June 30,2011 , Rs. 500 million by June 30,2012 and Rs. 700 million by June 30,2013 .
[6] For Investment banks involved in leasing business, only lease finance is considered as assets for calculation of concentration.

Figure 6.12

Composition of Net Assets (Rs. billion)

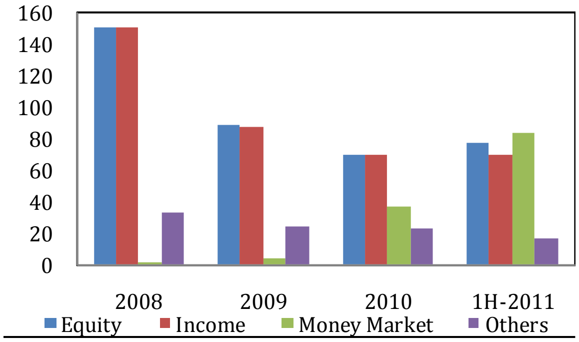


Figure 6.13

Profile of Insurance Industry (Rs. billion)

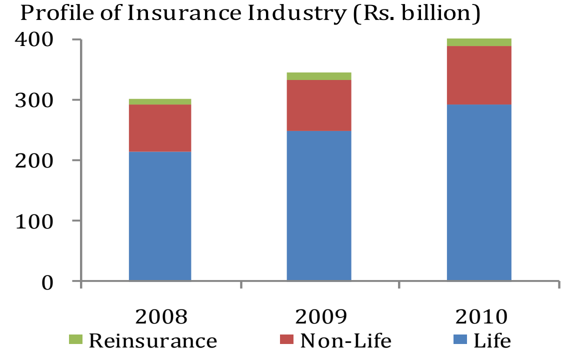
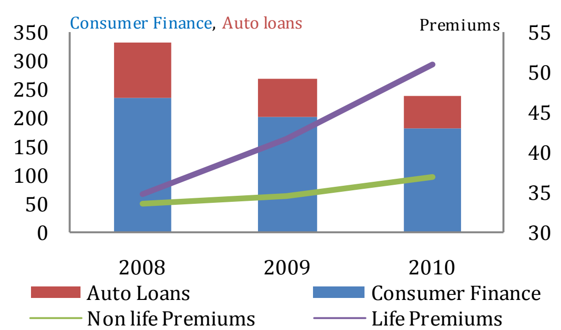


Figure 6.14

Consumer Finance and Insurance Premiums (Rs. billion)



decline in its net assets as the investors' interest was shaken by the freezing of the KSE in Sep-08. In last two years, the losses incurred discouraged the prospective investors to venture in the mutual funds. However, in H1-CY11, the mutual funds industry witnessed a recovery of 24 percent in its net assets mainly on the back of investment activities in the money market instruments and partially from the equity market.

Besides the revival in the net assets, the number of mutual funds has also increased to 145 in the same period with a majority (122) concentrated in open-ended mutual funds (*Figure 6.11*). However, it is the money market funds and investments in treasury bills that have improved the outlook of the mutual funds industry (*Figure 6.12*).

Insurance Sector[7]

Overall insurance sector registers strong growth

On the back of sound growth in the life insurance business which accounts for 74.8 percent of total insurance assets, the insurance industry witnessed a strong growth of 16.6 percent in CY10 as against 14.5 percent in CY09. On the other hand, the reinsurance sector (that only constitutes one nonlife reinsurance company) showed an insignificant improvement of 0.1 percent in its asset base *(Figure 6.13)*.

Despite a steep decline in the consumer finance business and an overall sluggish business environment prevailing in the country, the gross premiums witnessed an improvement of 15.2 percent in CY10 against 11.4 percent in CY09 *(Figure 6.14)*. In case of life premiums that are largely dependent on individual's net disposable income, a sharp increase since CY08 has been observed as new companies entered in the market offering innovative and somewhat cheaper products that have enticed medium to higher income group. Further, the prevailing law and order and social conditions have also necessitated the need for insurance coverage.

...though premium accumulation is compromised by rising claims ratio

The nonlife gross premiums witnessed a steady increase of 7.1 percent in CY10 as against 2.6 percent in CY09 *(Figure 6.15)*.

[7] The analysis is based on published annual audited accounts of 24 private non life insurance having 88 percent share in total assets for year 2009, 6 life insurance and a reinsurance company that were available with the SBP.

Figure 6.15

Non Life Premiums and Claims Ratio

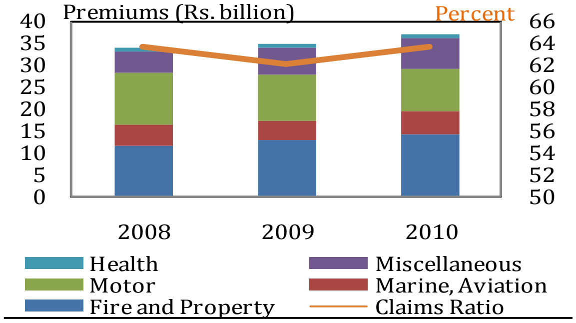


Figure 6.16

Profitability of Nonlife Companies (Rs. billion)

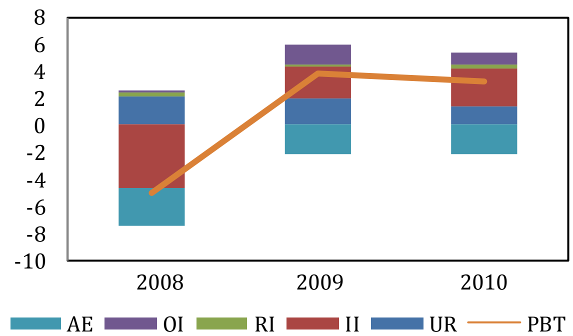


Table 6.2

Nonlife Financial Soundness Indicators (percent)

	2008	2009	2010
ETR	52.57	55.79	49.53
UEGR	12.67	13.18	14.08
Claims Ratio	63.72	62.12	63.42
MER	12.82	10.47	10.34
IIN	-21.43	11.02	13.42
IIA	-12.49	5.19	5.97
CR	76.38	75.30	77.50

Category-wise, the concentration of fire and property premiums further improved in period under consideration as its share in total premiums increased to 38 percent while the motor insurance witnessed a decline in its share – largely on account of diminishing auto financing by banks- from 30.8 to 26.6 percent in CY10.

However, deteriorating law and order situation and difficult socio-economic coditions led to a marginal rise in the claims ratio (net claims to net premiums) from 62.1 percent to 63.6 percent YoY. Claims ratio witnessed a much stronger rise in the categories of fire and property insurance while claims ratio associated with motor insurance fell from 66.4 to 63.3 percent.

Profitability rests on investment income as it compensates the declining underwriting revenues

With rising claims and related administrative expenses (AE), the underwriting revenues (UR) of the nonlife companies declined sharply in CY10. However, as in case of other financial institutions (banks & DFIs), investment income (II) supported the bottom-line. Furthermore, the rental income (RI) and other income components (OI) improved the pretax profits (PBT) of the companies which although remained lower than CY09 (Figure 6.16).

In terms of financial soundness, the performance of the nonlife insurance companies has been compromised by a rise in claims ratio and management expense ratio (MER). Accordingly, the combined ratio (CR) - sum of claims ratio and MER- has deteriorated from 75.3 to 77.5 percent YoY (Table 6.2). Similarly the underwriting expenses to gross premium ratio (UEGR) that signifies the cost of acquiring business has also deteriorated. Solvency-wise, the equity to total assets ratio (ETR) has also declined on account of un-proportionate increase in the asset base. However, improvements in the investment income has bolstered the investment income to net premiums (IIN) and investment income to assets (IIA) ratios in CY10.

Life insurance premiums boosts while claims ratio falls

In contrast to nonlife business that witnessed a moderate growth, the life insurance gross premiums grew robustly by 21.9 percent in CY10 compared to 19.8 percent in CY10. During the same time, the claims ratio fell drastically from 46.4 percent to 41.2 percent. In terms of gross premiums, the share of first year premiums rose from 25.2 to 26.9 percent indicating favorable outlook for new life business (Figure

Figure 6.17

Life Premiums and Claims Ratio

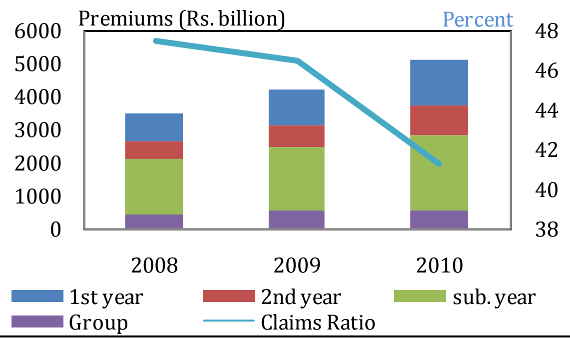


Figure 6.18

Life Insurance Profitability (Rs. million)

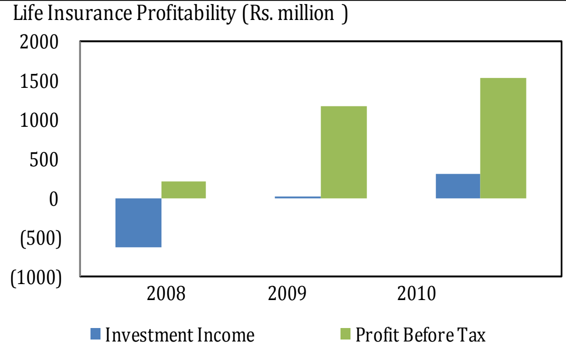


Table 6.3

Life Financial Soundness Indicators (percent)	2008	2009	2010
ETR	1.71	1.94	1.86
UEGR	35.63	40.02	38.88
Claims Ratio	47.47	46.44	41.27
MER	36.76	41.18	38.71
IIN	-1.92	0.02	0.59
IIA	-0.39	0	0.13
CR	84.23	87.62	79.98

Table 6.4

Profile of Reinsurance Sector (Rs. millions)	2008	2009	2010
Equity	7,265	6,786	6,412
Investments	5,459	5,482	4,674
Gr. Premiums	4,555	5,839	6,552
Net. Premiums	1,896	2,170	2,940
Net Claims	962	904	1,688
Expenses	250	231	301
Assets	12,528	12,372	12,534

6.17). However the share of subsequent premiums (3rd year and beyond) fell marginally from 46.4 to 45.1 percent.

Underwriting surplus helps improve life insurance profitability

The robust growth in gross premiums coupled with the declining claims ratio have boosted the underwriting or core surplus for the life insurance companies resulting in higher profits for CY10. For the life insurers, profits before tax surged by 30.2 percent (figure 6.18). This is in stark contrast to the nonlife business where investment returns played a significant role in their profitability.

Despite rising profitability and lower claims ratio, the solvency profile of life insurance presents a weak picture. The equity to assets ratio (ETR) has reduced to 1.86 percent in CY10 (Table 6.3). Although minimum capital requirements are imposed on the insurance companies, the solvency ratio requirement does not exist, prompting companies to take higher liabilities and build-up their balance sheets on a rather low capital base. Other financial soundness indicators such as claims ratio, management expense ratio (MER), combined ratio (CR) however witnessed improvements in CY10. Further, as the stock of investments has climbed up to Rs. 226 billion, the net investment income to investment ratio (IIA) depicts very low return (0.13 percent).

The analysis of reinsurance sector reveals some recovery in the performance of sole reinsurer, Pakistan Reinsurance Company Ltd. in CY10. Though the claims ratio further worsened to 57.4 percent in CY10, the profits (after tax) soared to Rs. 526 million on account of lower mark to market revaluation of its assets compared to CY09(Table 6.4).