Chapter 6 Non Bank Financial Institutions (NBFIs)

NBFIs after remaining on growth trajectory for last two years observed a contraction in H2-CY12. Much of the contraction was to blame on weak performance of mutual funds; the largest player in NBFIs sector followed by DFIs. Performance of mutual funds deteriorated due to decline in Net Asset Value (NAV) of money market and income funds. With the exception of Modarabas and Leasing, rest of the non-bank players struggled to survive. On the funding side, the deposits maintained an upward momentum gained during CY11 yet the borrowings registered a contraction of 15 percent which was observed all across the industry. Core financing activity gained momentum mainly on the back of Modarabas and leasing activities and maintained overall profitability of an otherwise loss making system; however it failed to subside the growing solvency concerns of IFCs and few leasing firms.

Overview [66]

The role of NBFIs in filling the credit gap and broadening the access to finance by individuals and corporations is well recognized. These entities promote financial inclusion and play an important role in sustainable growth for developing marketers. Financial deepening is a top priority in less developed financial markets and the role of NBFIs is to bridge this gap by providing financial services to those segments which do not have access traditional sources of finance. Presence of diversified financial services promotes competition among the participants, ultimately leading to efficiency and low cost services for the households and businesses. Although banking sector in Pakistan dominates the financial landscape like most of developing economies, it also constitutes diverse range of other Non-bank financial intermediaries viz. Asset Management Companies (AMCs), Mutual Funds (MFs), Leasing Companies, Modarabas[67], Investment Finance Companies (IFCs), firms rendering Investment Advisory Services (IAS), Venture Capital Companies (VCCs) and Development Finance Institutions (DFIs).

NBFIs growth trickled in period under review due to…

Apart from providing alternative avenues for investments, mitigating risks and providing liquidity for its customers, the NBFIs also offer wide range of financing products for households and businesses. However concentration in mutual funds; holding more than 60 percent share of NBFI, largely determines growth momentum of overall sector in Pakistan. Due to overall contraction in growth of NBFIs in the half year under review,

[66] 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(HFCs). The analysis of NBFCs and Modarabas is based on annual audited accounts, data provided by the SECP and MUFAP website.
[67] Modarabas companies' analysis is based on financials of 24 active companies.

they shed their share by 100 bps in total financial sector assets and now hold only 4.2 percent of overall financial sector.

...Massive contraction in mutual fund industry yet it still holds the top seat in NBFIs sector

The momentum gained by NBFIs in consecutive two years slowed down in H2-CY12. MFs industry remained the key reason behind this decrease; as its Net Asset Value (NAV) observed 22.0 percent deceleration, leading to a substantial decline in share of mutual funds in NBFIs' assets base (**Table 6.1**). Both income and money market funds showed a substantial deceleration in the half year under review owing to waning interest of banks in fund investment due to gradual removal of tax advantage and redemption of large amount of funds by a large bank owned asset management company.

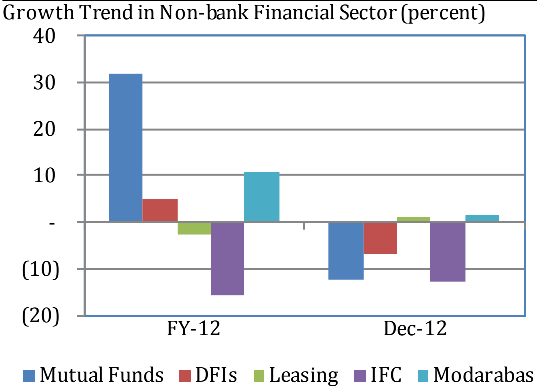
Table 6.1: Profile of NBFIs

	FY08	FY09	FY10	FY 11	Dec-11	FY 12	Dec-12
Assets (PKR Billion)	585.6	470.1	421.9	478.2	511.6	609.5	550.5
Growth rate	3.3	(19.7)	(10.2)	13.3	13.8	19.2	(9.7)
Share in Assets							
Mutual Funds	58.5	47.9	47.6	55.4	56.4	62.4	60.5
DFIs	14.5	24.2	26.8	25.7	28.1	24.7	25.5
Leasing	11.0	11.9	8.8	7.4	6.6	5.4	6.1
Investment Finance	7.4	6.6	6.2	5.4	3.7	2.6	2.5
Mudarabah	5.1	4.9	6.1	5.9	5.2	4.8	5.4

Leasing and Modarabas sector tried to contain steep reduction in NBFIs assets

The NBFIs (excluding mutual funds) observed a contraction of 4.3 percent in the half year under review, which was mainly contributed by net reduction of 12.9 and 6.8 percent in assets of IFCs and DFIs respectively **(Figure 6.1).** Meanwhile, the Leasing companies saw a marginal growth of 1.2 percent in their asset base after showing contraction of 3 percent in H1-CY12, followed by a moderate growth of 1.6 percent in Modarabas asset base. The number of NBFIs (except Mutual funds) further declined over the year due to consolidation and regulatory actions **(Table 6.2).**

Figure 6.1
Growth Trend in Non-bank Financial Sector (percent)



Deposits which started picking up in last year became the main funding source of large number of NBFIs

Borrowings from financial institutions historically remained the major funding source for the NBFIs. The trend however reversed during the period under review and borrowings registered a contraction by 15 percent which was observed across the industry. Most of the NBFIs retired their borrowings and relied on deposits to provide funding support to their asset base as evident from 170 bps rise in share of deposits in total liabilities. This factor was particularly pronounced in leasing sector which mobilized 21 percent higher deposits in the period under review and retired 10 percent of its costly bank borrowings.

Table 6.2: Number of NBFIs

	FY08	FY09	FY10	FY11	FY12	Dec-12
Mutual Funds	97	109	135	144	159	156
DFIs	6	8	8	8	8	8
Leasing	12	11	9	9	8	8
IFCs	11	9	8	7	7	7
Modarabas	27	27	26	26	26	23
Total	153	164	186	194	208	202

Core financing activity started picking up

Table 6.3 Key Performance Indicators of NBFIs*						
						percent (except in case of ratio)
	FY08	FY 09	FY 10	FY 11	FY 12	H1-FY13
Capital to Assets	35.2	35.9	36.2	36.8	35.0	36.3
Advances to Assets	52.5	47.7	41.4	38.5	35.7	38.0
Investments to Assets	28.6	34.0	39.2	40.7	43.5	41.7
Earning Assets to Total Assets	82.6	85.6	80.7	79.2	79.2	79.7
Debt to Equity Ratio	2	2.1	1.8	1.7	1.1	1.0
Borrowings to Liabilities	61.1	58.1	60.0	58.2	60.8	55.3
Deposits to Liabilities	25.2	28.7	27.8	24.4	21.8	23.5
Income to Expense	111.3	92.5	102.5	142.4	111.7	109.0
Return on Average Assets (after tax)	0.9	-1.6	-0.1	1.3	0.4	0.4
Return on Average Equity (after tax)	3	-5.1	-0.3	3.7	1.1	1.0

*Excluding Mutual Funds

The core business activity of the NBFIs picked up and asset structure of NBFIs which was highly tilted towards investments shifted to advances and lease business in the period under review. Most of the increase took place in Modarabas sector which showed a surge of 26 percent in their advances portfolio followed by leasing and DFIs sector. As a result, the share of NBFIs' advances in total assets increased by 230 bps to 38 percent in H2-CY12. Investments, on the other hand, saw a marginal decline of 180 bps mainly concentrated in DFIs which observed 10 percent decline in investment portfolio in the period under review.

…making it hard for leasing and IFCs to meet the regulatory capital requirements

The NBFIs sector posted after tax profit of PKR 402 million during H2-CY12; 55 percent lower than the corresponding period of last year. A dip in the profitability resulted from drop in income level due to decelerated business activity and increasing provisions charge because of growing delinquencies in DFIs and IFCs. Accordingly, the ROA and ROE also observed a marginal decline over the year [68](**Table 6.3).** Despite poor performance of DFIs and IFC business, improved performance of Modarabas Companies and leasing sector facilitated in positive earnings of NBFI sector in H2-CY12.

Despite profitability of few segments of NBFIs, capital base of overall NBFIs sector marginally declined. Though capital of few large players is up to mark however majority of the leasing companies and IFCs are falling short of Minimum Equity Requirements (MER) set by the SECP and this number has increased over the years.

During the period under review, the SECP took a number of policy measures for improving the governance regime, disclosure requirements and address the various risks facing the NBFIs sub-sectors. Further, keeping in view the prevailing business environment, the SECP rationalized some of the regulatory requirements for facilitating NBFIs business; leasing companies are allowed smaller tenor lease contracts, and IFCs are allowed to conduct brokerage business from their own platform. These measures are expected to help the struggling industries in enhancing business and improve chances of their revival.

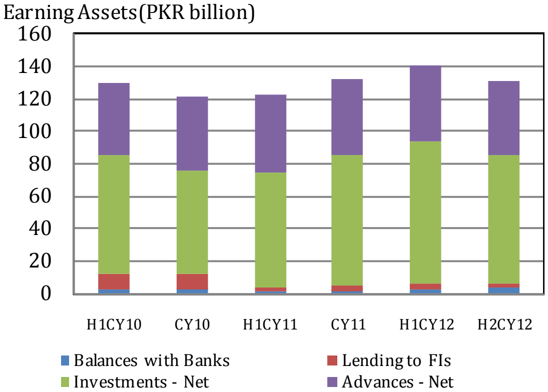
[68] Figures have been annualized for return indicators ROA and ROE.

Development Finance Institutions (DFIs)

Asset base of DFIs observed contraction due to reduction of investment portfolio of a single DFI

Figure 6.2

Earning Assets(PKR billion)

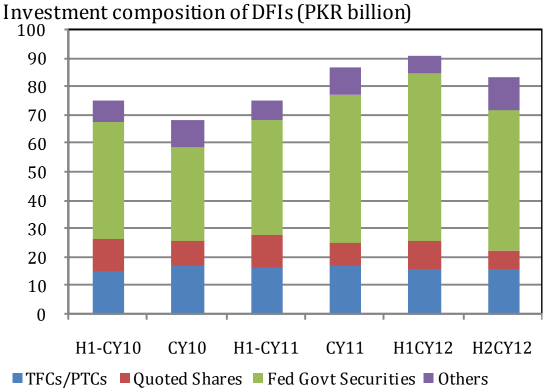


Assets base of DFIs contracted by 7 percent during H2-CY12, due to 14 percent decline in borrowings. Advances, however, grew marginally and improved their share in overall assets. The decline was not broad based and was largely contributed by a single DFI; which observed a massive 50 percent reduction in its market share. DFIs posted loss after tax due to higher provision charge and decrease in core income. Nonetheless, DFIs remained sufficiently capitalized with a high CAR of 55 percent, despite a marginal drop in the ratio during the half year.

Over the last three years, consistent increase in investments in Federal Government securities not only bolstered the overall assets of the DFIs but also increased concentration of assets in investment portfolio. The trend, however, reversed during H2-CY12 as investments portfolio trickled by 10 percent due to shrinkage in public sector securities, which fettered the size of the balance sheet. As a result, share of investments in assets dropped for the first time over the last three years. Nevertheless, investments still holds the top seat in DFIs balance sheet **(Figure 6.2).**

Figure 6.3

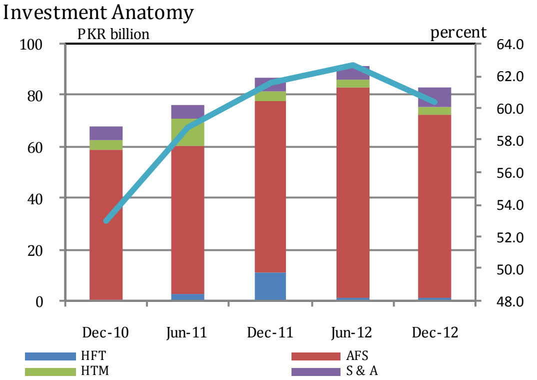
Investment composition of DFIs (PKR billion)



Analysis of investments showed that public sector securities decreased by 16 percent, which reduced their share in investments by 490 bps to 59 percent This decline was no way indicative of the industry trend as most of it was attributable to significant contraction in investments of a single DFI as a part of its investment strategy. With this exception, industry exhibited a moderate assets growth of 5 percent, while investments augmented by 13 percent during H2-CY12 **(Figure 6.3).**

Figure 6.4

Investment Anatomy



DFIs for sometime have opted to shift maturity profile of investments toward Available for Sale (AFS) category in the wake of the continuing stress in the money market. Given that investments have become main earning source of interest/mark-up income, DFIs remained focus on enhancing assets based liquidity through flexible investment strategy and placing major chunk of investments in the AFS category. Due to this strategy, holding in AFS category allowed the DFIs to off-load substantial portion of investment during the period under review. Despite this decline, DFIs still holds 85.4 percent of their investment portfolio in this category **(Figure 6.4).**

...while advances saw a nominal growth

Figure 6.5

Advances Composition (flow)

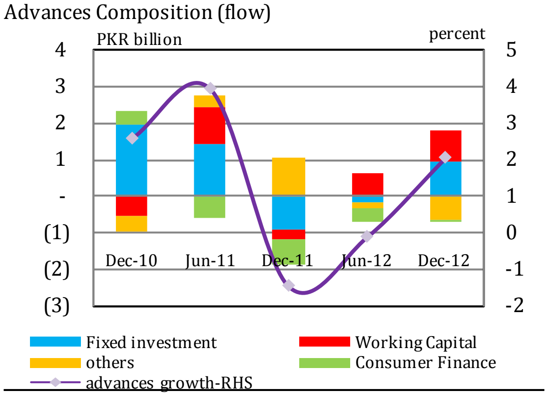


Figure 6.6

Asset quality of DFIs(percent)

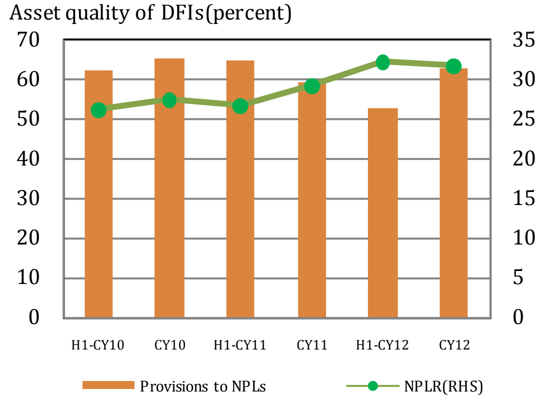
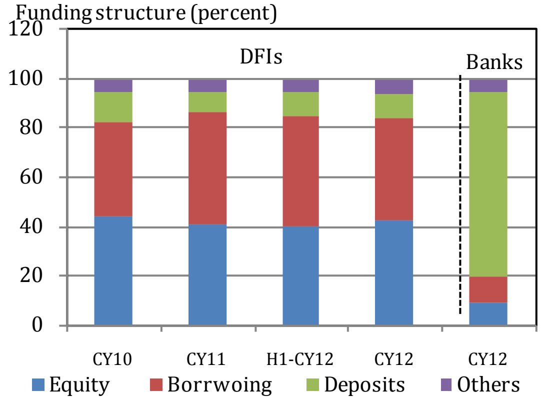


Figure 6.7

Funding structure (percent)



Amid increased risk aversion, lending portfolio of DFIs showed a nominal increase of 2.1 percent in H2-CY12. Breakup of incremental advances[69] reveals 4.5 percent growth in corporate sector advances mainly for working capital needs. SMEs, the most affected sector due to prevailing economic and business environment, got a major hit as financing to this sector declined by 11 percent. Consumer finance, the second largest segment in DFIs' loan portfolio, lost further shares due to decline in all categories of retail financing **(Figure 6.5).** Sector-wise analysis demonstrated healthy growth in advances to sugar and energy sector, with net payoffs in most of the remaining sectors with significant reduction in textile and chemical sectors during H2-CY12.

Asset quality indicators remained contained due to stagnant NPLs

With a smaller loan portfolio and due to sluggish growth over the last couple of years, the credit risk of DFIs kept a contained profile. This trend continued as asset quality saw a marginal improvement, during the half year under review. Infection ratio, with a marginal decline of 49 bps, decreased to 31.8 percent, due to a meager 0.5 percent increase in NPLs. Excluding, housing finance company, infection ratio of DFIs declined by 75 bps to 23.8 percent; conspicuously indicating that rising NPL in special mortgage finance institution contributed to high infection rate of DFIs. Provisions coverage ratio also improved due to upgrade of NPLs into doubtful category, which led to a decline in net-NPLs to net-loans ratio to 14.3 percent in H2-CY12 down from 18.3 percent in H1-CY12 **(Figure 6.6).**

Funding structure observed a lopsided dip in borrowings

Unlike banks, which rely on deposits as main funding sources, DFIs reliance remain on capital and borrowing, which jointly fund 83.9 percent assets **(Figure 6.7).** However, DFIs significantly decreased reliance on borrowings, which dipped by 14.1 percent during H2-CY12. Most of decrease took place in secured borrowing from the SBP, which were repaid through liquidation of investments during the period. Like investments, decline in borrowings was also lopsided as a single DFI retired almost all its secured SBP borrowing during the half under review. If we exclude this DFI, borrowings of DFIs increased by 14 percent due to substantial surge in secured SBP borrowings. Deposit base also contracted by 4 percent, which further

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

Figure 6.8
Profitability of DFIs

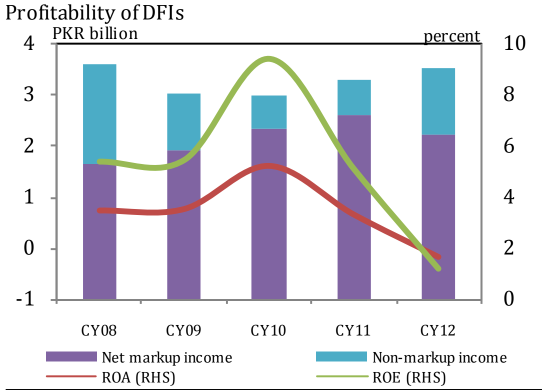


Figure 6.9
Solvency Profile of DFIs

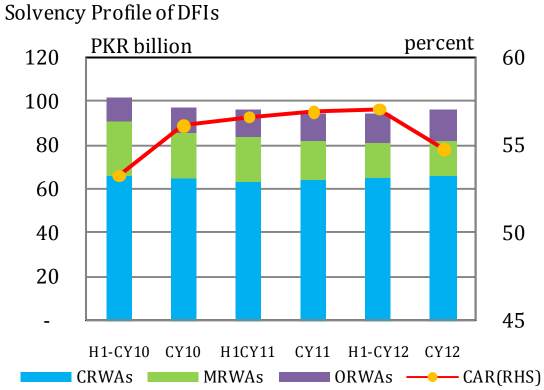
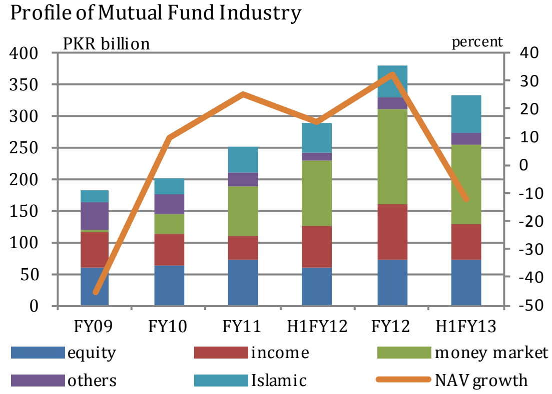


Figure 6.10
Profile of Mutual Fund Industry



contributed to overall decline in funding base. Equity of the DFIs observed 2 percent decline mainly on account of decline in un-appropriated profits.

Operating performance of the DFIs deteriorated during CY12

Operating performance of the DFIs deteriorated during CY12. The sector posted after tax loss of PKR 248 billion. The decline mainly resulted from significantly higher provision charge (almost 4 time the last year and contributed by a single DFI) and 11 percent decline in core income. The deceleration in mark-up income resulted from shrinking income on advances and higher borrowings cost. On the other hand, higher provisions wiped out almost 62 percent of the mark-up income. However, healthy 91 percent YoY growth in non-markup income somewhat minimized the overall loss. Most of the increase in non-mark-up income was contributed by gain on sale of investments and healthy growth in dividend income. Due to losses, ROA and ROE turned negative during CY12 **(Figure 6.8).** However *t*his weak performance was not broad based as only two out of eight DFIs posted losses while rest of the institutions improved earnings over the period.

Solvency remained strong though CAR observed some decline

DFIs have continuously maintained strong solvency profile over the years due to risk averse behavior. However, in H2-CY12, all categories of Risks Weighted Assets (RWA) increased with major jump seen in Operational Risk Weighted Assets (ORWA). Further, eligible capital also declined due to higher provisioning charge. As a result, CAR of industry dropped by 398 bps, however at 55 percent level it remained quite strong **(Figure 6.9).**

Mutual Funds

Performance of Mutual funds languished…

Mutual fund industry after remaining on growth trajectory for last four years saw a 12.5 percent decline in net asset value (NAV) during H1-FY13 (YOY growth of 15.4 percent). The performance of sector deteriorated due to dip in net assets of money market and income funds that remained the key growth drivers over the last few years. Equity funds continued to attract increasing investor's interest due to stellar performance of equity markets, which also supported healthy growth in NAV of close end, Islamic and pension funds **(Figure 6.10 and 6.11).**

Figure 6.11

Performance of Mutual Funds

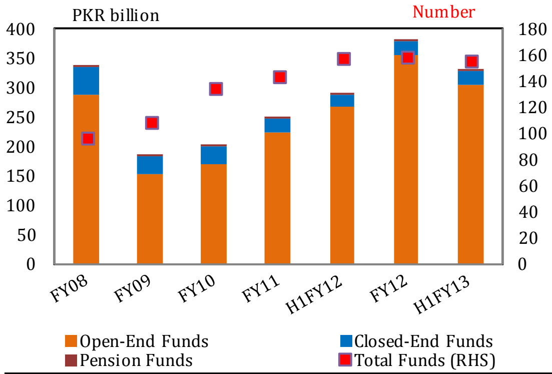
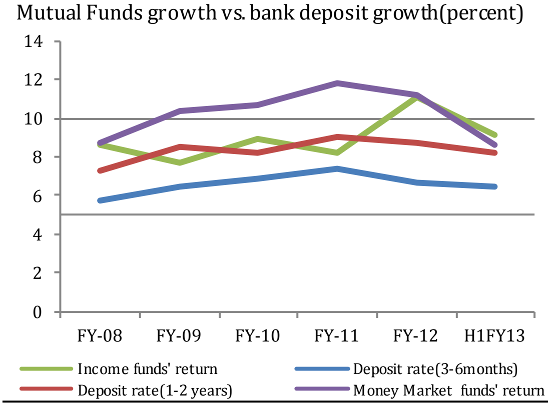


Figure 6.12

Mutual Funds growth vs. bank deposit growth(percent)



...due to decline in NAV of money market and income funds

The considerable decline in NAV of the mutual fund industry mainly resulted from a slowdown in open-end money market and income funds. As a result, share of open-end funds in the overall NAV dipped by 1.75 percent to 91.4 percent over the half year. Though, factors (substantial borrowing needs of the Government, providing risk free investment avenue and consistently growing equity market) responsible for surge in mutual fund industry during the previous half year still existed, dip actually took place due to i) waning interest of banks in fund investment due to gradual evaporation of tax advantage[70], ii) slashing of policy rate by 250 bps; and iii) redemption of over PKR 100 billion by one of the large banks owned asset management company (AMC).

High concentration of funds in few categories and institutions also faded the NAV of mutual fund industry. As highlighted in earlier FSRs, mutual funds industry was exposed to a high concentration risk. The industry held huge fund portfolio concentrated in money market mutual funds and banks invested substantially in these funds directly and indirectly. Such a scenario exposed mutual funds industry to both reinvestment risk as well as regulatory risk. The return on MMFs dipped with multiple slashing of discount rate over the year and a half. Furthermore, with the expected launch of Basel-III[71] and changes in tax regime, some banks pulled off their investments from mutual funds.

Declining variance in returns on mutual funds and deposits affected the performance of funds industry...

Return factor also seems to be another factor that played its part in dip in the NAV of the mutual funds market. Traditionally the gap between return on mutual funds and bank deposit was quite high (on average 4 percent between money market funds and short term (3-6 months deposit rates). This phenomenon of attractive and consistent returns, with investment in safe heaven, remained the key reasons behind increasing interest in the mutual funds over the last 3 years. However, market saw a shift in trend in H1-FY13 as returns offered on MMF declined from 11 percent to 9 percent in four year time due to 4.5 percent cut in policy rate over the last 18 months. As a result the gap between

[70] The income of banks is presently taxed as per the corporate tax rates i.e., at 35 percent of income before tax. However, the income generated by banks from investment in mutual funds was taxed at 10 percent. As per Finance Act 2013, dividend received from Money Market Funds and Income Funds has been taxable at 25 percent.

[71] Basel Capital accord under the look through approach for collective investment schemes, require banks to calculate capital charge on their mutual fund investments as if the underlying exposure/asset class is held by the banks themselves.

Figure 6.13

Category-wise NAV of Mutual Funds(share in percent)

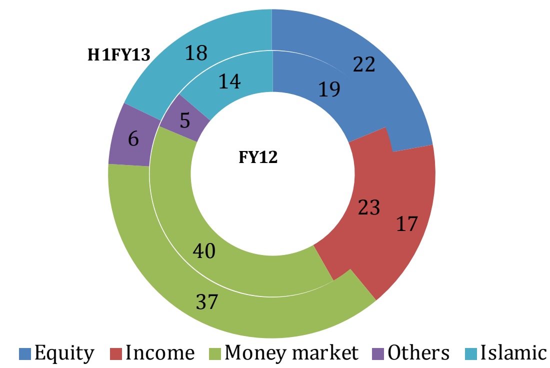
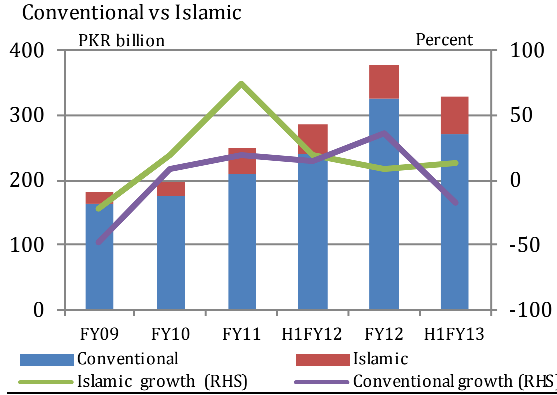


Figure 6.14

Conventional vs Islamic



return on bank deposits and mutual funds narrowed. In December 2012, the annualized return of open end money market funds was 8.61 percent **(Figure 6.12)** while income funds exhibited a return of 9.13 percent[72] (compared with weighted average return on deposits ranging between 6.6 to 8.7 percent with a maturity of 3 months to 2 years period).

Investment strategy shifted from interest based products to equity funds

Over the last few years, growth in NAV of money market funds (MMF) provided for most of the increase in value of the funds industry. Similarly, income funds, with an investment mix of government securities, debt instruments (TFCs, SUKUKs, etc) and banks deposits, supported the overall growth. However, the trend reversed during H1-FY13 as investment strategy shifted from income and MMF to equity funds. The NAVs of income funds and money market funds dipped by 23.3 percent and 17.6 percent respectively which lead to decline in their market share in H1-FY13. Despite decline in the NAV, the MMF held the highest followed by income and equity funds **(Figure 6.13).**

Equity funds gained ground thanks to healthy performance of equity market

Equity funds showed an overall growth of 6.8 percent on the back of robust capital market during H1-FY13. As a result, equity funds gained 4.8 percent market share. The growth in various categories of equity funds was broad based, though with a varying extent. Islamic equity funds, with an accelerated 37 percent growth, grabbed another 3 percent market share. On the other hand, conventional equity funds with 87 percent share in NAV of equity funds saw a meager growth of 3 percent; much lower than previous half year (19 percent).

Healthy growth in Islamic funds to some extent offset declaration in overall NAV of fund market.....

Islamic funds, after a sluggish growth in H2-FY11, gained momentum in period under review **(Figure 6.14)**. With a 14 percent increase in NAV, growth pattern of various categories of Islamic funds considerably varied from the industry trend. Islamic equity funds exhibited 37 percent growth while Islamic income funds registered 13 percent growth. Furthermore, a 3 percent decline in asset value of Islamic money market funds remained far below the industry average. Due to healthy growth

[72] MUFAP quarterly newsletter, Sep-Dec2012

Figure 6.15

Pension funds performance

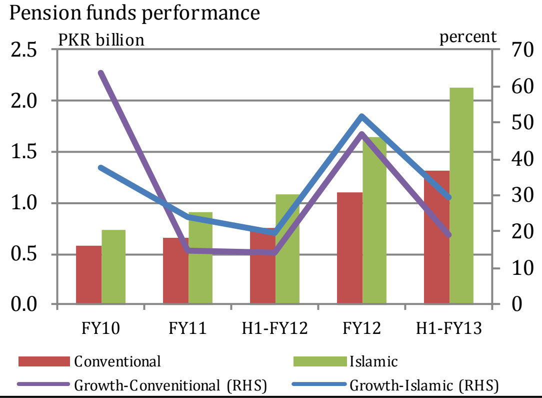
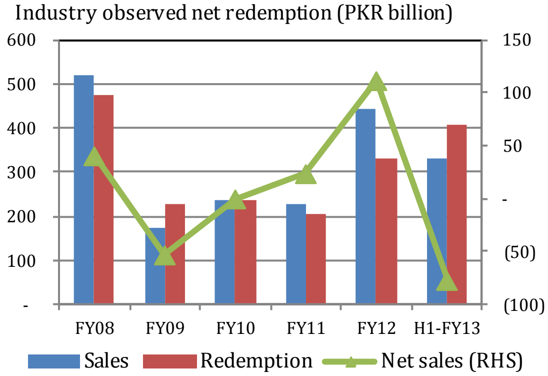


Figure 6.16

Industry observed net redemption (PKR billion)



during H1-FY13, market share of Islamic funds increased to 18 percent (13 percent in H2-FY12). With the booming equity markets and huge potential in Islamic funds, this segment is expected to show substantial growth and post reasonable gains in future.

Future prospects of growth in both conventional and Islamic pension funds are bright…

Most of the pension funds were introduced subsequent to notification of Voluntary Pension Scheme (VPS) Rules by the SECP in 2005[73]. Since then pension funds grew to 11 with PKR 3.4 billion worth of assets by end of December, CY12. Majority of the Pension funds were subsidiaries or associates of large banks operating in Pakistan. These funds are either general or Islamic with three sub-fund categories; debt, equity, and money market funds. In terms of share, the sub funds have almost equal share with debt fund leading marginally. Interestingly pension funds are one category where Islamic funds dominate the market share. Rather, an Islamic pension fund is the largest pension fund with almost 30 percent share in the pension fund market.

Despite overall slowdown, pension funds posted a decent growth of 25 percent (YoY 87 percent growth). The growth mainly resulted from favorable tax treatment[74] available to this segment of funds as also due to increased awareness among the investor and public regarding this attractive avenue for long-term savings, particularly for their old age **(Figure 6.15)**. With increasing demand for Shariah complaint products, growth in NAV of Islamic pension funds continues to outpace conventional ones. In line with rest of industry, more than half of pension funds investment resided in Government securities followed by 13 percent placed in equity markets and 14 percent in bank balances.

Industry observed net redemption due to slow down in money market and income funds

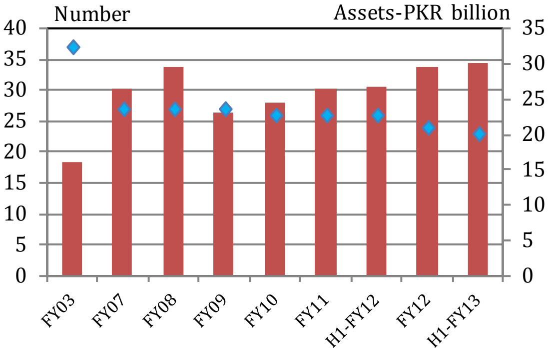
Sales and redemption pattern of mutual funds over the years have seen net sales, where sales outpaced redemption except in 2009 due to liquidity crunch faced by market in the aftermath of freezing of stock exchange. However, in H1-FY13, funds market observed selling pressure as redemption exceeded sales by 8 percent, resulting in overall shrinkage in the fund industry

[73] VPS rules issued by SECP vide notification dated 27.01.2005

[74] Under section 63 of income tax ordinance, pension fund investments are eligible for tax credit up to 20 percent of one's taxable income. Additional catch-up incentives are provided to participants over 40 years, with a maximum tax credit on 50 percent of taxable income for participants that are 55 years or older.

Figure 6.17

Profile of Modaraba sector



(Figure 6.16). Major redemption was seen in money market and income funds which experienced joint net redemption of PKR 73 billion in H1-FY13. On the other hand, Islamic mutual funds supported the industry by adding PKR 2.4 billion net sales across different categories of mutual funds.

To address the various issues and risk facing the industry, the need remains for reviewing the regulatory structure and introducing measures for addressing such risks. Similarly, fund managers need to revisit their strategy for diversifying their product base for ensuring relatively stable returns for the investors. To promote further diversification and address concentration issues, SECP issued various instructions. It allowed investment in commodities and commodity future as new asset class of open-end mutual funds. Further, valuation methodology and provisioning criteria for debt securities was improved, which include classification of securities into traded, thinly traded and non-traded and their valuation methodology in detail based on rated and unrated issues[75]. Lastly, per party and per sector concentration limits for equity exposures of pension funds have been revised (per fund limit revised upward from 5 to 10 percent and sector limit from 25 to 30 percent).

Modarabas

Modarabas financing exhibited healthy growth on the back of Ijarah business…

Modarabas business during the period under review remained as one of the profitable Islamic finance mode employed by NBFIs. The asset base of Modarabas companies reached PKR 30 billion mark albeit a moderate growth of 1.6 percent in H1-FY13 **(Figure 6.17).** The growth was concentrated in large-sized Modarabas primarily on account of trading portfolio gains and low borrowing cost. However one large firm also showed healthy business activity due to growing lease business. Increase in financing activity and cost control measure adopted by the companies led to improvement in earnings of the Modarabas Companies, which reflected in improved return indicators.

…yet concentration in top ten firms has increased over the years

Though Modarabas industry, with 23 institutions, is the second largest sector in terms of number of entities after mutual funds, its share in total NBFI assets is relatively small. Concentration in

[75] SECP circular no. 33 of 2012 dated October 24,2012

Table 6.4: Concentration in Modarabas					
					Percent share
	FY09	FY10	FY11	FY12	Dec-12
Top 3	42.3	45.0	42.5	45.5	48.6
Top 5	65.8	63.0	61.0	62.5	65.2
Top 10	83.3	83.0	84.0	85.6	87.1
Rest of firms	16.7	17.0	16.0	14.4	11.3

industry is increasing over the years. During the period under review, the sector continued to be dominated by top 10 firms whose market share increased to 87 percent from 85.6 percent in FY12, indicating a widespread fragmentation in the industry **(Table 6.4).**

Despite number of challenges both on economic and business front and in contrast to non-bank industry trend, Modarabas companies maintained their business on the back of improved core business activity, i.e., financing under various modes including Ijarah, Murabaha and diminishing Musharaka. On the funding side, deposits which represent 22 percent of assets, exhibited a healthy growth and supported the overall expansion of Modarabas industry. Besides, healthy growth in core capital also provided additional support to Modarabas business, which finances 44 percent of assets as of end December CY12.

Cautious business approach paid off; as evident from widespread profitability

Table 6.5: Performance Indicators of Modarabas						
						(PKR billion, Ratio in percent)
	FY08	FY10	FY11	Dec-11	FY12	Dec-12
Profit after tax	*0.8*	*0.8*	*1.1*	*0.55*	*1.2*	*0.64*
Income	*5.5*	*7.9*	*7.7*	*3.3*	*6.6*	*3.7*
Expenses	1.8	7.1	*6.5*	*2.7*	5.3	*3.1*
ROA	*3.6*	*3.4*	*4.4*	*2.2*	4.2	*2.3*
ROE	*7.9*	*7.2*	*9.4*	*4.6*	9.1	*5.0*

In an environment where major segments of NBFIs are struggling to survive, operating performance of Modarabas improved during half year under review. Modarabas industry registered half-yearly profit after tax of PKR 0.6 billion up by 16 percent compared to corresponding period last year. The surge came at the back of healthy 13 percent growth in revenue and gain on sale of investment portfolio in declining interest rate scenario. Profitability was widespread as 20 out of 23 companies posted profits. The return indicators substantially improved as annualized operating performance during H1-FY13 outweighed the growth in average assets and equity **(Table 6.5).**

Modarabas sector can draw strength from its business model to expand in non-conventional markets

Modarabas industry has come a long way in last ten years. Their legal framework[76] provides flexibility to undertake both financial and real businesses, which allow them a strong edge on their counterparts including banks. This peculiar business model allows them to enter in those markets where other financial institutions are reluctant. SECP being the lead regulator of Modarabas industry has tried to provide an enabling environment through improvements on the regulatory front. As mentioned in earlier FSR, the SECP issued Shariah Compliance and Shariah Audit Mechanism (SCSAM)[77] for Modarabas, which

[76] 'Modarabas Companies and Modarabas (floatation & Control) Ordinance' 1980 (the Modarabas Ordinance).
[77] SECP Circular No. 8 dated February 03,2012

Figure 6.18

Profile of Leasing sector

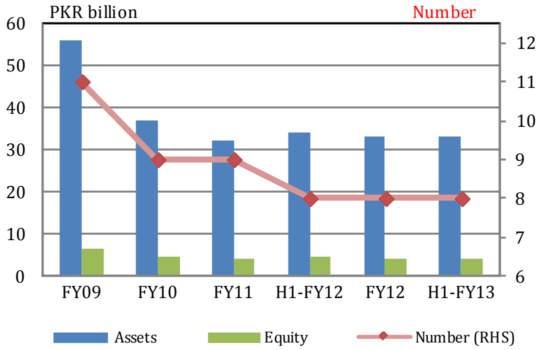
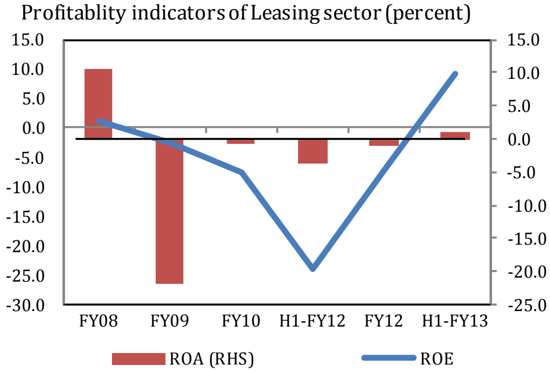


Table 6.6: Leasing sector ratios in percent					
	FY10	FY11	Dec-11	FY12	Dec-12
Advances to Assets	79.4	80.5	77.6	80.0	80.3
Investments to Assets	9.8	8.0	8.1	9.4	9.9
Borrowings to Liabilities	55.2	51.2	29.5	42.9	38.2
Deposits to Libilities	41.2	17.7	17.9	22.1	26.4

Figure 6.19

Profitablity indicators of Leasing sector (percent)



will help (i) to maintain the trust of stakeholders in Islamic financial system and (ii) to mitigate the reputational and operational risks faced by Modarabas as Islamic financial institutions. In the half year under review, SECP also standardized related party disclosure requirement for Modarabas, required to be submitted on semiannual basis[78]. These developments will definitely help to build a strong governance framework in Modarabas Sector, which is necessary to attract more investment in this profitable venture.

Leasing

Despite difficult operating conditions and competition from host of other institutions, operating performance of the leasing companies improved during H1-FY13 after staying negative in corresponding period last year. The sector succeeded in maintaining overall size and number of players. Asset base of the sector showed a marginal growth mainly on the back of healthy growth in deposits. However, most of the additional funds were utilized for retiring the borrowings from banks and partially for financing the leasing portfolio. The performance of the leasing sector remained skewed due to high concentration of assets in a couple of companies representing 82 percent of the market share. Further, solvency concerns continued to haunt majority of the leasing companies.

The leasing sector observed a minor growth of 1.2 percent during H1-FY13 after contracting over H2-FY12. Part of this increase took place in lease financing which saw a 1.5 percent growth, while investment portfolio grew by 6.6 percent. In terms of assets structure, lease financing and advances remained the major financing activity of the leasing companies representing 80 percent of the total assets[79] **(Figure 6.18).**

On funding front, deposit base continued the growth trend as deposits of the leasing sector increased by 21 percent during H1-FY13. Though, growth in deposits over the last two years is a good omen for the leasing sector, most of the increase was limited to a couple of large leasing companies. The higher deposit base facilitated leasing companies in reducing reliance on expensive borrowings. In lieu of this and due to absence of further business avenues; borrowings of leasing sector dropped by 9.7 percent over the half year **(Table 6.6).**

78 SECP circular dated September12,2012
79 NBFC and NE regulation, 2008 (Para 28a) requires Leasing companies to invest at least 70 percent of their assets in the business of leasing.

Figure 6.20

Capital of leasing companies during Dec-12 (PKR million)

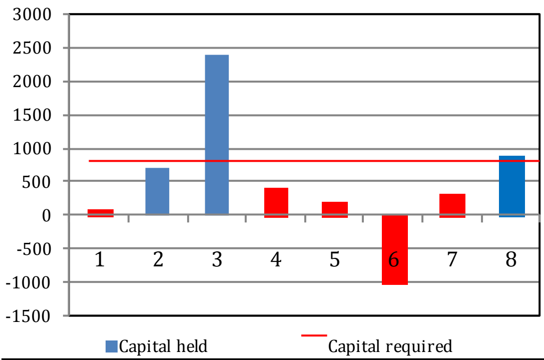
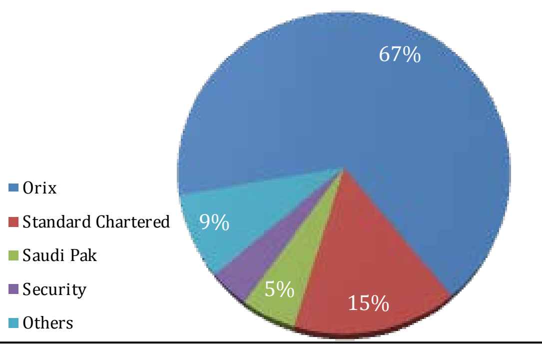


Figure 6.21

Asset concentration in Leasing sector during Dec-12



The shift in funding structure also had a positive bearing on the financial performance of the leasing sector, as it posted a profit after tax of Rs 180 million during H1-FY13 against a loss of Rs 600 million in H1-FY12. The earnings performance was broad based as 6 out of 8 leasing companied posted profits in half year under review against 4 in corresponding period last year. Improved profitability mainly resulted from higher lease income and investment income as also substantial reduction in gross expense. The expenses of the sector declined by 14 percent mainly on two counts; a) decrease in financial cost due to waning reliance on costly bank borrowings and b) and substantial reduction in provisions charge over the half year. As a result, the return indictors[80] (ROA and ROE) turned positive in H1-FY13 **(Figure 6.19).**

Despite improved performance, leasing sector remained under-capitalized as only 3 out of 8 operative leasing firms complied with the existing minimum equity requirement(MER) of PKR 500 million set forth by SECP[81] **(Figure 6.20).** Keeping in view the challenging economic environment, SECP allowed the leasing sector to meet MER of PKR 700 million by end June 2013[82] (previously required to be met by 2011). However meeting equity of PKR 700 million seems quite challenging for most of the players within the prescribed timeline.

Leasing industry characterized by small number of players is highly concentrated in terms of assets. Asset concentration kept on growing with shrinkage of industry size over the years (8 operative firms in H1-FY13 against 12 in FY07). Effectively 82 percent of industry assets are held by 2 firms **(Figure 6.21)** and this trend has been observed over last many years.

Leasing sector with asset based financing model relative to collateral based financing as offered by bank has huge potential to grow. This advantage is more pronounced in case of SME sector which generally lacks collateral and is unable to access formal banking sector. As such leasing companies needs to focus on diversifying their product and customer base to take benefit of their niche. They should also develop products for tapping agriculture sector, by providing agri-machinery leases for small

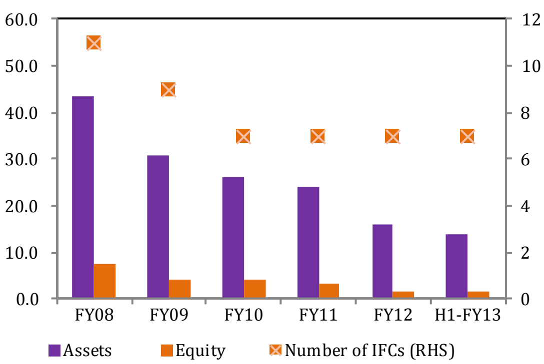
[80] Leasing sector review is based on data for half year ending Dec-12. However for two companies' financial year ends on December instead of June. To calculate ROA and ROE, profitability is annualized for overall sector.
[81] For MER of PKR 700 million required to be met by end June 2013, number of non-compliant firms stays the same.
[82] Non-Banking Finance Companies and Notified Entities Regulations, 2008 (amendment vide SRO 764, Dated September 2nd 2009) require fresh licensed leasing companies to hold PKR 700 million capital while existing companies to maintain PKR 350 million by June 30, 2011 , PKR. 500 million by June 30, 2012 and PKR 700 million by June 30, 2013)

farmers. Similarly microfinance can also prove a promising business venture for leasing sector which needs to be tapped.

Leasing sector though exhibited improved performance during the current period; however, volatility in its performance remained a cause of concern. Additionally, non-compliance of a number of firms with MER kept the chances of further consolidation open, which given the small number of firms in the industry will be non competitive and as such not desirable. As such regulator needs to take measures for facilitating the growth of this important sector. In this respect, SECP has already proposed amendments in NBFC Regulations which inter-alia included relaxed equity requirement for leasing sector and to meet equity of PKR 700 million in a phased manner by June 30, 2018[83].

Figure 6.22

Assets and Equity of IFCs (PKR billion)

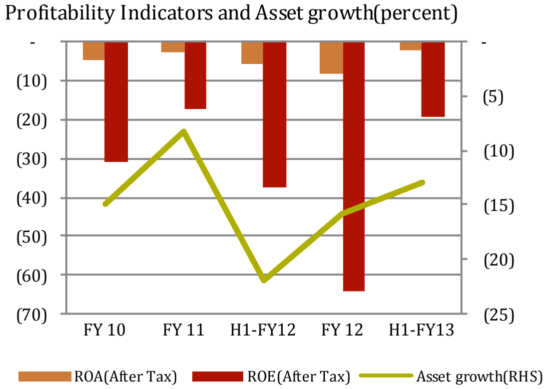


Investment Finance Companies

The performance of Investment Finance Companies (IFCs) deteriorated further during H1-FY13 as assets base contracted and sector posted losses after tax. Actually, the business model followed by investment banks seems not working. Funding constraints viz. parched liquidity from commercial banks, absence of regular stream of deposits, and low and shrinking equity base made it hard for many investment banks to survive. Further competition from commercial banks, DFIs, brokerage houses and even accountancy firms that overtime strengthened their financial advisory wings also contributed to subside the business avenues. Most of the IFCs failed to comply with the prescribed equity requirement, making it hard for some players to run business as a going concern.

Figure 6.23

Profitability Indicators and Asset growth(percent)



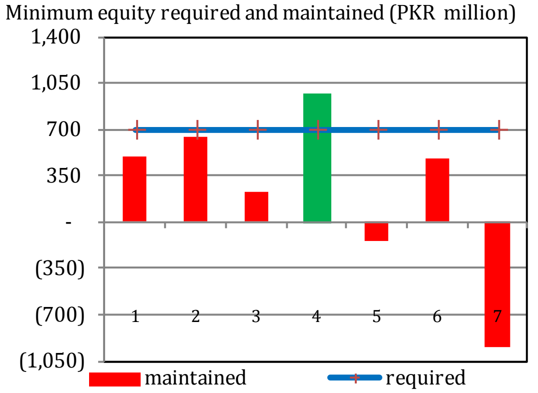
IFCs saw a 13 percent drop in balance sheet size as borrowings and deposits jointly saw a considerable decrease of 30 percent during H1-FY13. This contraction was broad based as six out of seven players observed reduction in asset base. Due to lack of business avenues, advances including lease finance dropped by 10 percent over the half year under review **(Figure 6.22).**

Overall slowdown in economy and liquidity pressure faced by IFCs resulted in the form of contracting business volumes and poor earning indicators. The sector posted loss after tax of PKR 172 million during H1-FY13. With shrinking business, the gross revenues dropped by 18 percent YoY basis. Though financial cost also dipped by 65 percent due to lower cost of funds, which provided some respite to overall losses, increasing administrative

[83] Report of Non-Bank Financial Sector Reform Committee for Public comments by SECP

Figure 6.24

Minimum equity required and maintained (PKR million)



expenses and substantial loan loss provisions added to deteriorating operating performance. As a result return indicators remained negative for the sector **(Figure 6.23).**

The continuous accumulation of losses over the last few years led to a substantial decline in equity of IFCs. During H1-FY13, equity declined by another 4 percent. As of end CY12, six institutions fail to meet the minimum equity requirement (MER)[84] of PKR 700 million that actually weakened further in case of loss making IFCs **(Figure 6.24).** SECP is currently in process of reviewing the regulatory regime for NBFCs including business model for investment banks and industry is anticipating some favorable developments in this regard[85].

Keeping in view the challenging business and economic environment, IFCs need to realign their business model to the changing financial needs of the market. In this regard, SECP has already allowed IFCs to conduct brokerage business from their own platforms[86]. With the expected off-take in equity market, brokerage business can become the major revenue source for IFCs in future. In addition, huge potential exist for developing domestic debt and equity market. IFCs can play a pivotal role in this process, for which they need to devise a sustainable business model by tapping stable funding sources and diversifying their product pool.

[84] As per S.R.O. 764 (I)/2009 dated September 2, 2009, SECP requires existing IFCs to hold PKR 700 million equity as on June 30, 2012 while for new entrants; this requirement is PKR 1000 million.
[85] Investment finance services are proposed to be broken into stock brokerage, investment advisory, corporate advisory, securities financing and securities underwriting services (Report of Non-Bank Financial Sector Reform Committee for Public Comment by SECP).
[86] Introduced vide S.R.O. No. 814(I)/2011 dated September 05, 2011 of SECP.