Chapter 6 Non Bank Financial Institutions (NBFIs)

The phenomenal increase in net asset value of mutual funds along with healthy growth in DFIs and Modarabas boosted asset base of NBFIs sector for second consecutive year. Much of the growth in Mutual funds was driven by enhanced interest in money market and income funds, due to their competitive returns and ample supply of risk free Government bonds. Borrowing continued as a major funding source of the sector, though deposits also picked up for leasing sector. However, except for DFIs and Modarabas, NBFIs sector consolidated its business activities, which led to further shrinking of total loan portfolio. The improved operating performance of Modarabas and DFIs provided for overall profitability of the sector. However, profits dipped by 45 percent due to heavy losses incurred by IFCs and couple of leasing companies, which further added to already growing solvency concerns related to these sub-sectors.

Overview [50]

Ideally, a well functioning financial system should provide wide range of financial products and services through a diversified group of financial institutions. It is an indicator of financial depth or penetration in an economy and 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 world economies, it also constitutes diverse range of other Non-bank financial intermediaries viz. Asset Management Companies (AMCs), Mutual Funds (MFs), Leasing Companies, Modarabas[51], Investment Finance Companies (IFCs), firms rendering Investment Advisory Services (IAS), Venture Capital Companies (VCCs) and Development Finance Institutions (DFIs).

Table 6.1: Profile of NBFIs

	FY04	FY08	FY09	FY10	FY11	FY12
Assets (Rs. Billion)	318.1	585.6	470.1	421.9	478.2	610.2
Growth rate	22.7	3.3	-19.7	-10.2	13.3	30.2
	Share in Assets (percent)					
Mutual Funds	32.4	58.5	47.9	47.6	53.2	62.4
DFIs	29.8	14.5	24.2	26.8	24.6	21.5
Leasing	14.1	11.0	11.9	8.8	7.1	5.4
Investment Finance	11.2	7.4	6.6	6.2	5.2	2.7
Modarabas	5.7	5.1	4.9	5.8	5.6	4.8
Housing Finance	6.1	3.1	4.0	4.6	4.0	3.2

NBFIs are slowly surfacing as a growing segment in financial sector landscape…

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. The NBFIs actually surfaced as a growing segment during FY12 with a half percent improvement in its share in the financial sector assets during FY12 to 5.2 percent.

…on the back of phenomenal growth of mutual fund industry

[50] 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 SECP and MUFAP website.

[51] Modaraba companies' analysis is based on financial data of 24 active companies.

Figure 6.1

Growth Trend in Non-bank Financial Sector (percent)

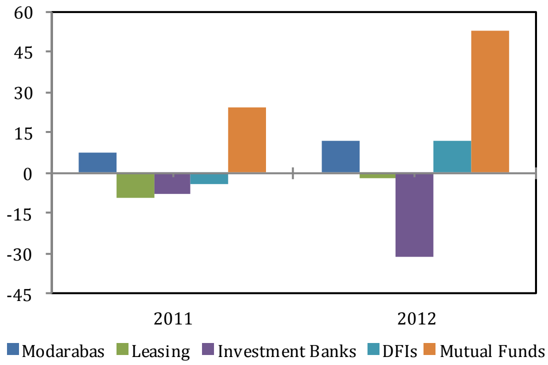


Table 6.2: Number of NBFIs					
	FY08	FY09	FY10	FY11	FY12
Mutual Funds	97	109	135	144	158
DFIs	6	8	8	8	8
Leasing	12	11	9	9	8
IFCs	11	9	8	7	7
Modarabas	27	27	26	26	26
HFCs	2	1	1	1	0
VCCs	4	3	4	3	2
DHs	1	0	0	0	0
Total	160	168	191	198	209

The NBFIs sector continued the momentum gained during the last year as its assets surged by 30 percent. MFs industry remained the key driver behind this increase; as its Net Asset Value (NAV) observed accelerated growth of 53 percent, leading to a substantial jump in share of mutual funds in NBFIs assets base **(Table 6.1).** Favorable environment in the money market mutual funds on the back of increased demand from the Government for matching the fiscal needs and investors' risk averse sentiment remained the major contributors towards growing mutual funds market share.

With the exception of Modaraba and DFIs, rest of the non-bank players are struggling to survive

The NBFIs (excluding mutual funds) observed a moderate growth of 5.2 percent, which was mainly supported by healthy 12.1 and 12.2 percent growth in assets of Modaraba Companies and DFIs respectively **(Figure 6.1).** Meanwhile, the Leasing companies saw a marginal decline in their asset base owing to exit of a leasing company, while the IFCs took a major hit in FY12, with a substantial decline in assets (31 percent) due to reduction in their advances and lease business, and growing delinquent portfolio. The number of NBFIs (except Mutual funds) further declined over the year due to consolidation and regulatory actions **(Table 6.2).**

Borrowing remained the main funding source yet deposits started picking up for the leasing sector

Borrowings from financial institutions historically remained the major funding source for the NBFIs. The trend continued during the period under review and borrowings registered a growth of 12 percent mainly on the back of 31 percent rise in borrowings of DFIs. While most of the other NBFIs retired their borrowings and relied on deposits to provide funding support to their asset base. Particularly the large leasing companies succeeded in mobilizing substantial amount of medium to long terms deposits for financing their operations.

Slowdown in core business activity and rising delinquencies resulted in further shrinking of loan portfolio and profitability indicators ...

In line with the trend prevailing in the financial sector, the asset structure of the NBFIs also observed a shift towards investments, which surged by 12 percent during FY12. Most of the increase

Table 6.3 Key Performance Indicators of NBFIs*

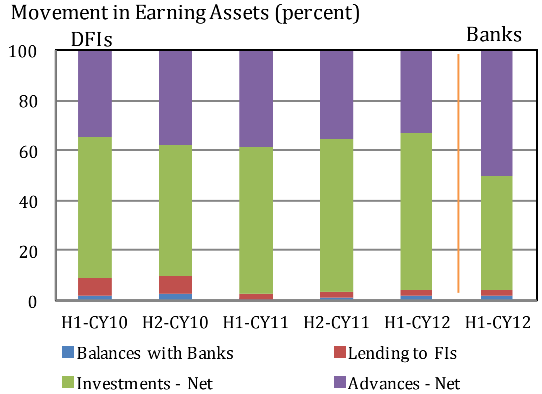
percent (except in case of ratio)

	FY08	FY09	FY10	FY11	FY12
Capital to Assets	35.2	35.9	36.2	36.8	34.6
Advances to Assets	52.5	47.7	41.4	38.5	36.2
Investments to Assets	28.6	34.0	39.2	40.7	43.1
Earning Assets to Total	82.6	85.6	80.7	79.2	79.3
Debt to Equity Ratio	2	2.1	1.8	1.7	1.9
Borrowings to Liabilities	61.1	58.1	60.0	58.2	58.7
Deposits to Liabilities	25.2	28.7	27.8	24.4	21.2
Income to Expense	111.3	92.5	102.5	142.4	135.2
Return on Average Assets (after tax)	0.9	-1.6	-0.1	1.3	1.2
Return on Average Equity (after tax)	3	-5.1	-0.3	3.7	3.4

*Excluding Mutual Funds, AMCs and investment advisory

Figure 6.2

Movement in Earning Assets (percent)



took place in DFIs and in the category of risk free government papers. As a result, the share of NBFIs' investments in total assets increased by 243 bps to 43 percent in FY12. Advances and leases, on the other hand, saw a marginal decline of 1 percent. This dip was observable across all the NBFIs segments except Modarabas, which managed to enhance their financing operations during FY12. Shrinking of core business and rising delinquent portfolio of a large number of NBFIs remained the key contributing factors towards contraction of financing portfolio.

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

The NBFIs sector posted after tax profit of PKR 920 million during FY12; 45 percent lower than the corresponding period 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 leasing and investment finance business. Accordingly, the ROA and ROE also observed decline over the year[52] **(Table 6.3).** Despite poor performance of leasing and IFC business, improved performance of Modaraba Companies and DFIs facilitated in positive earnings of NBFI sector in FY12.

Though profitability of few segments of NBFIs marginally increased the capital base of overall sector, however, this improvement remained concentrated to a few large players. As evident, 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 addressing 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 improving their chances of revival.

[52] Profitability of DFIs is discussed for the half year ended June 2012. Figures have been annualized for return indicators ROA and ROE.

Figure 6.3

Investment composition of DFIs (Rs. billion)

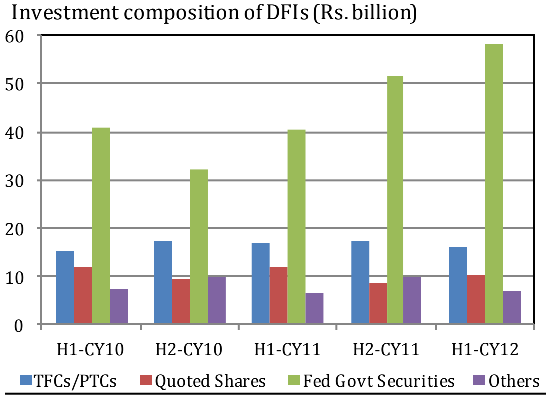


Figure 6.4

Investment Anatomy

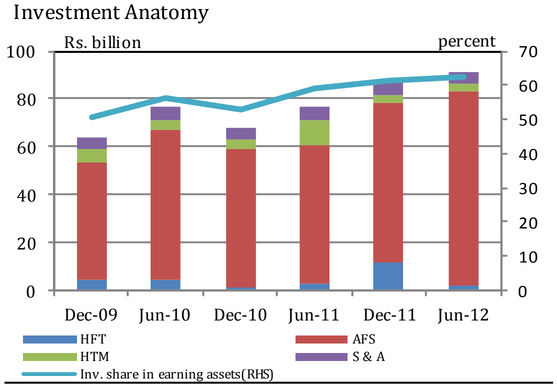
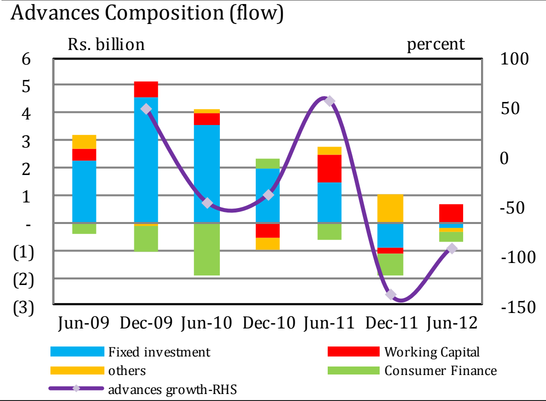


Figure 6.5

Advances Composition (flow)



Development Finance Institutions (DFIs)[53]

Despite deceleration, investment portfolio still holds the top seat in DFIs' asset book.

During H1-CY12, asset base of DFIs increased by 5 percent that was mainly funded by improved deposit base and borrowing from the financial institutions. Most of the fund funneled into investment which increased by 8 percent **(Figure 6.2),** while advances remained almost stagnant at CY11 level. The profitability of the DFIs improved remarkably due to lower provisions charge and higher non-interest income. Due to limited focus on exposure to risky assets, CAR of the DFIs improved slightly during the period under review.

Main thrust towards the increase in assets came from investments, though with a decelerated pace of 8 percent in H1-CY12 (against 15.5 percent in pervious half). Unlike H2-CY11 when increase in investments took place only in government papers, during H1-CY12 funds channeled into both Government securities as well as the quoted shares. Most of the 13 percent increase in Federal Government Securities came from investment in long term PIBs as yield curve steepened for longer tenures, while demand for short term T-bills slackened. On the other hand, the bullish trend in capital market activity increased the appetite for equities, leading a 20 percent growth in equity market investments **(Figure 6.3).**

With continuing stress in the money market, maturity profile of the investment observed a major shift as DFIs opted to further enhance their asset-based liquidity. The DFIs placed most of the new investments in the AFS category, while the securities in HFT category reached almost nil level **(Figure 6.4).** Accordingly, the share of AFS securities increased to 89 percent in H1-CY12 up from 73 percent in H2-CY11.

...while advances stay stagnant

Overall lending portfolio of DFIs stayed stagnant during H1-CY12 with a meager half percent growth as DFIs continued with their strategy of limiting exposure to risky assets. End use analysis of advances show that surge in lending to public sector helped in maintaining the loan book at the level of H2-CY11; while all other categories saw net repayments in H1-CY12. SME got the major

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

Figure 6.6

Flow of fresh loans and NPLs in H1-CY12(Rs. million)

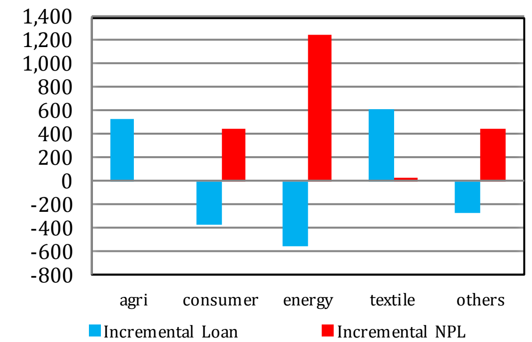


Figure 6.7

Asset quality of DFIs (percent)

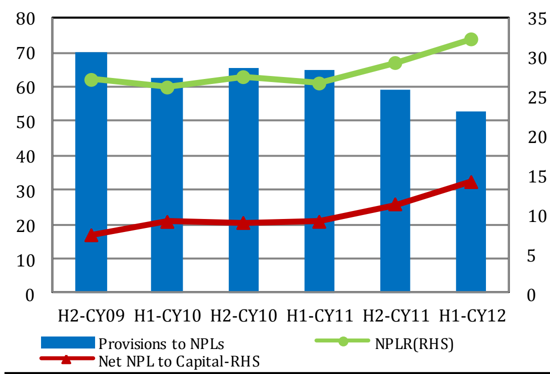
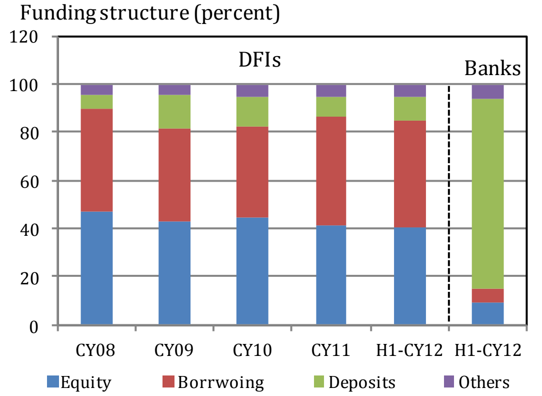


Figure 6.8

Funding structure (percent)



hit with 5 percent decline followed by consumer with net repayments of PKR407 million **(Figure 6.5).** Sector-wise analysis exhibited nominal increase in financing to agriculture and textile sector, most of which was offset by decline in lending to energy and chemical sectors **(Figure 6.6).**

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

With sluggish lending activity and worsening asset quality, infection ratio increased to 32.3 percent (highest in last three years). Energy and electronics sector remained the main contributors toward PKR 1.7 billion fresh flow of NPLs during H1-2012, followed by Consumer finance and the textile sector. With 10 percent incremental NPLs, which require lower provisions charge, provisions coverage deteriorated to 52.9 percent in H1-CY12 from 59.4 percent in CY11. Corresponding increase in Net NPLs led to an increase in Capital impairment ratio (Net NPLs to capital) by 280 bps to 14.1 percent **(Figure 6.7).**

Funding structure relied heavily upon equity and on costly borrowings yet deposits started picking up

Funding structure of DFIs generally remained reliant on equity and borrowings and partially supported by deposits. However, deposits grew by 17 percent during H1-CY12 at the back of growth in fixed term deposits, increasing their share in funding by 95 bps to 9.3 percent. Reliance on costly borrowing somewhat appeased with only 4 percent growth in the period under review against an increase of 25 percent during H2-CY11 **(Figure 6.8).** Most of the increase in borrowing was secured from SBP to manage the short-term liquidity needs.

Operating performance of DFIs improved in H1-CY12 relative to corresponding year

The broad based financial performance of DFIs improved significantly as they posted pretax profits of Rs 2.5 billion during H1-CY12, 25 percent higher than the corresponding period. As a result of improved earnings, the ROA (before tax) rose to 3.5 percent in H1-CY12 from 3.1 percent in H1-CY11 **(Figure 6.9).** Most of the increase resulted from reversal in provisions charge and improved non-markup income on account of gain on sale of shares. Meanwhile, the net mark-up income observed decline due to decreasing core income from advances and increasing repo borrowings.

Figure 6.9

Profitability of DFIs

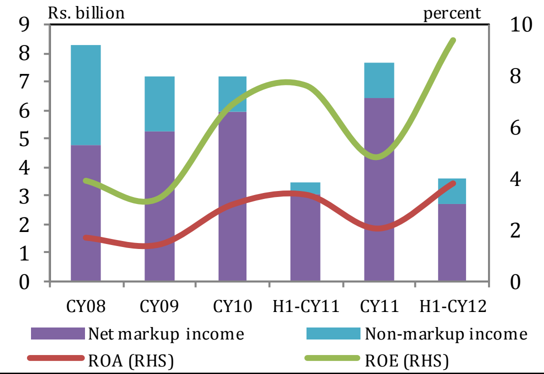


Figure 6.10

Solvency Profile of DFIs

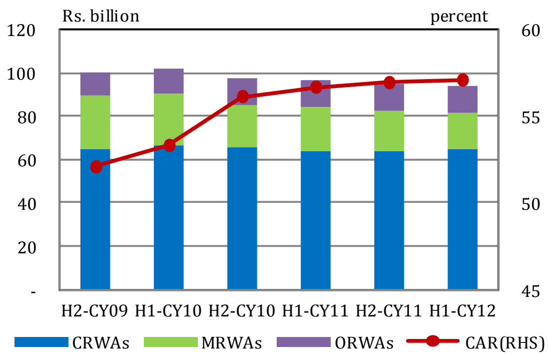
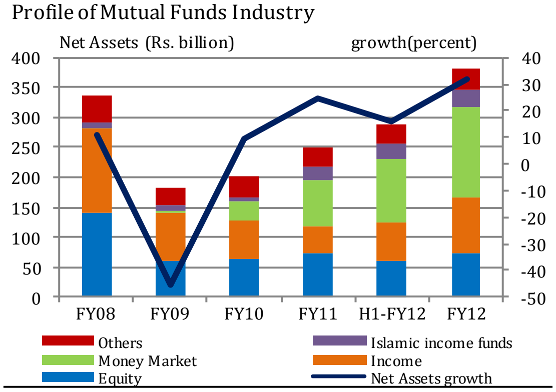


Figure 6.11

Profile of Mutual Funds Industry



Solvency though strong but excessive suggesting ineffective utilization of capital

Solvency of DFIs remained quite strong as CAR stood at 57 percent in H1-CY12, mainly due to limited risk based activity **(Figure 6.10).** This development, though 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, indicating less than optimum utilization of available resources. Such a high CAR coupled with low leverage of the sector, highlights the need for DFIs to broaden and diversify their exposures.

Mutual Funds

Fund industry growth can be attributed to increase in money market funds, income funds and equity funds…

The NAV of the mutual fund industry continued to grow at an accelerated pace during H1-CY12. The growth was relatively broad based compared to the first half of FY12, however healthy increase in net assets of money market and income funds remained the key driver of the growth; thanks to rising borrowing needs of the public sector and risk averse attitude of the investors. Increasing demand for equity funds further supported this growth due to strong recovery in the stock market indices.

Healthy growth in Pension funds to some extent offset decleration in Islamic funds.

Pension funds, which account for a small share of funds market, started to show healthy growth during FY12. Islamic funds, which emerged as a fast growing segment over the last few years, somewhat decelerated over the period under review. In terms of funding strategy, the growth of open-ended funds out paced growth of close end funds. The latter continued to lose ground in absolute terms due to regulatory restriction[54].

Mutual fund industry observed 32 percent increase in its net asset value during H2-FY12 (53 percent YoY) **(Figure 6.11).** Growth occurred in all major categories of open-ended funds including money market, income and equity funds **(Figure 6.12).**

[54] According to Para 65 of NBFC and NE Regulations of 2008, all closed end funds should be converted into open-end funds, wound up or revoked upon expiry of every five years from 21st November 2007 or the date of launch of the fund whichever is later.

Figure 6.12

Performance of Mutual Funds

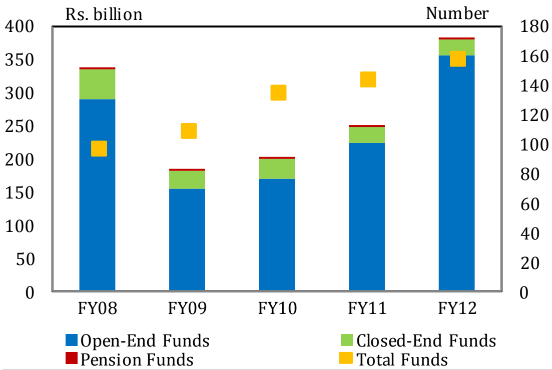


Figure 6.13

Mutual funds and equity market (Rs. billion)

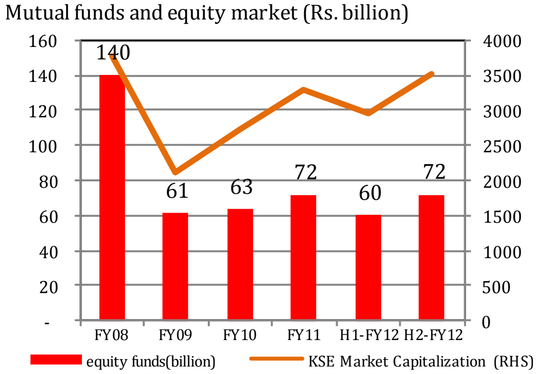
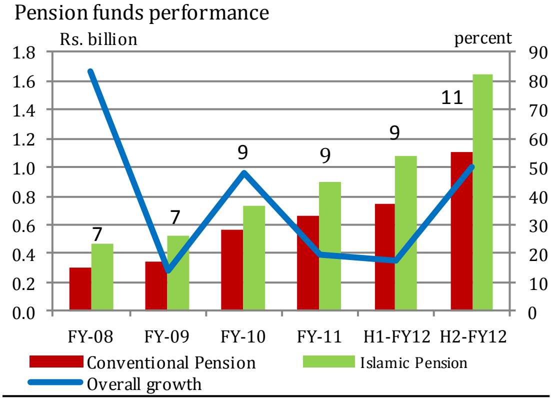


Figure 6.14

Pension funds performance



Money Market Funds (MMF) remained the key growth driver and with a 43 percent growth, continued to attract major chunk of funds due to their risk free competitive return. Similarly, income funds, with an investment mix of government securities, debt instruments (TFCs, SUKUKs, etc) and banks deposits, posted a remarkable 49 percent growth; increasing their share to a quarter of total NAV of mutual fund industry. Equity funds, which observed contraction in the first half of FY-12, gained 20 percent in NAV owing to 21.6 percent recovery in KSE-100 index **(Figure 6.13).**

Even though growth in Islamic funds decelerated, it remained in line with overall trend of mutual fund industry...

Islamic funds market remained somewhat sluggish during the period under review as its NAV increased by only 9 percent (against 19 percent H1-FY12). Though the growth pattern of various categories of Islamic funds remained in line with the overall trend of mutual fund industry, the major increase came in the NAV of money market, balanced and equity funds. On the other hand, Islamic income funds, which accounts for 57 percent of the Islamic funds industry, after enjoying substantial growth in last one and half year, observed a marginal 3 percent growth in NAV during H2-FY12.

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

An encouraging development in the mutual funds sector was increase in the pension funds[55] at a brisk pace. With the favorable tax treatment[56] available to pension funds for encouraging long-term savings, this segment grew in both numbers and size over the year. The NAV of pension funds recorded a remarkable growth of 50 percent to reach Rs 2.7 billion over the second half of FY-12, while with the addition of two new pension funds in H2-FY12, the number of pension funds increased to 11. Both conventional and Islamic pension funds observed surge in their NAV, though later outpaced the former **(Figure 6.14).** While the current share of pension funds in total market is nominal but with the tax incentive and increasing

[55] Pension funds are governed by Voluntary Pension system Rules,2005 issued by SECP and work in the form of unit trust schemes; comprising of equity sub-fund, debt sub-fund and money market sub funds.

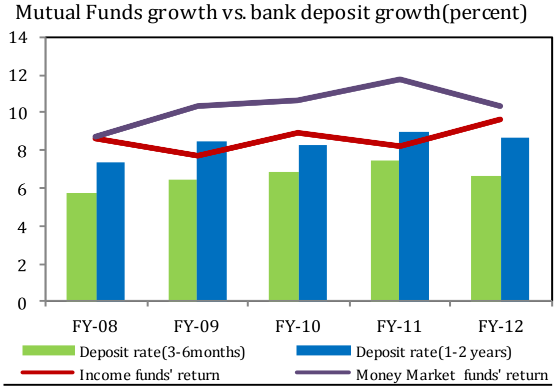
[56]Under section 63 of income tax ordinance, pension fund investments are eligible for tax credit up to 20% of one's taxable income. Additional catch-up incentives are provided to participants over 40 years, with a maximum tax credit on 50% of taxable income for participants who are 55 years or older.

awareness among the investors, pension funds are expected to observe continuous growth.

Consistent, attractive returns with tax incentives make mutual fund a better saving option for institutions and individuals…

Figure 6.15

Mutual Funds growth vs. bank deposit growth(percent)



Attractive and consistent returns, with investment in safe haven remained the key reasons behind increasing interest in the mutual funds over the last 3 years. Analysis of returns shows that return on MFs far exceeded the returns being offered by the bank deposits. This combined with the tax incentives make the mutual funds more attractive for the institutional as well as the retail investors. In FY-12, the annualized return of open-end money market funds was 10.4 percent while income funds exhibited a return of 9.6 percent[57] (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). Impact of returns reflected in the growth trend of mutual funds, which outpaced the bank deposits growth over the last couple of years **(Figure 6.15).** Further, the NAV of Mutual funds as a percentage of bank deposits increased from below 4 percent in FY10 to 5.6 percent by end FY12.

High concentration in money market funds can raise stability concerns

The growth in mutual funds over the H2-FY12 was broad based. However, high concentration in couple of fund categories raises stability concerns. Particularly, the extraordinary rise in investments in volatile MMFs and income funds (double the value in FY11) could have ramification for both mutual funds industry and the overall financial stability[58]. Mutual funds by their very nature are supposed to offer diversification benefits but their growing exposure to short-term money market instruments could pose reinvestment risk in a declining interest rate environment. Going forward, shift in the yield curve and changes in tax regime may pose challenges for the fund managers. Particularly the AMCs may have to revisit their investment approaches while offering new products and look for developing new investment avenues for retail investors.

[57] MUFAP quarterly newsletter, March-June 2012.

[58]Recent report of IOSCO on MMFs provides a range of policy options including capital and liquidity requirements as per their risks to the financial stability.

To maintain consistent growth, Mutual funds need to expand their outreach; shifting focus away from main cities …

On the funding side, banks remained the major players in mutual fund market due to tax advantage. In FY12, banks funding to NBFCs sector saw a major jump where a prominent share was taken by mutual fund industry in the form of banks' investment portfolio. With the on-going changes in tax regime[59] and expected changes in regulatory framework for the banks (discussed in detail in FSR of H2-2011)[60], the fund managers need to give due consideration to these developments while devising their future strategy. To this end, MFs industry needs to make efforts for further enhancing its outreach for providing this attractive investment opportunity to the retail investors. Presently, the industry is concentrated mainly in big cities with more financially literate population. The MF industry can enhance its outreach; through further investment in IT infrastructure and conducting awareness campaign on mutual funds beyond the main financial centers of the country.

SECP is working in collaboration with MUFAP for product diversification and for investor protection…

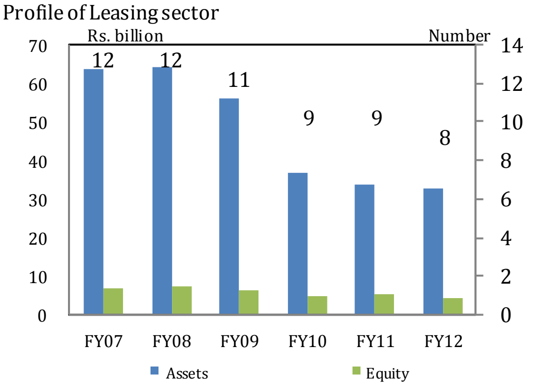
On the regulatory front, the SECP has taken a number of steps during the period under review, for product diversification and securing the interest of the investors. The SECP in collaborated with the Mutual Funds Association of Pakistan (MUFAP) for devising new products like gold fund investment schemes and creating awareness about recently developed pension funds. To safeguard the interest of small unit holders, the SECP has reinforced the fair valuation of mutual funds units and devised a clear timeline and circumstances under which redemption of units can be suspended. To ensure commercial viability of funds, all open-ended funds are now required to maintain minimum net asset size of PKR 100 million at all times effective from 1st July 2012. Further, the AMCs cannot make any amendment in constitutive documents (including increase in management fee, back end load, or amendment in investment objective) without notifying unit holders, consent of trustee and approval of the SECP[61].

[59]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%. As per section 15 (61) of Finance Act 2012, dividend received from Money Market Funds and Income Funds shall be taxed at the rate of 25% for tax year 2013 and at the rate of 35% for tax years 2014 and onwards.
[60] Basel Capital accord under look through approach for collective investment schemes, require banks to calculated capital charge on their mutual fund investments as if the underlying exposure/asset class is held by the banks themselves.

[61]NBFC and NE Regulations 2011(updated September 2011).

Figure 6.16

Profile of Leasing sector



Leasing Companies[62]

Performance of highly concentrated leasing sector subsided due to weak position of a couple of players; yet reliance on deposits is a positive development

The performance of leasing companies deteriorated during FY12 mainly due to huge losses incurred by couple of leasing companies. The industry further contracted in size and number during FY12. It shed another 1.8 percent of its asset base as a small sized firm ceased its operations. Overall structure of the industry remained lop-sided in terms of both performance and size. On the positive front, leasing sector decreased its reliance on borrowings and funded its lease financing requirements through mobilization of COD/COIs, issued by large sized leasing companies.

The leasing companies lost substantial market share over the last decade due to consolidation and strenuous economic environment and this trend continued during FY12 where another leasing firm opted to exit the market[63] **(Figure 6.16).** Adjusting for the out-going firm, the assets of the sector remained stagnant at the previous year's level. Accordingly, the overall asset structure of the leasing sector remained the same in terms of size and share.

Ownership structure of eight leasing companies' show that majority of them are owned by the financial institutions; four companies are owned by banks/DFIs and another company is majority owned by a foreign financial group. Interestingly leasing is one of the segments of the NBFCs in which public sector financial institutions contribute around 21 percent towards the overall equity.

Despite funding constraints and difficult business environment, sector maintained its core lease finance activity

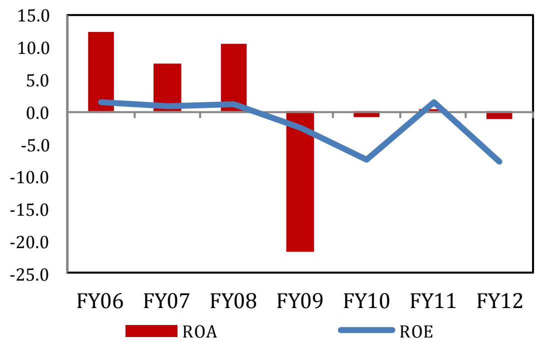
Lease financing, representing more than 80 percent[64] of the asset base, remained the main activity of the sector, followed by the

[62]Leasing sector review is based on annual audited accounts for FY-12. However, for two companies, financial year ends in December. To calculate ROA and ROE, profitability is annualized for them.
[63] Sigma Leasing Corporation Limited surrendered the leasing license and contemplating merger with other company. The company name has been changed to Sigma Corporation Limited.
[64] NBFC and NE regulation,2008 (Para 28a) requires Leasing companies to invest at least 70 percent of their assets in the business of leasing.

investments. Maintaining this high level of leasing business in the present economic environment shows continuing efforts made by the leasing companies for sustaining their business with particular focus on small lease contract. The performance can be considered admirable, when comparing with banks that are struggling to maintain their lease portfolio despite their wider outreach and cost effective funding resources.

Figure 6.17

Profitability indicators of Leasing sector (percent)

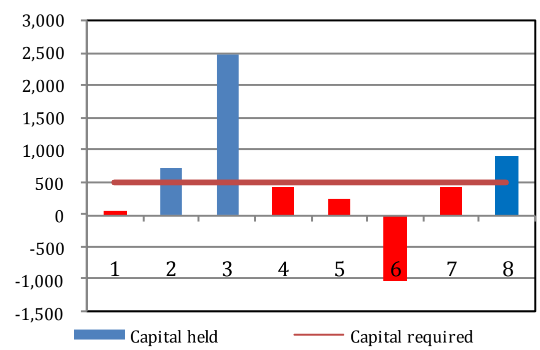


Over the last few years, funding constraints remained the key issues facing the leasing sector, with reliance on banks for raising required resources. However, the period under review saw a shift in the strategy, as leasing companies decreased their reliance on bank borrowing and raised substantial amount of funds through issuance of CODs/COIs. The deposits which declined during the last four years, saw 20 percent growth during FY12, while borrowings dropped by 15 percent. However, the large players in leasing sector mobilized most of the additional deposits from retail depositors' segment.

Growing provisioning expense and financial cost hit the bottom line most…

Figure 6.18

Capital of leasing companies (Rs.million)



The leasing sector incurred after tax loss of Rs. 371 million, mainly on account of surge in provisioning expense over the year against the non-performing leases. Magnitude of losses further increased due to growing financial cost, which forms 53 percent of expense book. As a result, return indicators (ROA and ROE) turned negative in FY12 after showing positive signs in FY11 **(Figure 6.17).** Company wise analysis shows that increase in delinquent portfolio of a public sector leasing company actually overshadowed the performance of the sector. Adjusting for the performance of this company, overall performance of the sector remained decent, with most of the key players posting after tax profits.

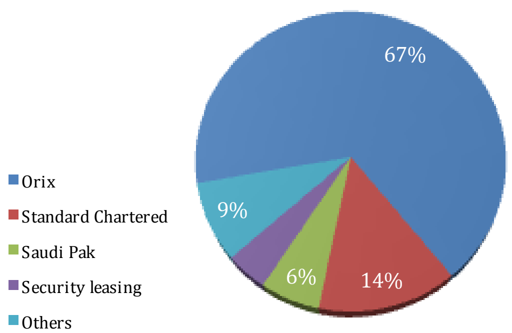
…raising solvency concerns in a highly concentrated leasing sector

The leasing sector continued to face solvency issues with five out of eight firms falling short of existing equity requirement[65] **(Figure 6.18).** Due to continuing capitalization problems, the industry continued to consolidate, leading to reduction in number of firms offering leasing finance and thereby increasing

[65] Non-Banking Finance Companies and Notified Entities Regulations, 2008 (amendment vide SRO 764, Dated September 2nd 2009) require fresh licensed leasing companies to hold Rs. 700 million equity while existing companies to maintain Rs. 500 million by June 30,2012 and Rs. 700 million by June 30,2013.

Figure 6.19

Asset concentration in Leasing sector during FY12



concentration of assets in few large firms **(Figure 6.19).** Effectively 90 percent of industry assets are held by four firms and with the gradual increase in equity requirement, concentration may increase further. In wake of the issues faced by the NBFCs and particularly the leasing sector in meeting the capital requirements, the SECP has formed a reforms committee, which is reviewing the overall regulatory regime for NBFIs including rationalization of minimum equity requirement. In the past, the SECP relaxed the timeline for leasing companies to meet the MER of PKR 700 million by end of year 2013 however, in the wake of challenges faced by leasing sector in terms of liquidity and growing provisioning expense, small sized firms might have to think about restructuring in near future.

Sector is having strong potential for growth…

Despite an ongoing consolidation in the leasing industry, there is a huge potential to grow in future. Leasing sector plays an important role in the SME sector development as evident from growing business of successful leasing companies. Currently, sector is experiencing issues on funding side but going forward with the declining yield curve, the industry may benefit from low funding costs. Apart from bank borrowing, the industry needs to tap retail fund market by offering innovative products. To this end, the SECP has already waived the minimum three years limit on lease contracts, which is expected to facilitate leasing business in tapping shorter lease contracts as well[66] .

Investment Finance Companies

The badly hit segment of NBFIs with huge contraction in asset base and rising solvency concerns…

In the backdrop of competition from commercial banks[67] in investment and advisory business, IFCs are finding it quite challenging to survive. Overall business of the sector is shrinking as evident from broad based contraction in asset base and number of institutions. Over the last five years, number of IFCs came down from 11 to 7 and asset base contracted by 70 percent. As a result, most of the IFCs continue to post losses and face increasing solvency concerns.

[66] S.R.O. No. 814(I)/2011 dated September 05, 2011 .

[67] Given the leverage available in the legal framework of Banking Companies, banks entered in investment advisory business, project finance and underwriting ventures.

Figure 6.20

Assets and Equity of IFCs (Rs. billion)

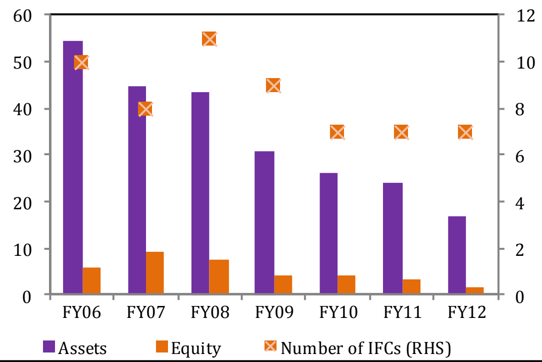


Figure 6.21

Profitability Indicators and Asset growth(percent)

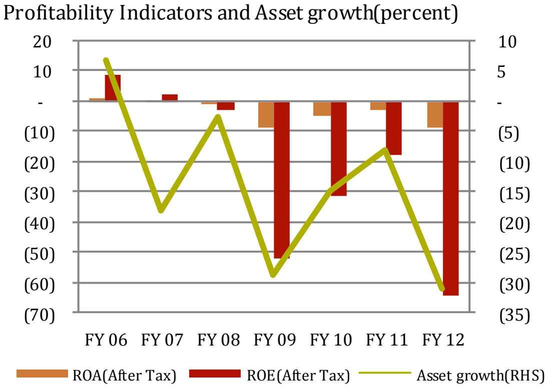
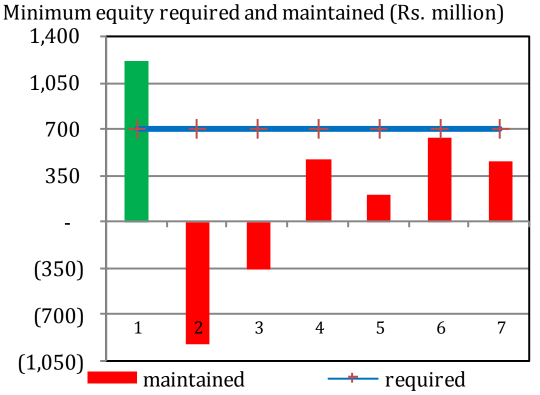


Figure 6.22

Minimum equity required and maintained (Rs. million)



...due to shrinking funding sources and worsening credit quality

During the period under review, performance of IFCs further deteriorated as asset base declined by 31 percent mainly due to shrinking funding resources **(Figure 6.20).** Investment portfolio sustained a major hit as industry offloaded investment portfolio to manage liquidity pressures. At the same time, worsening credit portfolio further took its toll on already small asset base of IFCs, which resulted in a dip in their share in NBFIs assets by 240 bps to 2.7 percent during FY12. The contraction was broad based as six out of seven players saw a substantial reduction in asset base in the range of 12 to 50 percent.

Operating position deteriorated across the board

Overall, a slowdown in economic activity, deteriorating asset quality and liquidity pressure further worsened the earning indicators. The IFCs posted heavy after tax loss of Rs. 1.7 billion mainly on account of decline in revenues and a substantial increase in provisions over the year **(Figure 6.21).** This trend was observed across the board; with the exception of one, all IFCs incurred huge losses.

Growing solvency concerns due to buildup of losses...

Continuous accumulation of losses over the last few years led to a substantial decline in equity of the IFCs. The trend continued in the period under review as equity of the IFCs observed 50 percent decline. Such a heavy decline in equity raises further concerns about the soundness of the IFCs as a whole. As of end FY12, six institutions failed to meet the minimum equity requirement [68](four in FY11), with couple of them having negative equity **(Figure 6.22*)*.**

Keeping in view the challenging business and economic environment, IFCs need to realign their business model with the changing financial needs of market. In this regard, SECP allowed IFCs to conduct brokerage business from their own platforms[69]. With the expected off-take in equity market, brokerage business can become the key revenue source for IFCs in future. In addition, there is a huge potential to develop domestic debt and

[68] As per S.R.O. 764 (I)/2009 dated September 2, 2009, SECP requires existing IFCs to hold Rs. 700 million equity as on June 30, 2012 while for new entrants; this requirement is Rs. 1000 million.

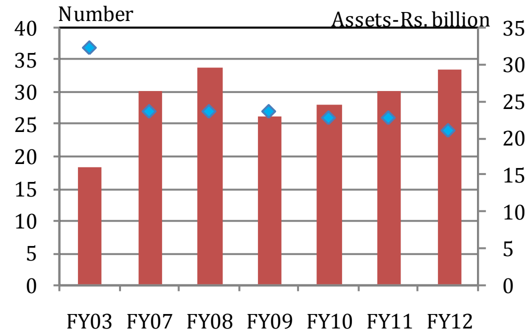
[69] Introduced vide S.R.O. No. 814(I)/2011 dated September 05, 2011 of SECP.

equity market. IFCs can play a pivotal role in this process by devising a sustainable business model for tapping stable funding sources and diversifying their product pool.

Modarabas

Modarabas exhibited healthy growth on the back of Ijarah business…

Figure 6.23
Profile of Modaraba sector



The asset base of Modaraba Companies maintained its growth pattern of last three years and registered an increase of 12 percent to reach PKR 29.5 billion in FY12 compared to PKR 26.3 billion in FY11 **(Figure 6.23).** Most of the growth was observed in second half of FY-12, which was largely contributed by large Modaraba Companies; however, some small firms also showed healthy business activity on the back of growing lease business. Increase in financing activity and cost control measure adopted by the companies lead to improvement in earnings of the Modaraba Companies, though return indicators saw a marginal dip due to base effect.

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

Table 6.4: Concentration in Modaraba

	FY08	FY09	FY10	FY11	FY12
Top 3	42.0	42.3	45.0	42.5	46.6
Top 5	64.0	65.8	63.0	61.0	62.4
Top 10	86.0	83.3	83.0	84.0	85.6
Rest of firms	14.0	16.7	17.0	16.0	14.4

Modaraba industry, with 26 Modarabas, is the second largest sector in terms of number 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 4.8 percent as of end FY-12. Concentration in industry is increasing over the years and during FY12, top 10 firms increased their market share to 86 percent (84 percent in FY-11), indicating a widespread fragmentation in the industry **(Table 6.4).**

Despite a number of challenges both on economic and business front and in contrast to industry trend, Modaraba companies exhibited a healthy growth (12 percent) in FY-12 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 and borrowings, which represent 38 percent of assets; exhibited a healthy growth and supported the overall expansion of Modaraba industry. Healthy growth in lease deposits, which represent new underwriting of leases, further substantiated the increasing financing activity by the Modarabas during H2-FY12.

Cautious business approach paid off; as evident from widespread profitability

Table 6.5: Performance Indicators of Modarabas
(Rs. billion, Ratio in percent)

	FY08	FY10	FY11	FY12
Profit after tax	*0.8*	*0.8*	*1.1*	*1.2*
Income	*5.5*	*7.9*	*7.7*	*6.6*
Expenses	1.8	7.1	*6.5*	5.3
ROA	*3.6*	*3.4*	*4.4*	4.2
ROE	*7.9*	*7.2*	*9.4*	*9.2*

In an environment where major segments of NBFIs are struggling to survive, operating performance of Modarabas improved during FY12. Modaraba industry registered profit after tax of Rs. 1.17 billion; 4 percent higher than FY-11. Increase came at the back of cautious business approach and cost management practices. Overall efficiency measures improved as evident from 18 percent reduction in administrative and financial expenses. This efficient management supported the sector to keep performance steady in FY-12. Operating performance was widespread as 20 out of 24 companies posted profits. The return indicators marginally declined in FY-12 as growth in average assets and equity outweighed the operating performance **(Table 6.5).**

Modaraba sector has shown resilience despite challenging economic environment. The key support to the Modaraba Companies stems from the legal framework[70] which provides Modarabas flexibility to involve in both financial and non-financial business for financing on Islamic modes; a comparative advantage over banks. However, like banks Modarabas are also prone to reputational risk arising from offering Shariah based products. The SECP being cognizant of the fact is taking measures not only to develop this sector but also to address the reputational risk associated with sector. To this end, SECP has recently issued Shariah Compliance and Shariah Audit Mechanism (SCSAM)[71] for Modarabas, which 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 present environment of business and economic uncertainty, when banks and other financial institution are enslaved by risk averse behavior, the SMEs and proprietary concerns have been most affected. Modaraba Companies, with their focus on non-conventional lending, can turn this situation into opportunity by tapping such market segments where banks are shying away like SMEs, agri and micro finance services and take advantage of the large customer base with religious sentiments.

[70] Modaraba industry structure consists of Modaraba management companies, which float Modaraba. There are two types of Modarabas; (i) Multipurpose (ii) Specific purpose. Currently all Modarabas are listed on stock exchange. Established under 'Modaraba Companies and Modaraba (floatation & Control) Ordinance' 1980 (the Modaraba Ordinance).

[71] SECP Circular No. 8 dated February 03,2012.

Investment Advisory Services (IAS)[72]

IASs are surfacing to cater large institutional investors with discretionary and non-discretionary portfolio products

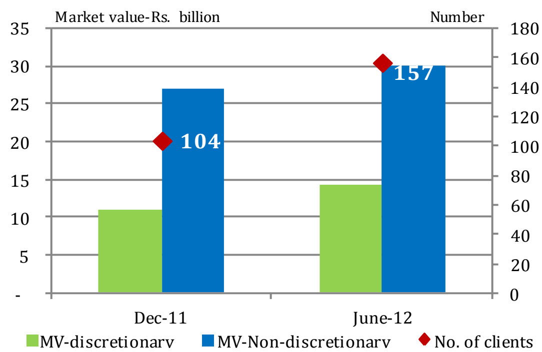
Investment advisors are licensed by the SECP to undertake portfolio management services by managing portfolios of clients under discretionary[73] or non-discretionary[74] form of investment authorization. The IAs mainly serve large institutional investors with minimum investment limit of Rs 5 million and are required to provide a prior undertaking regarding understanding of risks involved in portfolio management. Investment advisory fees charged by the IAS from investors for managing their investment portfolio forms the main source of their revenue.

… Representing a decent seven percent share in NBFI with a healthy growth

Currently investment advisory services are largely provided by AMCs having dual license of IAs; however, there are two firms, which are solely offering investment advisory service in the market. As of end FY12, the investment advisories were managing investment portfolio to the tune of PKR 44 billion, most of which was invested in debt and equity securities. This segment accounts for 7 percent share in total NBFIs sector with half-yearly growth of 17 percent. In terms of market value (MV), major portfolio is held by sophisticated customers under non-discretionary agreement where clients make the investment decisions themselves **(Figure 6.24).** However, discretionary clients; who rely on portfolio manager for investment decision, out-numbered the non-discretionally ones.

Figure 6.24

Investment advisory Services



[72] Due to data constraints in previous year, IASs is discussed first time in NBFIs section in FSR.

[73] Discretionary Portfolio" means a portfolio of securities managed by an NBFC under an agreement entered into with a client on a duly notarized stamp paper of applicable value and whereby investment decisions are made and executed by the NBFC on behalf of its client".

[74] Non-Discretionary Portfolio" means a portfolio of securities managed by an NBFC under an agreement entered into with the client on a duly notarized stamp paper of applicable value whereby investment decisions are executed by the NBFC on written instructions of the client.