4.1 Performance & Risk Analysis of Development Finance Institutions (DFIs)

The participation in long-term project financing, the core function of DFIs, has remained limited during CY18. Lack of availability of affordable long-term liquidity remains one of the key hurdles for DFIs. Encouragingly, DFIs, have renewed their interest in SME financing, which is beneficial for the economic and financial development of the country. To play their due role, DFIs need to make concerted efforts for resource mobilization and explore the possibilities of arranging funds through other sources, necessary enhancing suit of their asset product and effectively contributing in the economic development of the country.

DFIs, in the 60s, have contributed significantly in channelizing funds to the private sector (See Box-4: Brief history of DFIs in Pakistan). However, during the past few decades, the performance of DFIs has remained sub-par and their importance in the financial sector has diminished.

The share of DFIs in total assets of the banking sector is minimal...

The total assets of DFIs amounting to PKR 238 billion represent only 0.92 percent of financial sector assets (1.21 percent of the total banking sector's assets) (Table 4.1.1).[173] The expansion of asset base of DFIs by 4.60 percent during CY18 is less than the growth of 7.31 percent achieved by the banks. This low growth is despite the fact that a new DFI has commenced operations, which contributed to the expansion in assets by 1.61 percent.[174] Thus, DFIs, due to their small size, pose limited systemic risk concerns.

Table 4.1.1: Key variables & financial soundness indicators of DFIs

	CY13	CY14	CY15	CY16	CY17	CY18
	PKR billion					
Investments	79.5	108.3	115.3	108.9	122.1	122.3
Advances	45.3	48.6	56.8	68.6	76.7	82.3
Total Assets	149.4	176.1	190.5	208.8	228.0	238.5
Borrowings	67.3	74.4	86.5	98.4	100.5	111.4
Deposits	8.9	15.0	12.0	10.9	17.1	11.6
Equity	62.3	76.4	79.3	82.2	99.5	106.2
NPLs	17.1	15.1	15.0	13.9	15.0	14.7
	Percent					
CAR	50.33	44.85	43.62	40.78	47.04	46.95
NPLs to Advances	30.04	25.27	21.98	17.48	17.15	15.83
Net NPLs to Net Advances	12.41	7.93	6.21	4.51	5.52	5.29
ROA (After Tax)	3.05	4.48	3.36	3.56	2.36	2.25
ROE (After Tax)	7.00	10.64	7.92	8.66	5.77	4.89
Cost to Income Ratio	40.25	30.96	32.59	38.78	37.28	40.08
Liquid Assets to Short-term Liabilities	84.77	84.80	86.31	90.23	90.90	86.95
Advances to Deposits	506.85	323.92	471.61	627.65	447.93	707.08

Source: SBP

DFIs show signs of risk taking…

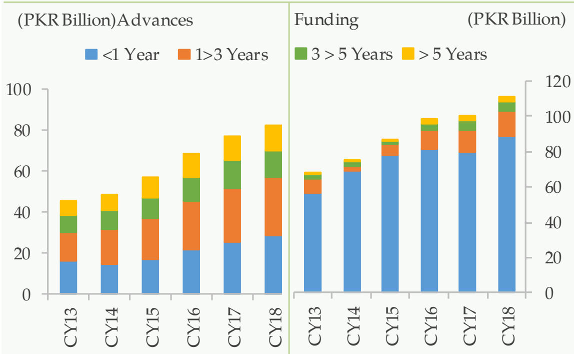
The asset composition of DFIs, still, remains tilted toward investments. Total assets of the DFIs constitute 51.27 percent investments and 34.53 percent advances indicating risk averse behavior. However, there are indications that the DFIs might be taking more risk. During CY18, the DFIs have increased their lending to SMEs, invested in commercial paper and reduced their stock of government bonds. However, the risk taking ability of DFIs is constrained by the non-availability of long-term funds. The DFIs are mainly dependent on short-term borrowing from the interbank market to finance

[173] Assets of financial sector includes the assets of banking sectors, NBFIs, Insurance and CDNS, while banking sector assets include the assets of Banks, DFIs and MFBs only.

[174] Pakistan Mortgage Refinance Company Limited (PMRC).

their asset growth **(Chart 4.1.1)**. Funding constraint is also limiting their ability to extend long-term project financing—their core business.

Chart 4.1.1: Maturity profile of advances and funding



Source: SBP

The maturity profile of advances remains short-term oriented…

Although, the advances have grown at 7.39 percent in CY18 (11.71 percent in CY17), most of the increase has been in advances having maturity of less than 3-years. Further analysis reveals that more than 68.80 percent are maturing in less than 3 years, while only 14.84 percent have maturity over five years. The size of long-term advances further reduces to 10.50 percent if a DFI with a mandate to provide long-term housing finance are excluded. This state of affairs is contrary to the objective of DFIs to provide long-term project financing.

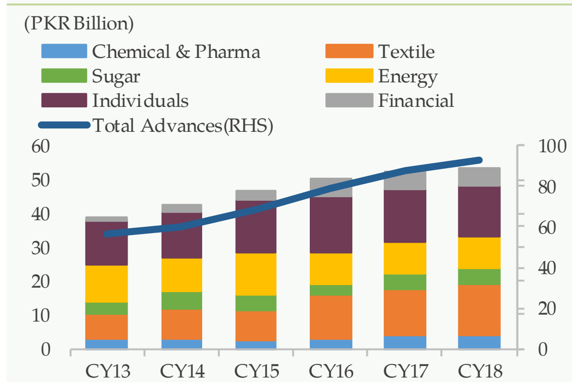
Corporate segment is the biggest borrower though SME financing has increased …

The share of corporate loans in total loans has come down to 78.04 percent in CY18 from 79.22 percent in CY17. It has been made possible due to deceleration in corporate financing and rise in SME financing. Corporate loans have decelerated to 4.39 percent on YoY basis as compared to 15.18 percent growth in CY17. The SME financing has increased by 59.16 percent on YoY basis as compared to 26.82 percent growth in the previous calendar year. The rise in SME financing, apart from other factors, could be the result of indicative targets for banks & DFIs set by SBP.

Flow of advances has increased to Textile sector…

In terms of segment wise advances, the flow of loans is tilted towards textiles followed by cement and electronics and electrical appliances **(Chart 4.1.2)**. As loan portfolio is well diversified among various sectors, it pose no concentration risk.

Chart 4.1.2: Sectorwise breakdown of advances

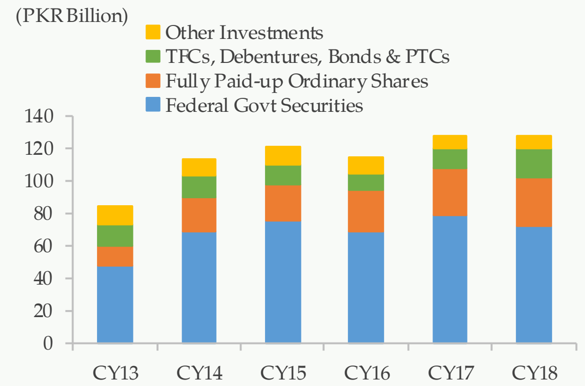


Source: SBP

"Search for yield" motive dominates investment decisions…

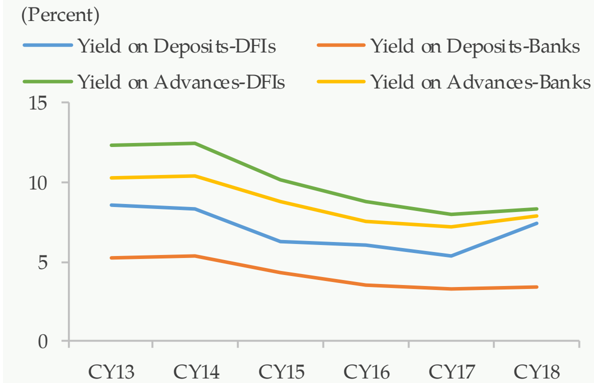
A compositional change has occurred in the investment portfolio of DFIs. The amount divested from government securities has been placed in TFCs of private listed companies, likely, in search of higher yield **(Chart 4.1.3)**. Moreover, considering the rising interest rate scenario, the DFIs have off-loaded T-Bills in the first quarter and then made re-investments in PIBs in the third quarter **(Table 4.1.2)**. Moreover, in order to remain liquid, the DFIs have mostly kept their investments in the Held-For-Trading (HFT) (18.09 percent) and Available-For-Sale (AFS) (65.32 percent) categories.

Chart 4.1.3: Investment portfolio of DFIs



Source: SBP

Chart 4.1.4: Costly source of funds restrict asset expansion



Source: SBP

Table 4.1.2: DFIs' investments in federal government securities

(PKR Billion)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
T-Bills	71	39	39	36	39
PIBs	7	8	18	34	33

Source: SBP

Share of deposits in funding has declined …

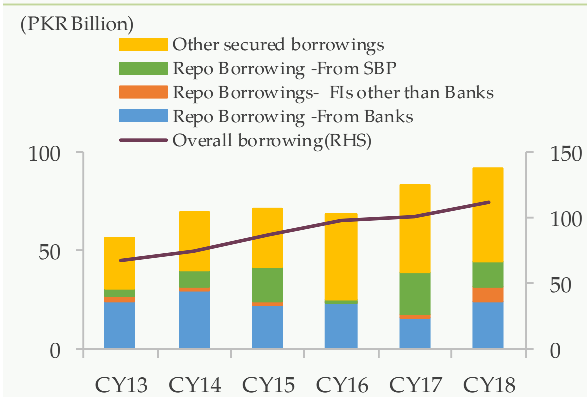
Deposits have funded 4.88 percent of total assets of DFIs during CY18 compared 7.51 percent in CY17. They have reduced by 31.97 percent during CY18 compared to an increase of 56.52 percent in CY17. The decline has mainly resulted from shift in deposits to banks in search of higher yield.

DFIs have limited avenue for mobilizing deposits. Particularly, they raise relatively costly deposits from institutional investors (Chart 4.1.4).[175] Moreover, the limited branch network further restricts their ability to attract cost effective deposits. The DFIs need to work on expanding outreach to mobilize additional funding necessary for enhancing the suit of asset products, which will also be helpful in pursuing their renewed commitment to SME financing.

High cost of funding restricts DFIs to play their intermediary role effectively…

Besides issues in mobilizing deposits, the DFIs have limited access to bond market because of underdeveloped capital markets. Resultantly, they resort to inter-bank borrowings to fund their asset base. Inter bank borrowing is actually major funding source as DFIs have funded 46.74 percent of the total asset during CY18. They rely on short term secured borrowings to fund their assets (Chart 4.1.5). This coupled with higher cost of funding make the borrowing expensive thus making it quite challenging for the DFIs to expand their asset base on sustainable basis.

Chart 4.1.5: Breakdown of secured borrowings



Source:

[175] DFIs can only raise deposits through issuance of Certificates of Investments (COIs) minimum up to maturity of 30 days. Due to limited applicability of BCO, 1962, DFIs are not deposit taking institutions. Hence, they cannot raise the low cost CASA deposits, which raises their cost of funds.

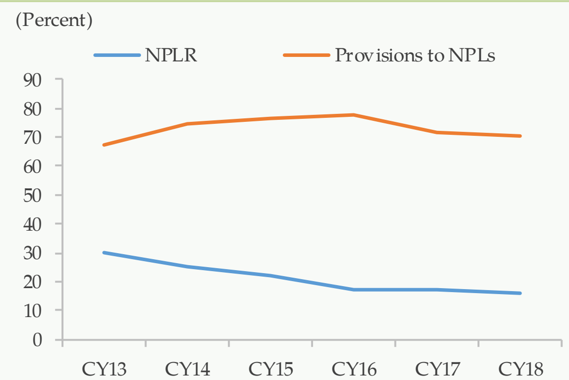
Shareholders' equity is the prime source of long-term funding…

The shareholders equity is the prime source of financing long-term assets. It is funding 44.42 percent of the total asset base. The shareholders equity increased by 8.66 percent during CY18 primarily due to addition of a new DFI.

Asset quality of DFIs is improving…

The infection ratio of DFIs has declined to 15.83 percent during CY18 (17.15 percent in CY17) **(Figure 4.1.6)**. The decline in infection ratio is attributed to reduction in NPLs stock and increase in advances. Most of the NPLs i.e. 75.17 percent are parked in the loss category. The overall provision coverage ratio is 70.28 percent at the end of CY18. With the expansion in SME financing portfolio, DFIs need to be proactive in managing their credit risk.

Chart 4.1.6: Asset quality indicators

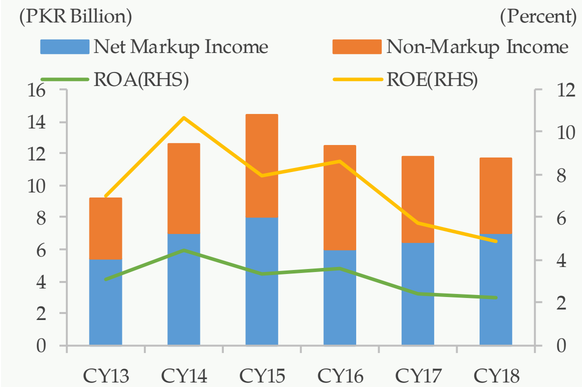


Source: SBP

Interest income from advances has contributed significantly in net interest income…

Though the profitability of the DFIs has marginally declined during CY18, the net markup/interest income has registered a rise of PKR 574 million.[176,177] However, decline in non-markup/interest income has declined by PKR 735 million **(Chart 4.1.7)**. Further, rise in non-markup/interest expense by PKR 266 million has also reduced the net profits. Resultantly, the DFIs have posted an after-tax profit of PKR 5.0 billion in CY18 as compared to PKR 5.4 billion in CY17. Accordingly, the ROA and ROE have also declined on YoY basis.[178]

Chart 4.1.7: Profitability of DFIs



Source: SBP

CAR remains significantly higher than regulatory requirement...

DFIs have high CAR, indicating both underutilized capital and capacity to enhance their financing portfolio. The CAR has marginally declined to 46.95 percent in CY18 from 47.04 in CY17. This downward adjustment has resulted from increase in loans due to renewed interest of DFIs in SME financing and reduction of investments in government securities.

Need remains for enhancing the role of DFIs for contributing in economic activity…

Financial depth is the key to a resilient financial sector, which is also one of the priorities of SBP. Enabling the DFIs to revert to their primary role of

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[176]The gross outstanding advances are PKR 90 billion in CY18 as compared to PKR 85 billion in CY17. The increase in interest rates has further increased the interest income on advances.

[177] The average outstanding amount of investments in government securities during CY18 has been PKR 61 billion as compared to PKR 89 billion in CY17. Therefore, the markup/interest earned on investments has declined by 10.57 percent during the year.

[178] The sharp decline in ROE during CY18 is due to increase in equity by PKR 8 billion due to entry of a new DFI.

providing long-term project financing can help achieve this objective. The main impediment in this regard appears to be the dearth of long-term affordable funding for DFIs. This can be arranged through long-term cheaper credit lines to DFIs from government or multilaterals, as in the past. The World Bank has already provided a credit line to a DFI to refinance the existing mortgages. Besides, DFIs may explore the possibility of securitizing their loan portfolio and issuing bonds/TFCs in the secondary market to tap liquidity. Only then, can the DFIs be able to focus on long-term project financing.