5.2. Non-Bank Financial Institutions

Despite tight operating conditions, NBFIs performed reasonably well during CY19. Their asset growth slowed down in H1CY19 but rebounded in H2CY19, as the conditions improved. Mutual funds witnessed net-inflows during the year. However, the investments remained tilted towards capital preservation and investors avoided excessive risk taking. On the other hand, entities involved in financing business faced broad-based slowdown in asset growth, as demand contracted in the wake of rising financing cost. Going forward, the on-going COVID-19 pandemic could increase vulnerabilities for the NBFI's sector.

NBFIs asset growth followed the economic cycle during CY19…

Despite the challenges faced by Non-Bank Financial Institutions (**NBFIs**) in CY19, their asset base expanded at an accelerated pace of 13.03 percent compared to 8.74 percent growth recorded in CY18 (**Table 5.2.1**). Most of this increase occurred in the second half of CY19, however.

Table 5.2.1: Asset Profile of NBFIs

	FY16	FY17	CY17	FY18	CY18	FY19	CY19
				PKR billion			
AMCs/IAs	**37.3**	**40.9**	**37.3**	**39.0**	**36.5**	**36.6**	**40.2**
AUMs *(of which)*							
Mutual Funds	546.2	710.0	654.2	678.9	641.7	577.6	724.1
Pension Funds	19.3	25.8	24.1	26.8	26.5	26.5	30.2
Portfolios	139.2	141.1	139.0	152.9	188.3	197.6	225.6
RMCs	1.5	1.5	5.0	5.1	5.7	5.7	6.0
REITS	27.2	40.9	40.6	41.8	45.9	46.1	49.5
PE & VC Firms			0.2	0.2	0.2	0.2	0.1
PE Funds	-	-	0.6	5.0	6.5	6.6	6.7
Modarabas	36.5	44.1	48.1	52.9	54.3	53.5	53.7
Leasing Companies	42.3	43.3	44.6	10.4	10.5	10.2	10.7
IFCs	9.9	20.7	25.1	58.3	58.1	63.2	65.9
NBMFCs		61.5	70.3	97.2	110.2	116.7	125.9
Total Assets	**859.4**	**1,129.9**	**1,089.1**	**1,168.5**	**1,184.3**	**1,140.4**	**1,338.6**

Source: SECP

As economic uncertainty prevailed during the first half of the year, the stock market remained quite volatile during this period **(See Chapter 2)**. There was a contraction in NBFIs assets during H1CY19. However, as the policy uncertainty subsided, and the fundamentals of the economy started showing signs of improvement **(See Chapter 1)**, there was a turnaround in the performance of NBFIs with an increase of 17.38 percent in their assets during H2CY19.

The rebound in equity market was the key factor…

As the equity market rallied in H2CY19, the NBFIs, being pegged with the market regained their growth momentum. For example, there was a growth of 25.35 percent in mutual funds' assets during H2CY19, while an overall growth of 12.83 percent during CY19. Thus, it was the mutual funds, followed by portfolios, which lifted the growth in overall assets. Together they contributed around 78 percent in the expansion of assets.

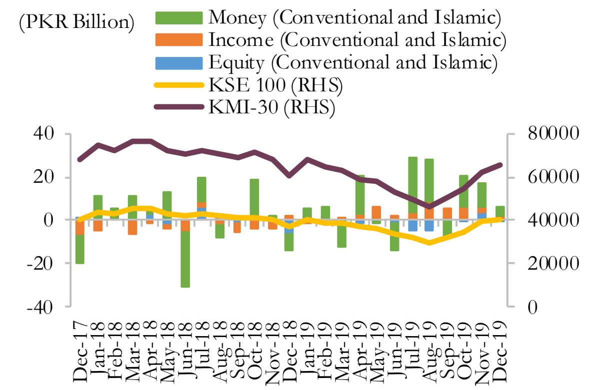
On the other hand, the NBFIs involved in financing based business faced difficulties in sustaining growth as the demand plummeted due to monetary tightening.

…while flight to safety remained the prime motive…

During H1CY19, the investors, anticipating increased interest rates, market volatility and economic uncertainty, offloaded their positions in equity funds, which declined by 15.8 percent (**Chart 5.2.1**). At the same time, they increased their investment in Income and Money Market funds by 19.87 percent and 1.78 percent, respectively. As the stabilization measures brought some certainty and boosted the investors' confidence in H2CY19, investments poured into all types of funds.

Nevertheless, flight to safety remained paramount during CY19 as the income and money market funds expanded by 74.75 percent (decline of 19.86 percent in CY18) and 45.60 percent (expansion of 47.18 percent in CY18), respectively. Whereas the equity funds declined by 3.48 percent in CY19 compared to a decline of 11.21 percent in CY18. The increasing investments in income and money market funds depicted the risk averse behavior of the investors.

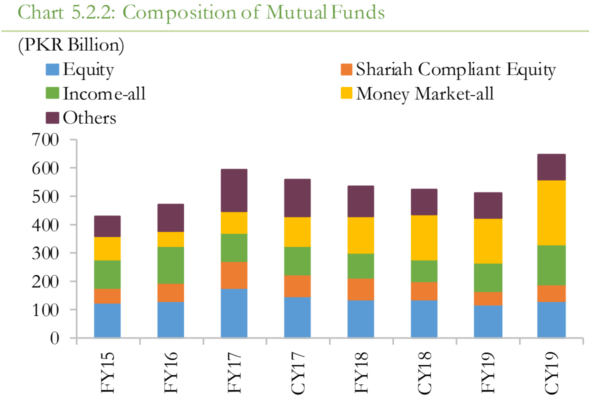
Chart 5.2.1: Net sales of top three mutual funds categories



Source: MUFAP & SECP

Due to inclination of the investors towards capital preservation and reaping maximum benefit from higher interest rates, the share of money market and income funds increased to 35.22 percent (29.86 percent in CY18) and 21.60 percent in CY19 (15.26 percent in CY18), respectively (**Chart 5.2.2**). Accordingly, the share of equity funds reduced to 29.62 percent in CY19 compared to 37.87 percent in CY18.

Chart 5.2.2: Composition of Mutual Funds

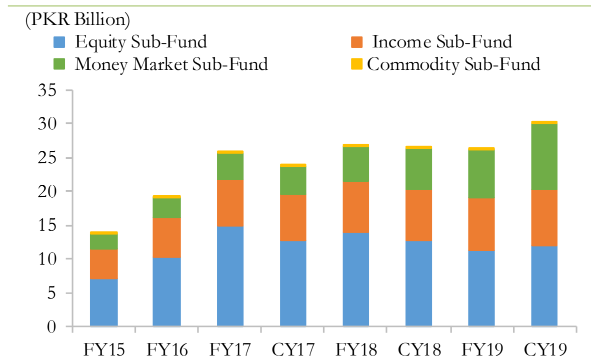


Source: MUFAP

Pension funds, too, rebalanced their portfolio…

As was the case with mutual funds, the pension funds also rebalanced their portfolio from risky stocks to safer instruments. There was a decline of 5.38 percent in equity sub-funds of pension funds in CY19 (0.99 percent in CY18) and a simultaneous increase of 57.97 percent in the money market sub-funds (48.12 percent in CY18) (**Chart 5.2.3**). As a result, the share of equity sub-funds reduced to 40.10 percent in CY19 (48.33 percent in CY18), whereas the share of money market sub-funds increased to 31.94 percent in CY19 (23.06 percent in CY18). Within the money market sub-funds, pension funds made more placements in bank balances rather than government securities (PKR 6.84 billion or 70.89 percent vs PKR 0.93 billion or 9.66 percent). Despite this rebalancing, the overall expansion in pension fund was quite robust (14.04 percent in CY19 compared to 9.84 percent in CY18.)

Chart 5.2.3: Composition of pension fund assets



Source: SECP

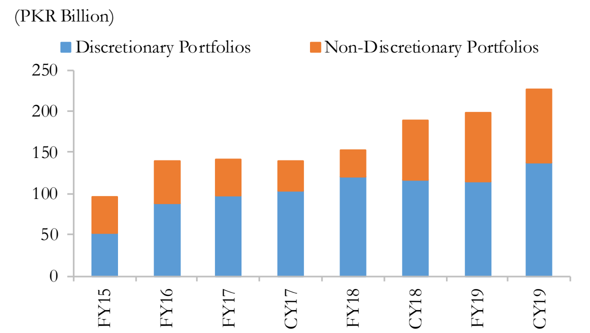
High net-worth individuals were also cautious…

The overall portfolio investments made by high net-worth individuals decelerated to 19.78 percent in CY19 compared to increase of 35.51 percent in CY18. In an uncertain environment i.e. during H1CY19, the overall growth in portfolio investments decelerated to 4.94 percent compared to the growth of 10.04 percent in H1CY18.[250] During the same period, the high net worth individuals appeared cautious and kept decision by making investment under non-discretionary portfolio. Accordingly, the non-discretionary portfolio increased by 15.94 percent in H1CY19 as compared to contraction of 6.69 percent in H1CY18. Whereas, the investments under discretionary portfolio contracted by 1.80 percent

[250] Portfolios are investments of eligible investors (person offering a minimum of PKR 3 million investment) managed by Investment Advisors. Under "Discretionary Portfolios", investment decisions are made and executed by the Investment Advisor on behalf of clients. While under a "Non-Discretionary Portfolio", investment decisions are made as per the written instructions of the clients.

in H1CY19 compared to growth of 15.61 percent during the corresponding period of previous year. Therefore, the share of non-discretionary portfolio in total portfolio investments increased to 42.01 percent at the end of Jun, 19 compared to share of 21.14 percent as of Jun, 18 (Chart 5.2.4).

Chart 5.2.4: Portfolios classified by investment decision making



Source: SECP

However, during the second half of CY19, as the economic uncertainty subsided, the investors preferences changed under portfolio investments. High net-worth individuals relied on fund managers to take investment decisions. Accordingly, the investments under discretionary portfolio increased by 19.91 percent. During the same period, the investments under non-discretionary category period decelerated to 6.18 percent compared to an increase of 121.5 percent in H2CY18. The share of discretionary and non-discretionary portfolios, at the end of CY19, was recorded as 60.92 percent (61.97 percent at the end of CY18) and 39.08 percent (38.03 percent at the end of CY18), respectively.

The switching towards discretionary portfolio, during H2CY19, was a positive development for the sector as high net worth investments are sometimes more prone to panic sales. The high net worth individuals are likely to offload investments at early signs of trouble. Placing investments in the hands of professional may reduce panic sell-outs under the episodes of political/economic uncertainties. This may also increase the investment holding period.

Investors appeared to be doubtful of the revaluation gains reported by REITs…

By the end of CY19, there were six REIT Management Companies (**RMC**) with the accumulated assets of PKR 6.0 billion and only one rental REIT scheme having asset size of PKR 49.5 billion (PKR 46.0 billion at the end of CY18). Despite high occupancy level of more than 95 percent, 93 percent of the expansion in the assets of rental REIT was due to unrealized gain from revaluation of the property (**Table 5.2.2**). Being the rental REIT, the rent income should be the major source of increase in total assets.

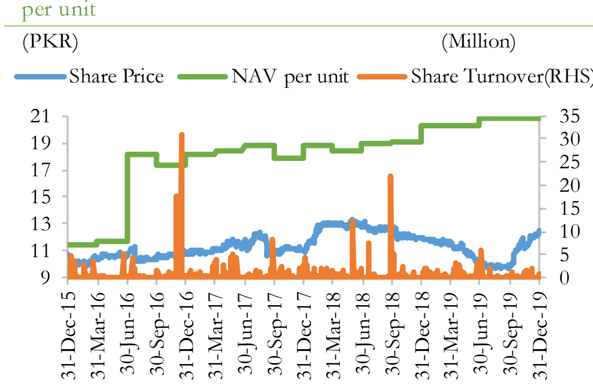
Table 5.2.2: Impact of change in fairvalue of underlying property on assets expansion

	Dec-16	Jun-17	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19
	PKR Billion						
Total Assets	40.86	42.40	41.73	43.00	45.90	46.05	49.53
Change in Total Assets	-0.02	1.54	-0.67	1.27	2.91	0.15	3.48
Change in fair value of property	1.03	0.15	1.13	1.15	2.87	0.96	2.42

Source: Financial Statements of REIT

However, from the stock performance of REIT, it appeared that investors weighed real returns more than the unrealized gains. Resultantly, the unit of a REIT traded at discount of 43.02 percent to its NAV on December 31, 2019 as compared to discount of 40.99 on December 31, 2018 (**Chart 5.2.5**).

Chart 5.2.5: REIT share's closing price, turnover & NAV per unit



Source: Accounts of REIT & PSX

In future, the principal risks to business of rental REIT are significant supply of offices, which may undercut property prices and provide better alternate to existing occupants. Another risk is the default of tenants.

For the flourishment of REITs, it is pertinent that the legal framework and taxation regime remain supportive and consistent in the longer term. However, the recent increase in tax rates on dividends distributed by a REITs Scheme from 15 percent to 25 percent and uncertainty regarding continued availability of profits/capital gains on sale of immovable property to REIT Scheme have made the REIT sector less attractive from both a sponsor and investor standpoint.

The tighter financial conditions affected the NBMFCs, IFCs and modarbas…

The difficult operating environment had an impact on Non-bank Microfinance Companies (**NBMFCs**). The slowdown in economic activity had a negative impact on demand for microfinance., As a result, their asset decelerated to 14.25 percent in CY19 compared to 56.71 percent in CY18. In addition, the credit risk increased due to shrinking repayment capacity of the microfinance borrowers. Resultantly, the portfolio at risk increased to 4.80 percent as of Dec-19 compared to 2.20 percent at the end of Dec-18.[251]

The Investment Finance Companies (**IFCs**) fared no better than other NBFIs. Not only did their asset growth slowed down, but also increased their credit risk (**Table 5.2.3**). There was a small rise of 2.91 percent in the leasing and advances portfolio of IFCs (217 percent in CY18[252]), which led to an increase of 13.53 percent in their asset base. Though the infection ratio of IFCs moderated to 8.04 percent at the end of CY19 from 8.06 at the end of CY18, their residual risk increased. The provision coverage ratio reduced to 55.53 percent as of Dec-19 from 65.52 percent at the end of Dec-18. Another concern in case of IFCs was the concentration risk because more than 85 percent of the assets belonged to two large investment banks only.

Table 5.2.3: Key statistics of IFC sector

	FY17	CY17	FY18	CY18	FY19	CY19
	PKR Billion					
Total Assets	20.7	25.1	58.3	58.1	63.2	65.9
Advances & Leases	6.9	14.0	41.7	44.3	46.0	45.6
Asset Classified	6.2	4.6	5.7	4.7	5.2	5.3
Provisions	4.0	2.7	3.8	3.1	2.8	2.9

Source: SECP

The modarabas were equally strained under the prevalent conditions. Their assets witnessed a decline of 1.02 percent in CY19 compared to 12.90 percent growth in CY18. The infection ratio improved to 5.89 percent as of end Dec-19 from 7.19 percent a year earlier, while the provision coverage ratio reduced to 53.93 percent in CY19 from 62.02 percent in CY18. The concentration risk in Modaraba Management Companies (MMCs) also remained high as the top 4 modarabas accounted for more than 73.91 percent share in the assets of the sector as of end CY19 (73.9 percent at the end of CY18).

However, despite slowdown in business, a new modaraba was registered and a no objection certificate was issued to it to form and register as a modaraba management company. It showed that modaraba model was becoming a preferred financing mode.

The business of leasing companies remained on the brink…

The number of leasing companies remained the same unchanged over the year. The assets of the sector increased by 2.19 percent in CY19 compared to a decline of 76.53 percent in CY18 (**Table 5.2.4**). This slowdown resulted from decline in advances and leases by 2.22 percent, though growth receivables kept the overall assets growth in positive territory. The fierce competition from banks and non-availability of long-term funding on affordable rate hindered the growth of leasing companies. Moreover, the asset quality remained a concern as infection ratio remained high at 18.33 percent as of end CY19 (18.11 percent in CY18), though the provision coverage

251 Portfolio at Risk are the portion of advances whose payment is overdue by more than 30 days.

252 The inception of new company and conversion of largest leasing company into IFC during CY18 increased the asset base of IFCs.

ratio improved to 77.32 percent in CY19 from 75.73 percent in CY18.

Table 5.2.4: Key statistics of Leasing sector

	FY17	CY17	FY18	CY18	FY19	CY19
	PKR Billion					
Total Assets	43.3	44.6	10.4	10.5	10.2	10.7
Advances & Leases	35.3	36.7	7.6	7.9	8.2	7.7
Asset Classified	3.5	3.4	1.9	1.9	1.7	2.0
Provisions	2.6	2.6	1.5	1.4	1.4	1.5

Source: SECP

Risks from interconnectedness between banks and NBFIs remained muted…

As end of December 2019, there were 22 operative AMCs and IAs out of which 10 were owned by banks. These 10 AMCs floated 229 funds, which constituted 79.10 percent of the total mutual fund assets. Further, in total AUMs the share of bank owned AMCs increased to 77.73 percent in CY19 from 75.41 percent in CY18 (**Table 5.2.5**). However, banks reduced their direct investment in mutual funds during the year as the risk-free investment opportunities with relatively higher return became abundant. Accordingly, the banks share in direct investment in mutual funds reduced to 1.79 percent in CY19 from 2.59 percent in CY18. The share of investment in mutual funds in banks' overall investment reduced to 0.14 percent as of Dec-19 as compared to 0.21 percent in CY18.

On the other hand, the exposure of mutual funds on banking sector through investments in deposits, COD/TDR/COI and money at call/placements with the banks increased to 49.38 percent of total assets in CY19 as compared to 43.30 percent in CY18.

Further, the exposure of the banking sector on NBFIs in terms of lending has increased by 15.0 percent in CY19 compared to growth of 36.0 percent in CY18. This deceleration was due to withdrawal of requirement to arrange credit lines from banks/DFIs equivalent to 10 percent of net assets of each fund.[253] However, issuance of credit lines to a company operating to support non-bank microfinance sector led to some off-take of credit.

Keeping in view the extent of the cross exposure of banks and NBFIs on each other, the NBFI sector poses limited systemic risk concern to the banking as well as the financial system. However, these cross-linkages may pose reputational risk for the whole financial system, in case a bank dominated NBFI faces any financial challenges.

Table 5.2.5. :NBFIs flow of funds & exposure to the banking sector

	Total Value (i)	Banks share (ii)	Banks share in Total* (iii= ii/i)	Total Value (iv)	Banks share (v)	Banks share in Total* (vi= v/iv)	Total Value (vii)	Banks share (viii)	Banks share in Total* (ix= viii/vii)
	Dec-17			Dec-18			Dec-19		
	PKR billion		Percent	PKR billion		Percent	PKR billion		Percent
1. Equity of AMCs/ IAs	23.7	11.9	50.22	23.7	12.9	54.42	28.5	14.4	50.46
2. Assets Under Management of AMCs/ IAs	817.3	597.3	73.07	856.6	645.9	75.41	979.9	761.6	77.73
3. Mutual Funds size	654.2	21.0	3.22	641.7	16.6	2.59	724.1	12.9	1.79
4. Mutual Fund exposure in Financial Institutions	254.2	230.6	90.70	277.8	257.1	92.54	357.6	342.5	95.79
5. Mutual Funds exposure in top 20 equity securities	91.8	3.8	4.18	84.7	6.2	7.27	81.3	6.4	7.91
6. Mutual Funds exposure in top 10 debt securities	15.0	9.0	59.74	16.7	8.0	47.55	17.3	5.6	32.24
7. Top 20 holders of mutual fund units	68.7	13.1	19.10	68.8	11.2	16.25	97.4	6.0	6.16

Source: SECP

*Banks share for the respective head means:

1.Equity of Bank-owned AMCs /IAs

2.Mutual/Pension Funds and Portfolios being managed by bank-owned AMCs /IAs

3.Banks' investments in mutual fund units

4.Mutual Funds' investments in deposits, COD/TDR/COI and money at call/placements with banks

5.Mutual Fund investments in ordinary shares of banks

6.Mutual Funds investments in TFCs/Commercial Paper/Sukuk etc. issued by banks

7.Banks(investment value) in the top 20 holders of mutual fund units

[253] Direction no. 37 of 2017 dated December 29, 2017 available at: https://www.secp.gov.pk/document/circular-no-37-2017-withdrawal-of-liquidity-requirements-for-mutual-funds/?wpdmdl=30212