Chapter 5.1: Development Finance Institutions (DFIs)

DFIs were able to increase financing, partially supported by the SBP sponsored schemes. In a low interest rate environment, search for yield motivation seems to have dominated investments decision as DFIs observed an uptick in advances and a shift to long term government securities. Asset mix, however, remained skewed towards treasury investments. The deposits base showed an uptick during the year; however, their reliance on short-term borrowing to fund long-term assets continued. The sector posted substantial growth in profitability at the back of improved net interest income and non-interest income largely due to gain on sale of securities and dividend income. Earnings further augmented the capital base that helped maintaining the CAR well above the regulatory benchmark. With strong capital cushions, the DFIs need to focus on expanding their long-term advances portfolio. In this regard, the start of mortgage refinance activity by a DFI may provide further impetus to government's efforts for low-cost housing initiative.

Assets growth moderates due to stemming in the flow of borrowings, as the institutions strive to diversify their funding and investment avenues…

The balance sheet footing of DFIs has increased by 16.50 percent during CY20 - lower than 58.12 percent growth witnessed during CY19, which was led by investments and financed through a sharp increase in borrowings. This year's growth, however, has been funded by a mix of deposits, equity and borrowings, which is encouraging as the DFIs were mainly reliant on the borrowings from financial institutions. Similarly, increase in assets has resulted from a mix of growth in advances and investments, though the later saw a sharp deceleration during CY20 **(Table 5.1.1)**.

Table 5.1.1: Key Variables & Financial Soundness Indicators

	CY16	CY17	CY18	CY19	CY20
			PKR billion		
Investments (net)	109	122	122	240	287
Advances (net)	69	77	82	92	111
Total Assets	209	228	238	377	439
Borrowings	98	101	111	229	261
Deposits	11	17	12	12	27
Equity	82	99	106	117	132
NPLs	14	15	15	15	16
			Percent		
CAR	40.78	47.04	46.95	44.95	43.14
NPLs to Advances	17.48	17.15	15.83	14.53	12.77
Net NPLs to Net Advances	4.51	5.52	5.29	4.17	3.15
ROA (After Tax)	3.56	2.36	2.25	2.68	3.27
ROE (After Tax)	8.66	5.77	4.89	7.16	10.72
Cost to Income Ratio	38.78	37.28	40.08	32.38	25.19
Liquid Assets to Short-term Liabilities	90.23	90.90	86.95	97.60	97.51
Advances to Deposits	627.65	447.93	707.08	763.81	405.09

Source: SBP

The assets mix is traditionally skewed towards investments as the institutions focus more on risk-free avenues over the core business of loans and advances. During the last year, investment posted a strong growth which significantly decelerated during the year under review. However, the investments still constitute 65.34 percent share in the assets in CY20 (63.71 percent in CY19). The share of advances has, however, inched up a 93 bps to 25.31 percent during the year. The maturity profile of the assets shows that there has been a higher increase in the assets having relatively long-term maturity, implying that in a declining interest rate environment, the search for yield and prospects of revaluation gains have encouraged DFIs to increase exposure to long-term investments and advances. Moreover, SBP's refinance schemes such as Long Term Financing Facility (**LTFF**), TERF, and Renewable Energy (**RE**) refinance facility facilitated the DFIs to increase long-term financing.

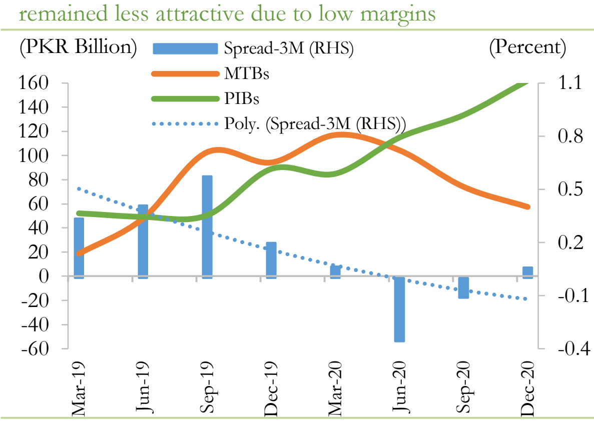
… Short-term investments decelerated significantly as preference shifted to long-term instruments in the wake of easing monetary policy environment

The stock of investments in treasuries increased during the year, however, the pace of the growth slowed down. On the other hand, DFIs continued to heavily rely on short-term borrowing from interbank market to finance their assets, especially the investment in government securities, as around 59 percent of assets are being funded through borrowing.

Further, the tenor-wise composition of investments changed from short- to long-term maturities, as the share of PIBs in total government securities increased from 48.55 percent by end-CY19 to 73.84 percent by end-CY20. More specifically, the stock of investments in PIBs increased significantly to PKR162 billion in CY20 compared with PKR 89 billion in CY19, a growth of 82.27 percent. Besides, the institutions have also tried to hedge their repricing risk through investments in floating rate PIBs, which constituted a little over half of total investments in PIBs as at end-CY20.

As for investments in MTBs, an inflow of PKR 23 billion was recorded during Q1CY20 – bringing stock to PKR 117 billion, highest since December 2008. A sharp decline in the benchmark interest rates during the ensuing quarter, however, brought about a drastic decline in MTB holding to PKR 57 billion by the end December 2020. The shrinking margins[154] in a pandemic-induced low interest rate environment and shift in government's strategy to elongate the maturity of its borrowing prompted a change in investment strategy by DFIs, as they started to invest more in long-term PIBs (**Chart. 5.1.1).**

Chart 5.1.1: Post pandemic investment in MTBs remained less attractive due to low margins

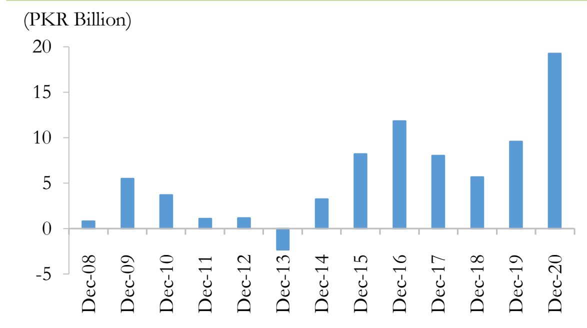


Source: SBP

While, advances growth accelerated …

Advances growth, on the other hand, was recorded at 20.96 percent during CY20 compared with 11.63 percent in CY19. Despite the ongoing health crisis, there was a broad based addition to the advances of PKR 19 billion, the highest disbursement in a single year in over a decade **(Chart 5.1.2)**. Incidentally, SBP-sponsored long-term refinance schemes and strong surge in the lending by a relatively new mortgage refinance company facilitated the growth and advances. House financing (PKR 7.1 billion), LTFF (PKR 3.0 billion), RE (PKR 1.5 billion) and TERF (PKR 0.9 billion), remained major drivers.

Chart 5.1.2: The highest disbursement of advances in line with their core business



Source: SBP

..However, the short term financing still dominates...

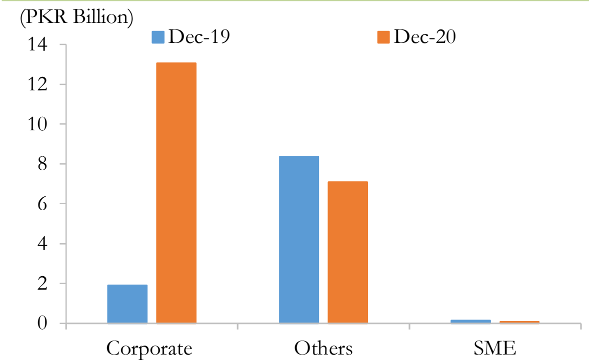
Although a significant amount of long-term advances has been disbursed during CY20, the short-term loans still dominate the outstanding advances portfolio. For example, more than 64 percent advances are maturing within three years, whereas, only 17.75 percent advances have maturities of more than five years. If the lending portfolio of a housing finance institution is excluded, the share of long-term advances with maturity of more than five years reduces to 11.10 percent.

[154] Margin is the difference between three-month repo rate and the yield on three-month MTBs in the secondary market

Corporate segment advances show significant growth…

Corporate segment which consumes lion of share of financial sector financing (i.e. more than 70 percent share in advances), availed a substantial amount of additional lending (i.e. PKR 13 billion) during CY20 **(Chart 5.1.3)**. More than half of these fresh advances (56.59 percent) were for fixed investments; around one-third (i.e. 34.72 percent) was working capital and the rest was trade finance.

Chart 5.1.3: A significant flow of advances towards corporate segment

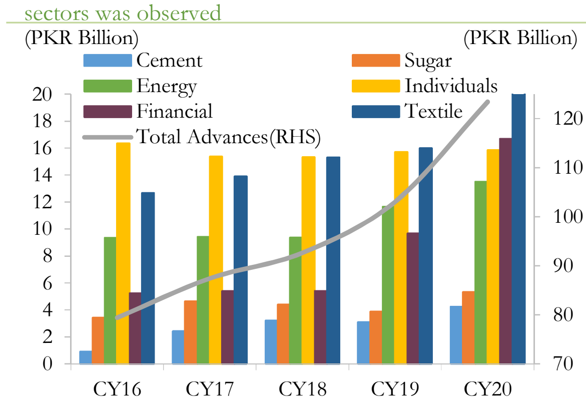


Source: SBP

… and remained broad based…

The sector wise analysis reveals abroad based growth in advances during CY20. More specifically, the 'Financial' sector availed PKR 7 billion, followed by Textile (PKR 4 billion), Energy (PKR 2 billion), Sugar (PKR 1 billion) and Cement (PKR 1 billion) **(Chart 5.1.4)**. The advances to financial institutions surged by 72.40 percent during CY20 and constituted 13.52 percent of the total advances. This addition mainly came from strong growth in financing to financial institutions by a mortgage refinance company. This segment achieved a significant advances growth owing to a couple of reasons: broadening of customer base and introduction of a unique product in the market by this mortgage refinance DFI.[155] The mortgage refinance activity was also facilitated and promoted by government's efforts for low cost housing under 'Naya Pakistan Housing Program'. Moreover, despite COVID related health crisis, loans to the textile sector experienced a significant growth of 27.46 percent in CY20 compared to a meager 4.62 percent during CY19. The current addition in advances was mainly observed in the first and last quarter of CY20. The enhancement in both quarters was mainly due to outlays under LTFF, as SBP extended the scope of LTFF to boost exports and accommodate the financing requirement of export-oriented sectors and manufacturing concerns.[156] The addition in textile sector advances was primarily attributed to a few large textile companies, which invested to enhance their capacity so as to meet increase in export orders.

Chart 5.1.4: A broad based growth in advances across the sectors was observed



Source: SBP

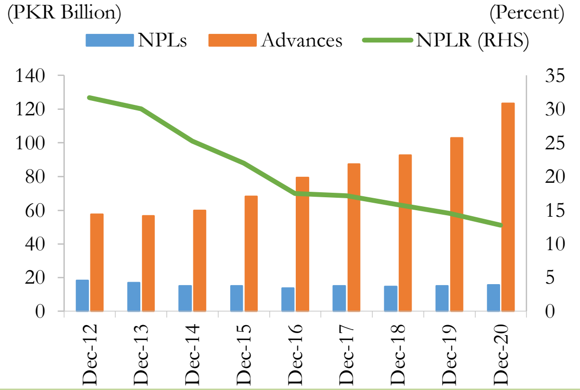
Assets quality continues to improve…

Infection ratio of the DFIs has continued to decline and lowered to 12.77 percent in CY20 from 14.53 percent in CY19 – mainly driven by a higher growth of advances compared with non-performing loans **(Chart 5.1.5)**. Moreover, by allowing deferrals of PKR 12 billion and

155The DFI with the mortgage refinance mandate is in an expansionary phase and has broadened customer base to conventional and Islamic banks, regional banks, microfinance bank, microfinance institution, Modaraba and NBFCs. Moreover, the DFI has developed a working model with banks where it will fund one of their fixed mortgage products.

156Maximum limit of PKR 2.5 billion has been enhanced to PKR 5 billion per project under LTFF (http://www.sbp.org.pk/press/2020/Pr2-28-Jan-20.pdf) restructuring/rescheduling loans of PKR 5 billion under SBP relief measures to combat the pandemic, the DFI sector was shielded from potential rise in infections and the related provisioning expenses.

Chart 5.1.5: Asset quality continues to improve



Source: SBP

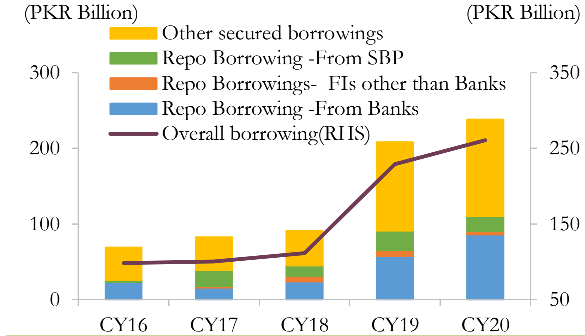
Encouragingly, deposit inflows increased….

The remunerative deposits in the form of Certificate of Investments (**COIs**)[157]appreciably increased (by PKR 15 billion) during CY20, and their share in overall asset base rose to 6.25 percent of total assets compared with 3.19 percent in CY19. The increase in deposits was mainly due to: i) Covid-19 related uncertainties that restricted corporations from investing in their businesses as well as the bar on corporate investments in CDNS prompted placements with DFIs[158], ii) efforts by DFIs to expand funding base and divert to the sources other than repo borrowing.

Borrowing still remained major source of funding…

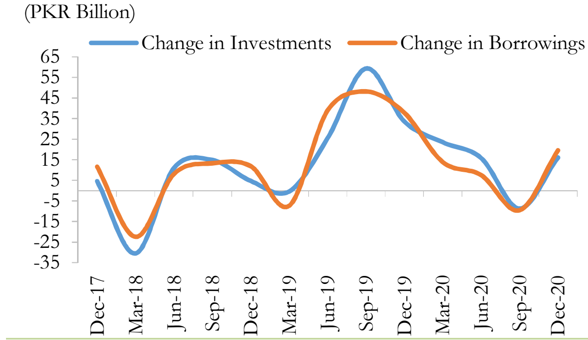
Due to the limited outreach of the capital market to raise capital and dearth of direct funding sources, DFIs mainly depend upon short-term secured borrowing, especially against treasury securities, from interbank market to finance their assets. Last year these borrowings surged to more than double (i.e. 105.47 percent increase); however, the pace of borrowing decelerated to 13.77 percent in year under review **(Chart 5.1.6).** The sharp deceleration in borrowing was naturally followed by a corresponding retardation in growth of investments **(Chart 5.1.7).** The squeezing margins in the wake of sharp reduction in policy rate COVID-19 may have dampened the prospects and incentive to invest in short-term securities through interbank repo borrowings.

Chart 5.1.6: Borrowing decelerated during CY20



Source: SBP

Chart 5.1.7: Sharp deceleration in borrowing led to decline in investments



Source: SBP

Strategy to rely more on short-term funding, however, created maturity mismatches...

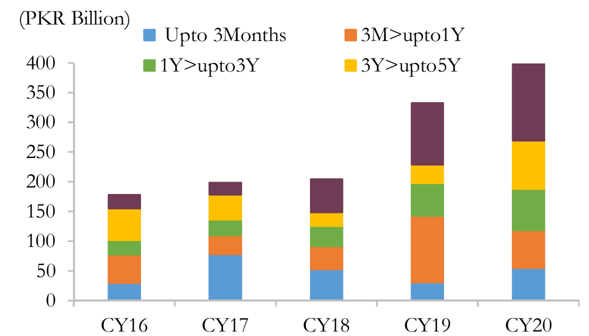
More than 80 percent of inflows (borrowing and deposits) had a maturity of up to one year, whereas only 29.69 percent outflows (advances and investments) matured within a year, creating a huge maturity mismatch in up to one-year bucket. Moreover, 52.82 percent of asset maturing beyond three years is financed by only 10.26 percent of funds with similar maturity. The DFIs are thus

[157] SBP allowed all DFIs (except HBFCL) for Issuance of Certificate of Investments. (BPRD circular No.2 of 2015).

[158]The government barred institutional investments in CDNS w.e.f. July 01, 2020

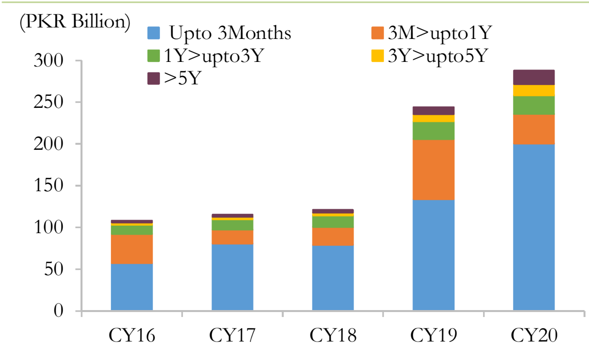
remain exposed to the rollover and refinance risks. The sector therefore needs to make efforts to raise funding from stable sources **(Chart 5.1.8 A & B).**

Chart 5..1.8-A : Maturity-wise breakup of earning assets



Source: SBP

Chart 5.1.8-B: Maturity-wise breakup of funding sources

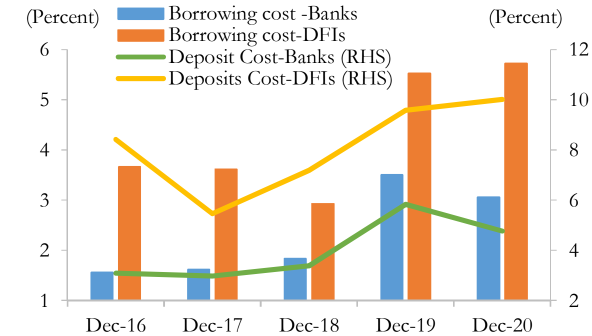


Source: SBP

Reliance on costly and wholesale interbank funding restricts assets expansions…

Moreover, heavy reliance on borrowing from financial institutions and institutional remunerative deposits have raised the cost as well as the uncertainty about the availability of funds, which further restricted the DFIs' ability to expand their assets base and optimize the returns. On average,[159] the rates on borrowing and deposits for DFIs remained, respectively, 193 bps and 426 bps higher than the banking industry.[160] **(Chart 5.1.9)**

Chart 5.1.9: High cost of borrowings restrict DFIs from assets expansion



Source: SBP

Due to lack of stable sources of funds, equity remains a major source of funding…

Since December 2008, DFIs seem to have remained reluctant to raise long-term funding through capital market, as both capital market as well as investment opportunities to invest in long-term projects remained limited. Moreover, due to their access to stable funding sources and better resources, the banks enjoy significant competitive advantage over DFIs. Therefore, strong capital base of the DFIs cannot be leveraged, as they focus on money and capital market activities through short-term borrowings, which are invested in relatively long-term investments so as to increase their margins. Accordingly, higher amount of capital is also required to cover any liquidity risks. The equity, therefore, remains the major source for funding. During the year under review, the equity of the DFIs increased by 12.52 percent (YoY growth) to PKR 132 billion. This growth in equity was largely (73.29 percent) explained by retained earnings.

Profitability of the DFIs accelerated significantly…

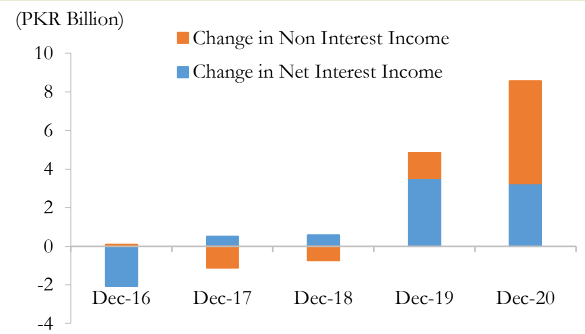
Despite the challenging environment, the profitability (after tax) of the DFIs increased significantly to PKR 13.4 billion in CY20, a YoY rise of PKR 6 billion or 70.64 percent. This was

159 Last three years average

160 Cost of funding for borrowing and deposits are calculated as follows: Interest expense on borrowing is divided by average borrowings in last two years, and Interest expense on deposits divided by average deposits in last two years.

the highest profit ever recorded during any calendar year in over a decade **(Chart 5.1.10).**

Chart 5.1.10: Earnings accelerated during CY20



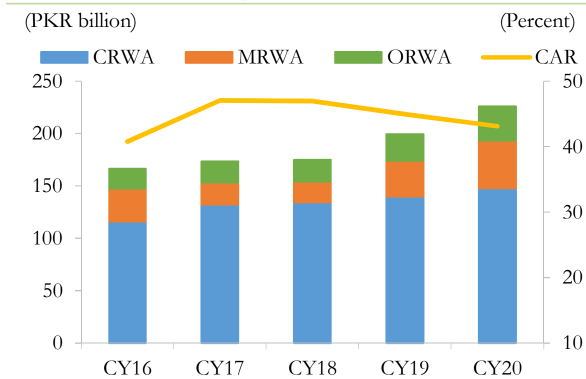
Source: SBP

The strong growth in profitability was supported by increase in net interest income as the timely investment decisions helped to boost the interest income. Moreover, DFIs posted healthy gains on sale of fixed income securities in the wake of sharp decline in interest rates, while the dividend and other income also witnessed appreciable growth during the year under review. Incidentally, SBP's Covid-19 relief measures to ensure the flow of credit and preserve the capital base of regulated institutions may have contributed in the profits by obviating provisioning expenses for deferred and rescheduled/restructured loans. In line with the growth in bottom line, the key earning indicators of ROE also improved to 10.72 percent (from 7.16 percent in CY19).

CAR marginally declined, but remained significantly higher than regulatory benchmark …

Due to strong capital base and limited financing operations, the capital adequacy ratio (**CAR**) of the DFIs generally remains high. The CAR of the sector marginally declined to 43.14 percent in CY20 from 44.95 percent in CY19. However, CAR remained significantly higher than the regulatory benchmark of 11.50 percent **(Chart 5.1.11).** The decrease was due to an increase of 13.22 percent in total RWA during CY20. More specifically, expansion in advances contributed to an increase in credit RWAs by 5.70 percent. The market RWAs also increased significantly by 33.30 percent owing to an increase in investments and shift in their mix from short-term investments (MTBs) to long term investment (PIBs) which, especially the fixed rate bonds, involves relatively higher capital charge.[161] Finally, Operational RWAs increased by 27.51 percent due to continuous increase in gross income of the DFIs.

Chart 5.1.11: Solvency profile of DFIs moderated



Source: SBP

With strong capital cushions, the DFIs are in a position to withstand unusual shocks and have the capacity to expand their earnings assets e.g. financing to real sector.

….DFIs need to focus on their core objectives…

In CY20, DFIs have displayed some efforts to revive their core business, as long term funding accelerated, partially on the back of SBP-sponsored schemes as well as mortgage financing, including low cost housing finance. However, DFIs still remain shy of meeting their stated objectives. The sector is facing a number of limiting factors e.g. lack of depth and outreach of

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161 As per Basel standards, interest rate risk has two components i.e. (i) issuer specific risk and (ii) general market related risk. The higher duration of instruments, attract higher capital charge for general market related interest rate risk.

the capital market to raise long-term funding at economical rate, limited demand for long-term finance and tough competition from banks which enjoy both access to stable and economical funding and resources. While there is a need to improve the infrastructure and market development, the DFIs can also enhance their dynamism and improve the capacity in the core business.