Chapter 5.2: Non-Bank Financial Institutions

Despite the emergence of the COVID-19 pandemic and the ensuing lockdowns, Non-Bank Financial Institutions (NBFIs) managed to increase their asset base on the back of increase in the Asset Management (AM) segment, which has the largest share in NBFI sector. However, lending NBFIs faced pressures due to asset quality challenges on account of slowdown in economic activity and resultant impairment in repayment capacity of the borrowers. The delinquencies and non-performing assets occurred despite the SECP relaxations and exemptions to defer or restructure advances and leases of borrowers. Going forward, the earnings and solvency indicators of the sector will largely depend upon the dynamics of the pandemic, continuity of COVID-related support measures, and general macro financial-conditions of the economy.

NBFI sector posted asset management-led growth during the pandemic; however, the performance of lending NBFIs dampened …

Despite the slowdown in economic activity due to the Pandemic and ensuing lockdowns – which resulted in the largest albeit short lived dip in the equity market in the last six years, the Non-Bank Financial Institution (**NBFI**) sector[162] managed to enhance its asset base with Mutual Funds and Portfolios registering significant increases. **(Table 5.2.1)**

Table 5.2.1: Asset Profile of NBFIs

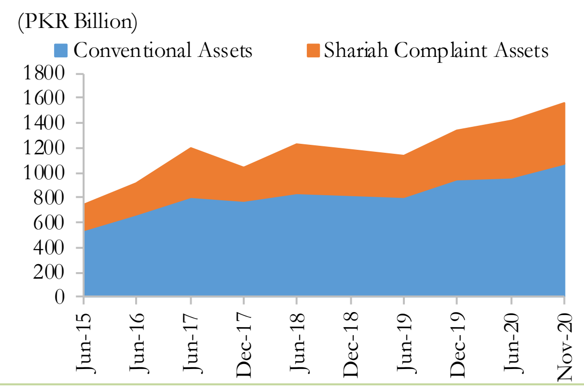
	Jun-18	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
	PKR billion					
AMCs/IAs (own assets)	**39**	**36**	**37**	**40**	**40**	**44**
Mutual Funds	679	642	578	724	802	985
Pension Funds	27	27	26	30	31	36
Portfolios	153	188	198	226	229	314
Total AUMs	**859**	**857**	**802**	**980**	**1,062**	**1,335**
RMCs	5	6	6	6	6	6
REITS	42	46	46	50	49	54
PE & VC Firms	0	0	0	0	0	0
PE Funds	5	6	7	7	7	8
Modarabas	53	54	53	54	51	51
Leasing Companies	10	10	10	11	11	6
IFCs	58	58	63	66	65	66
NBMFCs	97	110	117	126	122	129
Total Assets	1,169	1,184	1,140	1,339	1,412	1,700

Source: SECP

The Asset Management (**AM**)[163] segment continues to dominate the NBFI sector – as the market share of Assets Under Management (**AUMs**) further increased from 73.20 percent in CY19 to 78.53 percent in CY20.

However, NBFIs involved in the financing business[164] registered an overall decrease in assets as the Leasing sector experienced consolidation as a public leasing company – the largest leasing company in terms of asset size - merged with and into the associated public sector bank.[165]

Chart 5.2.1: Breakup of conventional & Sharia compliant assets



Source: SECP

During the year, the share of Shariah-compliant assets in total assets has increased from 28.85 percent for the year ended December 31, 2019 to

162 NBFIs for our analysis purpose include NBFCs, Real Estate Investment Trusts (**REITs**), and Modaraba Companies. As per section 282A of Companies Ordinance, 1984, Non-banking finance companies (**NBFCs**) include companies licensed by the Commission to carry out any or more of the following forms of business, namely: Investment finance services, Leasing, Housing Finance Services, Venture Capital Investment, Discounting Services, Investment Advisory Services, Asset Management Services, and any other form of business which the Federal Government may, by notification in the official Gazette specify from time to time. Non-bank Microfinance Companies (**NBMFCs**) are also included in NBFCs.

163 The Asset Management (**AM**) segment includes Asset Management Companies (**AMCs**), Investment Advisors (**IAs**), REITs, Mutual Funds, Pension Funds, and Discretionary/ Non-discretionary Portfolios.

164 NBFIs involved in the financing business (also referred to as the non-AM segment) include Leasing Companies, Modarabas, Investment Finance Companies (**IFCs**), and NBMFCs.

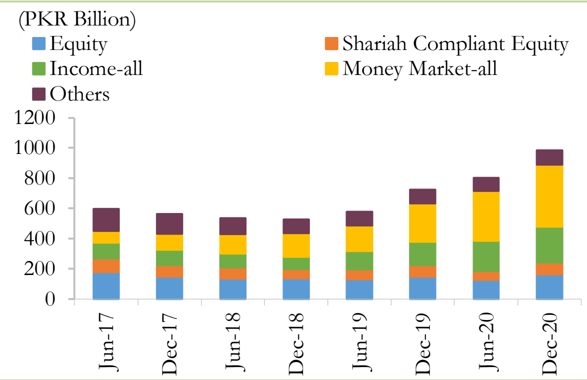
165 See Merger of Sindh Leasing Company Limited; http://www.sindhleasingltd.com/wp-content/uploads/2021/01/sl_emerger.png

31.32 percent in November 30, 2020 mainly on the back of growth in Shariah-compliant Mutual Funds, particularly, Money Market funds. Shariah-compliant assets have grown on the back of continuing supportive government policies and resilient demand. In addition, Shariah-compliant Money Market funds are allowed to take clean corporate exposures (provided they meet credit quality requirements), which resulted in their significant growth. **(Chart 5.2.1)**

Due to volatility in the equity markets in CY20, Net Sales of Money Market and Income Funds have increased in the Mutual Funds sector…

The Mutual Funds sector is mainly dominated by the Money Market Funds (41.86 percent market share), followed by Equity Funds (24.51 percent market share) and Income Funds (24.09 percent market share), indicating a general risk-averse nature of investors. The Pandemic-related uncertainties and volatilities have further affected the risk-appetite of investors as indicated by the drop in market share of Equity Funds from 30.95 percent in CY19 to 24.51 percent in CY20. **(Chart 5.2.2)**

Chart 5.2.2: Composition of Mutual Funds



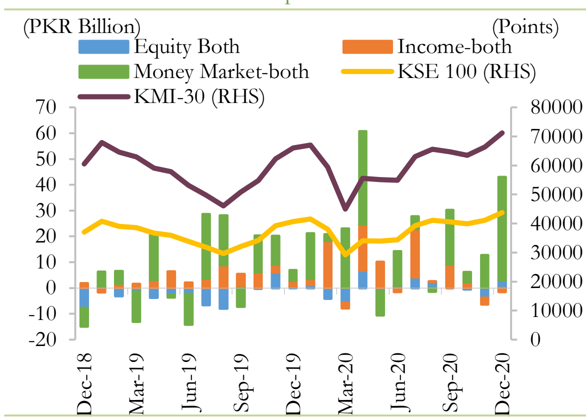
Source: SECP

There has been a large spike in the assets of mutual funds (36.04 percent increase) as risk-averse investors search for higher returns in the backdrop of heightened uncertainties and easing monetary policy, which resulted in corporates parking their excess liquidity in Money Market funds.

The risk appetite of general investors was largely influenced by the cumulative cut of 625 basis points in the policy rate and the volatility in the equity markets during CY20 – with the KSE-100 index dipping to almost 27,000 points in March 2020 and then recovering to 43,755 points by December 2020. This is demonstrated by the increase in Net Sales for Money Market and Income Funds (as fund performance is gauged vis-à-vis market rates). (**Chart 5.2.3**)

Investment in mutual and pension funds was also supported by the government's decision[166] to bar institutional investors from investing in Central Directorate of National Savings (**CDNS**) instruments. As a result of this decision, the AM segment became an attractive alternative for the institutional investors.

Chart 5.2.3: Net Sales of top three mutual funds



Source: MUFAP & PSX

Due to the dip in equity markets, Equity Funds witnessed Net Redemptions while Money Market Funds witnessed Net Sales in the February-March 2020 period. Since then, the markets rallied, which spurred recovery in Equity Funds resulting in overall Net Sales in CY20. The recovery was aided by the relief measures introduced by the

166 The government barred institutional investments in CDNS w.e.f. July 01, 2020.

government and regulatory authorities[167] and strong fundamentals of the underlying stocks.

Consequently, growth in Money Market and Income Funds mainly drove the increase in Mutual Funds assets (constituting 72.32 percent and 34.34 percent of overall growth, respectively) in CY20. **(Chart 5.2.2)**

The small asset base of the 23 AMCs and IAs – which is only 3.27 percent of total AUMs – could involve the moral hazard of excessive risk taking, particularly, since AMCs' investments in funds under management constitute only 2.13 percent of total AUMs. However, this moral hazard is well contained through a strong regulatory and governance regime, and checks and balances (including the arrangements between trustees, custodians, and audit process, disclosures requirements, etc.) to ensure that the investments and risks are strictly in line with the stated risk profile and constituting document of the respective funds.

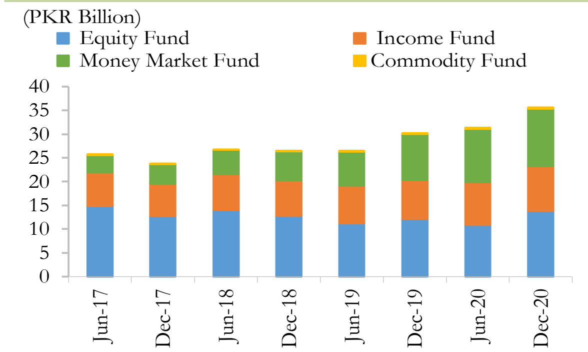
The credit risk for the sector is low with Classified Assets of PKR 3.8 billion (0.38 percent of gross AUMs) while AMCs held provisioning of PKR 3.6 billion (provisioning coverage of 96.56 percent) as of December 31, 2020. The small amount of Classified Assets are partly due to the large market share of the relatively safe Money Market and Income Funds.

Money Market Funds have driven the growth in Pension Funds…

Pension Funds increased their asset base by 17.85 percent to PKR 36 billion in CY20 despite the onset of the Pandemic, which led to a cut in policy rates. Money Market funds increased their balance sheet footing from PKR 10 billion to PKR 12 billion contributing 45.21 percent to overall growth for the sector.

The sector is highly concentrated with one fund manager managing 34.41 percent of total assets through a single fund (consisting of four sub-funds) for the sector.

Chart 5.2.4: Composition of pension funds

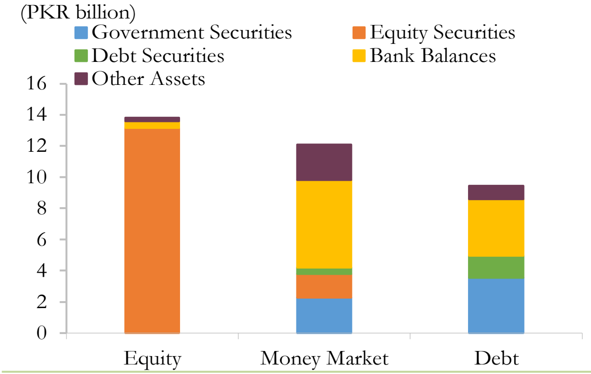


Source: SECP

Although growth in Pension funds has been mainly driven by Money Market funds, Equity funds still constitute the largest share (38.75 percent of Total Assets) in the pension funds segments with growth of 13.90 percent over the year. Despite volatility in the first half of CY20 – which led to a year-on-year decrease of 2.53 percent in Equity funds - the stock market recovered in the second half of the year that led to strong growth in the value of Equity funds, which contributed 31.21 percent of the overall YoY growth in the pension fund portfolio. **(Chart 5.2.4)**

[167] Some of the relief measures introduced by the SECP in light of the Pandemic for mutual funds include: extension in the maximum period of borrowing by mutual funds for redemption purposes; increase in time for regularization of breach of investment limits due to redemptions from four months to six months for mutual funds/collective investment scheme (**CIS**); extension in time period for classification of non-performing securities by mutual fund/CIS from 15 days to 180 days; among others.

Chart 5.2.5: Asset Allocation of Pension Funds in CY20



Source: SECP

However, the capital market of the country is quite shallow and significantly lacks width and depth. Large institutional investors such as Life Insurers and Pension Funds do not invest in long-term projects, partly because of a dearth of such long-term investment avenues and partly because of their risk-averseness. A look at the asset allocation of Pension Funds (barring Equity Funds) suggests that most have a short-term investment horizon although their liquidity needs are generally low. **(Chart 5.2.5)**

Development of long-term financial products by the private sector and enabling policy and macro environment may lead such institutional investors to elongate their investment horizons, which may help maximize returns and, in turn, partly bridge the financing gap that the country faces.

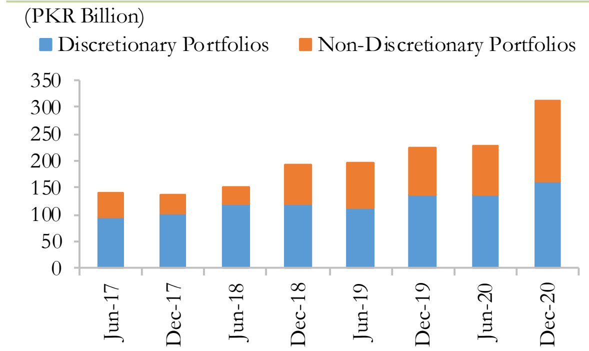
Decrease in economic activity did not affect growth in Portfolios Under Management [168]…

Despite the uncertainty surrounding the Pandemic, there has been a significant increase in the growth of Portfolios (39.15 percent increase in CY20) suggesting that high-income individuals and entities were largely unaffected by the decline in economic activity.

However, the uncertainty of the Pandemic led to a decrease in the share of Discretionary Portfolios from 60.92 percent in CY19 to 52.07 percent in CY20 indicating that clients increasingly took investment decisions in their own hands. **(Chart 5.2.6)**

The macroeconomic uncertainty might have led to panic sell-outs and shorter investment-holding periods as these large investors tend to capitalize on the market volatility rather than holding investments in line with market fundamentals.

Chart 5.2.6: Portfolios classified by investment decision making



Source: SECP

Despite a decrease in rental income, the REIT scheme has managed to retain high occupancy levels and long lease terms…

Despite the presence of seven REIT management companies, only one has launched a REIT scheme yet.

Table 5.2.2: Two Major heads of REIT Earnings

	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
	PKR Billion				
Total Assets (Stocks)	45.90	47.02	49.53	52.03	54.40
Change in Total Assets	2.91	1.12	2.51	2.50	2.37
Rental Income (HY)	1.61	1.73	1.70	1.12	1.42
Change in fair value of property (HY Flows)	2.87	0.96	2.42	3.04	2.13

Source: Financial Statements of REIT

168 Portfolios (Under Management) 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 executed as per the written instructions of the clients.

During the year, the REIT scheme managed to increase its asset base on the back of increased property valuation. **(Table 5.2.2)**

Even in the face of the pandemic-induced lockdowns, which hampered business activity and interrupted retail sales, the REIT management company strived to retain tenants by providing rental waivers, and enhancing customer engagement while implementing prescribed safety protocols to encourage footfall and retail sales. While the renegotiation of tenancy contracts (in light of the pandemic) reduced rental income in the short term, it helped maintain occupancy level above ninety percent. Besides these dynamics of occupancy rate, the other key performance indicator i.e. weighted average lease expiry (**WALE**) was 3.3 years[169].

Leasing Companies continue to lose market share…

The leasing sector, which holds a minimal market share contracted sharply as the largest leasing company exited the sector with its merger into the associated public sector bank. This has resulted in a 44.12 percent and 40.81 percent decline in the asset base and advances & leases of the leasing sector, respectively**. (Table 5.2.3)**

Asset quality issues coupled with funding constraints still hamper the growth of the leasing sector. With the exit of the largest leasing company, the Classified Assets to Total Assets ratio has increased from 18.31 percent in CY19 to 36.70 percent in CY20.

Table 5.2.3: Key statistics of Leasing sector

	Jun-18	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
	PKR Billion					
Total Assets	10.4	10.5	10.2	10.7	10.6	6.0
Advances & Leases	7.6	7.9	8.2	7.7	7.2	4.6
Asset Classified	1.9	1.9	1.7	2.0	2.4	2.2
Provisions	1.5	1.4	1.4	1.5	1.5	1.5

Source: SECP

If statistics are compared only for the existing leasing companies, the results are still insipid with 8.29 percent decline in advances and leases and a 12.00 percent increase in Classified Assets during CY20, indicating that leasing companies are still losing market share.

Competition from commercial banks, which enjoy access to relatively low-cost and stable funds, and Modarabas has slowly chipped away at the business from leasing firms over the years. A few firms continue to struggle due to liquidity crunch and shortage of capital.

Declining discount rates can be a boon for leasing companies as it can reduce cost of funding; however, competition from other sectors will remain fierce.

Going forward, once COVID-related relaxations and exemptions – including deferral in repayment of principal, rescheduling/ restructuring the financing facility, relaxation in classification of the deferment/ rescheduled request, among others - lapse, leasing companies may experience an uptick in non-performing loans putting further strain on their profitability and equity.

To mitigate risks, IFCs curtail disbursements…

The pandemic has resulted in a decline in Advances and Leases for the IFC sector as some IFCs have curtailed disbursements during the year.

169 Higher occupancy rates and longer average lease terms are two primary determinants of a quality REIT. WALE is a measure of a property portfolio's risk of going vacant. A longer WALE points to a stable tenant base and high satisfaction among tenants. A shorter WALE will lead to a quicker turnaround among tenants, with extra potential costs involved in managing and minimizing those turnarounds.

The IFC sector overlaps with the NBFI sector as a NBFC licensed to undertake the business of Investment Finance Services might also undertake the business of leasing, housing financing, discounting, and micro-financing under the same license.[170] In view of the above, the two largest IFCs are involved in leasing and microfinance activities. The sector is also heavily concentrated with these two IFCs constituting 77.11 percent of the total market share in terms of assets and making up 96.19 percent of total Advances & Leases for the sector for the period ended December 31, 2020.

Non-availability of low-cost funds remains a challenge for the Modaraba sector…

Despite the entrance of three new Modaraba companies in CY20 (taking the total up to 27[171]), the concentration in the sector remains high. The big three Modarabas hold 56.84 percent of total assets of the sector as of December 31, 2020.

Although the various Modaraba companies are clubbed under the same sector, the Modaraba companies differ from each other as various Shariah-compliant business ventures can be operated on the premise of Modaraba, including equipment-rental services, trading, manufacturing, and Islamic financing services.

Some of the companies are still undercapitalized, with one of the largest (constituting 21.06 percent of total assets) registering significant negative equity. However, since this is a manufacturing Modaraba that is not involved in the financing business, it does not pose systemic risk to the rest of the sector. The company aims to convert debt obtained from its parent company into equity and spinoff one of its loss-making segments into a separate entity.

The sector's growth is still hampered by the non-availability of relatively low-cost funds with the sector registering a 4.29 percent decline in assets for CY20. Out of the 27 Modaraba companies, only five raised deposits (with one raising negligible amounts); consequently, the deposit to equity ratio for the sector is 0.61, indicating that significant room exists for Modarabas (which are engaged in financing business) to expand their business through deposits and optimize the risk-return matrix and meet the financing demand of the real economy.

Asset Quality of NBMFCs has deteriorated rapidly…

Generally, the purpose of most NBMFCs is not profit-maximization but to alleviate poverty and enhance financial inclusion by providing microfinancing, among other services; however, these NBMFCs still need to have a sustainable business model.

The NBMFCs sector is highly concentrated with the top three NBMFCs constituting 64.06 percent and 68.77 percent of total assets and total microcredit loans, respectively, in CY20.

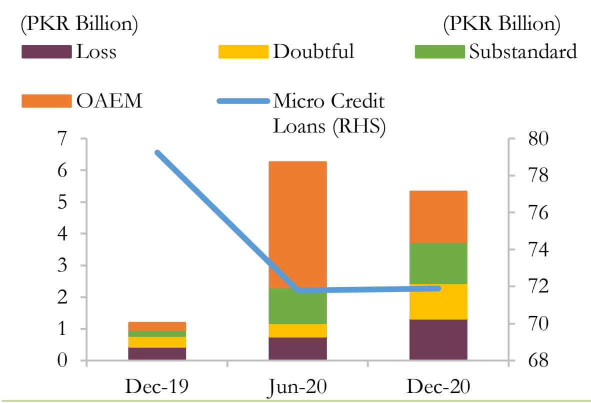
Due to the implementation of lockdowns and the ensuing slowdown in economic activity, the NBMFC sector has registered a decline of 9.27 percent in Microcredit Loans for the year ended December 31, 2020. A combination of demand- and supply-side factors led to the decline. To keep their risk profiles manageable, some NBMFCs began to restrict loans to borrowers who availed financing from multiple sources. In addition, field teams involved in client outreach adopted a conservative approach while disbursing loans. With regards to demand-side factors, due to the slowdown in economic activity, some existing clientele did not avail new loans from NBMFCs.

[170] Incorporation of NBFC and grant of license; https://www.secp.gov.pk/licensing/nbfcs/investment-finance-services/

[171] While there are 28 Modarabas, this analysis is based on the available data of 27 Modarabas, covering 99.61 percent of the sector (in terms of assets).

The real cause for concern is the substantial increase in Classified Assets, which, despite SECP's special pandemic-related relaxations, have increased by 347.90 percent to PKR 5 billion for the year ended December 31, 2020. While the associated provisioning has increased, it has not increased on a proportionate basis resulting in a decline in Provisioning Coverage from 54.54 percent in CY19 to 41.50 percent in CY20. Accordingly, the Classified Assets to Microcredit Loans ratio has increased from 1.50 percent in CY19 to 7.41 percent in CY20.

Chart 5.2.7: NBMFCs' Composition of Classified Assets



Source: SECP

In addition, the composition of Classified Assets has worsened over the year. Initially, there was a large increase in the classification of assets as "Other Assets Especially Mentioned (**OAEM**)" in the half-year ended June 30, 2020. Subsequently, the majority of OAEM classified assets transitioned to lower categories such as "Loss" by the year ended December 31, 2020; this resulted in a 206.50 percent increase in Loss classified assets in CY20. This caused a deterioration in asset quality and increase in provisioning expense, which, in turn, affected the NBMFCs' earnings and solvency. (**Chart 5.2.7**)

One reason for this deterioration in asset quality may be the fact that most microfinance borrowers might be unaware of the SECP's loan deferment and restructuring package, resulting in increasing delinquencies as the income and cash flow of capacities of the microfinance borrowers were also affected by the pandemic

This deterioration in the asset quality of NBMFCs may have implications for microfinance intermediaries – including investment finance companies and wholesale lenders to NBMFCs. These intermediaries mobilize funding from donors and commercial lenders i.e. development agencies, financiers, commercial banks and capital markets, and are key providers of funding for a number of NBMFCs. As of June 30, 2020, a leading IFC had provided financing of PKR 21 billion to NBMFCs. This forms 37.73 percent of total borrowings for 17 NBMFCs, which may not seem significant. However, if the borrowings of the top two NBMFCs (whose funding sources are well diversified) are excluded, the borrowing provided by the IFC to the remaining 15 NBMFCs constitutes 68.83 percent of their total borrowings, which is quite significant for these small-sized firms. This may raise concerns for the health of the IFC and highlights a feedback channel between the investment finance and NBMFC sectors.

Detailed analysis shows that in order to fund its financing operations, the IFC had obtained borrowings worth PKR 7 billion (24.40 percent of its total assets) from the banking sector as of June 30, 2020. This delineates how the IFC channelizes liquidity between the banking sector and the NBMFC sector. The asset quality issues that the NBMFC sector is currently facing can portend the build-up of system-wide risk for the microfinance intermediaries and the banking sector. However, the quantum of the banks' exposure to the sector remain minute, especially in comparison with the asset base and capital levels of the banking sector. Moreover, a decrease in micro-credit loans by NBMFC during CY20 also shows that these firms are trying to implement prudent risk management practices in their lending activities.

Nevertheless, upon withdrawal of SECP's relaxations to NBFCs engaged in lending business (including NBMFCs), the asset quality and earnings indicators could face further pressures.

Interconnectedness between the AM segment and the banking sector remains high …

The Asset Management (AM) segment remained interconnected with the banking sector especially in terms of banks' investments in mutual funds' unit, which was 38.23 percent of total AUM. In addition, mutual funds' exposure in different instruments of banking sector constituted 94.31 percent of the segment's total exposure in financial institutions in the form of investments in deposits, Certificate of Deposits (**COD**), Term Deposit (**TDR**), Certificate of Investment (**COI**), and money at call/placements with banks. Indicators for banks' share remained somewhat stable over the previous year. **(Table 5.2.4)**

Further, bank-owned AMCs/ IAs had 76.90 percent share in total AUM, highlighting another aspect of interconnectedness that banking sector provides significant ownership and sponsorship support to AM segment.

From the AM segment's perspective, the transfer of vulnerabilities from the banking sector, in terms of Mutual Fund exposure, is a concern as the AM segment has placed a significant portion of its assets in banks. However, given the resilience of the banking sector, with CAR at more than 18 percent and ample liquidity buffers, the residual risk is minimal for AM segment. Further, the CAR non-compliant banks do not have associates in AMCs.

In addition, the investments in Mutual Funds by their associated Banks, DFIs and AMCs constituted 3.48 percent of the value of total investments as of December 31, 2020. Similarly, Other Banks/DFIs' investment in Mutual Funds as percentage of total investment in Mutual Funds was only 1.12 percent.

From the banking sector perspective, vulnerability from the AM segment can emanate from sudden withdrawal of funds placed with banks. However, given the overall low risk profile of the AM's asset composition and strong liquidity cushion of banks, this risk remains low.

The AM segment increased its exposure in the NBFC sector through different modes of investments including Term Deposit, COI, COD, Certificate of Musharaka (**COM**), Debt Security, and Equity Security. It has increased from PKR 1 billion in CY19 to PKR 4 billion in CY20, which, nevertheless is still negligible - constituting 0.31 percent of overall asset base of AM segment.

In addition, the microfinance intermediaries, which partly borrow from banks and provide financing to NBMFCs, are a source of interconnectedness between the NBMFCs and the banking sector. Though, the asset quality issues plaguing the NBMFCs may reflect the buildup of cross-sectoral vulnerabilities for the banking sector; however, again, given the footing of the banking sector and strong capital base, any transfer of risks from the NBMFC sector will be negligible and remote.

The rest of the lending NBFCs are not significantly interconnected with the banking sector. Over the years, the reliance of this NBFC sector on banks has declined due to high cost and uncertainty in the availability of bank financing.

Going forward, the performance of overall NBFI sector will largely depend upon the success in controlling the pandemic, continuity of regulatory support measures, and general economic conditions and liquidity in the financial markets.

Table 5.2.4: Asset Management segment's 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-18			Dec-19			Dec-20		
	PKR billion		Percent	PKR billion		Percent	PKR billion		Percent
1. Equity of AMCs/ IAs	23.7	12.9	54.42	28.5	14.4	50.46	31.9	17.0	53.36
2. Assets Under Management of AMCs/ IAs	856.6	645.9	75.41	979.9	761.6	77.73	1,334.7	1,026.4	76.90
3. Mutual Funds size	641.7	16.6	2.59	724.1	12.9	1.79	985.2	15.5	1.58
4. Mutual Fund exposure in Financial Institutions	277.8	257.1	92.54	357.6	342.5	95.79	541.0	510.2	94.31
5. Mutual Funds exposure in top 20 equity securities	84.7	6.2	7.27	81.3	6.4	7.91	76.5	9.2	12.07
6. Mutual Funds exposure in top 10 debt securities	16.7	8.0	47.55	17.3	5.6	32.24	20.3	6.0	29.62
7. Top 20 holders of mutual fund units	68.8	11.2	16.25	97.4	6.0	6.16	359.0	205.4	57.22

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