Chapter 6.1: Development Finance Institutions (DFIs)

DFIs witnessed expansion in asset base primarily driven by investments, which constitutes a major part of their assets. The appetite for long-term instruments remained intact owing to rising interest rate expectations during CY21. Revival in economic activities and higher input prices served as impetus for acceleration in advances, wherein growth remained broad based. Reliance on short-term borrowing remained the major source of funding. Asset quality of the sector improved on the back of contained growth in NPLs and borrowers' improved repayment capacity. However, deceleration in net interest income and non-interest income driven by low interest rates and losses on sale of securities squeezed profitability. DFIs still maintained strong solvency profile, though CAR declined due to utilization of capital for extension of credit. In order to fulfill their mandate and optimize the risk-return matrix, the DFIs may focus on developing and enhancing their investment banking capabilities and make concerted efforts to raise sustainable long-term financing to facilitate and finance the capital formation in the economy.

Growth momentum of DFIs continued during CY21…

The asset base of **DFIs** observed strong expansion of PKR 99 billion (22.6 percent growth YoY) during CY21, primarily driven by an increase PKR 51 billion (17.9percent growth YoY) in investments which form the major part of the asset base. Although investments continued to dominate growth in assets, there was a slight deceleration in investments as compared to last year while advances grew at an accelerated pace during the reviewed year. **(Table 6.1.1)**

Table 6.1.1: Key Variables & Financial Soundness Indicators

	CY17	CY18	CY19	CY20	CY21
	PKR billion				
Investments (net)	122	122	240	287	338
Advances (net)	77	82	92	111	140
Total Assets	228	238	377	439	539
Borrowings	101	111	229	261	348
Deposits	17	12	12	27	34
Equity	99	106	117	132	136
NPLs	15	15	15	16	15
	Percent				
CAR	47.0	47.0	44.9	43.1	38.7
NPLs to Advances	17.1	15.8	14.5	12.8	9.5
Net NPLs to Net Advances	5.5	5.3	4.2	3.1	1.6
ROA (After Tax)	2.4	2.2	2.7	3.3	2.4
ROE (After Tax)	5.8	4.9	7.2	10.7	8.9
Cost to Income Ratio	37.3	40.1	32.4	25.2	32.5
Liquid Assets to Short-term Liabilities	90.9	86.9	97.6	97.5	98.0
Advances to Deposits	447.9	707.1	763.8	405.1	412.6

Source: SBP

Funding composition of DFIs showed that they mainly rely on secured borrowings and shareholders' equity to fund their business operations. DFIs financed 90.0 percent of total assets through equity and borrowings from financial institutions while only 6.3 percent was funded by deposits. Notably, reliance on borrowings from financial institutions increased to 64.70 percent at end Dec-21 (59.31 percent in Dec-20).

Investment composition skewed towards long-term instruments…

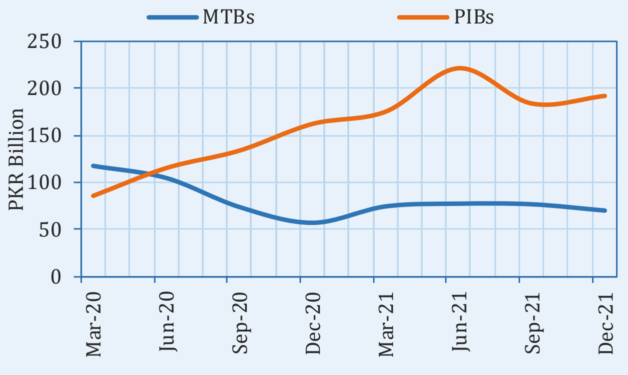
DFIs' appetite for investment in long-term instruments remained intact in CY21. The stock of investments in PIBs increased to PKR 192 billion in CY21 from PKR 162 billion in CY20. Most of the long-term investments were parked in floating rate category[129] reflecting rising interest rate expectations.[130]

As for investments in MTBs, a meager inflow of PKR 13 billion was recorded during CY21 – bringing the outstanding stock to PKR 70 billion, as DFIs shifted their portfolio from short-term investments to long-term floating PIBs, which were nevertheless less sensitive to interest rate risk as they carry variable rate and shorter-repricing period. (**Chart 6.1.1).**

Investment in shares and bonds also increased …..

Apart from investment in government securities, the other avenues of investments such as shares, TFCs, debenture etc. also observed some uptick. The lower interest rates and contained volatility in the equity market during most part of CY21 led to rise in DFIs' investment in equity stock by 11.8 percent to PKR 5 billion. On the other hand, investments in TFCs/ bonds/ debentures increased by 9.5 percent over the same period.

Chart 6.1.1: Appetite for PIBs remained intact in CY21

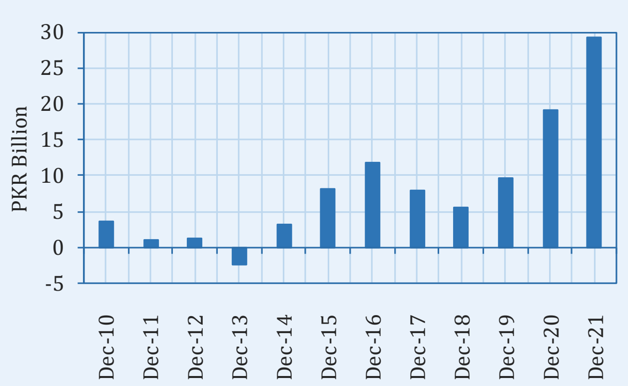


Source: SBP

Advances growth accelerated amid revival in economic activity and other supportive factors…

Advances witnessed notable increase of 26.3 percent during CY21 compared with 21.0 percent in last year**. (Chart 6.1.2).** The net inflow increase of PKR 29 billion was broad based across different economic sectors. Pick up in the financing activity was attributable to a number of factors such as revival of economic activities, accommodative monetary policy, higher input prices, disbursement under SBP's refinance schemes[131] and surge in lending by the newly formed mortgage refinance company.

Chart 6.1.2: High disbursement of advances



Source: SBP

[129] PKR 20 billion and PKR 15 billion were invested in floating rate and fixed rate PIBs respectively.

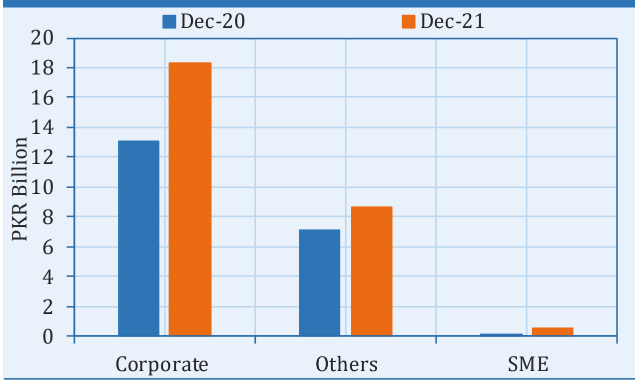
[130] In rising interest rate expectations scenario, financial institutions tend to lock their investments in short-term instruments (e.g. MTBs) and floating rate instruments (e.g. floating PIBs). In floating category, though investments are locked for a longer period, however, returns are re-priced with shorter frequency thus reduce re-pricing risks.

[131] PKR 18.6 billion, PKR 2.7 billion and PKR 1.8 billion were disbursed to DFIs under TERF, Renewable Energy (RE) and LTFF during CY21, respectively.

Corporate segment grasped major chunk of advances…

Segment-wise advances depict that corporate segment availed both long-term (fixed investment) and short-term financing (working and trade financing) during CY21. **(Chart 6.1.3)**. Fresh loans worth PKR 18.3 billion and 3.6 billion were disbursed to corporates on account of fixed investment and working capital, respectively.

Chart 6.1.3: A significant inflow of advances towards corporate sector



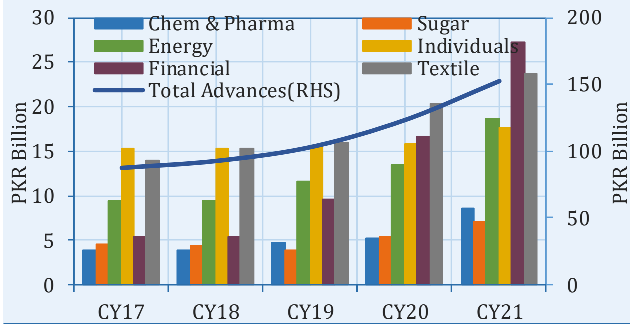
Source: SBP

and disbursement of loans remained borad-based and diversified….

The sector-wise analysis indicates that advances remained diversified across economic sectors. Particularly, financial, textile, energy, chemical and pharmaceuticals, and sugar sector availed major chunk of advances. **(Chart 6.1.4)**. The growth in advances to financial institutions maintained its momentum in CY21 as well, mainly on account of financing by the mortgage refinance company.[132]

The firms in energy sector availed additional financing of PKR 5 billion for working capital needs. Moreover, textile sector availed highest financing along with individuals, witnessing increase of PKR 24 billion and PKR 18 billion, respectively. The long-term loans for capacity expansion/ BMR explain the increase in textiles' advances during CY21, as the sector also benefited from SBP refinance schemes such as LTFF and TERF.[133]

Chart 6.1.4: Broad based growth in advances across sectors



Source: SBP

Deposits slightly inched up….

Share of deposits in DFIs' fund base remained minimal due to the limitation in both the scope and scale of business[134]. The share of deposits in total funding inched up to 6.3 percent during CY21 compared with 6.25 percent in CY20.

However, borrowings remained the key source of funding and their contribution in asset base further increased over the year…

As the capital markets remain underdeveloped with DFIs having limited access, they mainly rely on borrowings from financial institutions to finance their assets. Borrowings recorded a robust growth of 33.7 percent in the reviewed year against 13.8 percent rise in CY20 **(Chart 6.1.5).** It mainly reflected the effects of SBP refinance schemes which accounted for 88.0 percent of the increase in borrowings. Moreover, DFIs reduced their clean borrowing and increased secured borrowings from SBP and interbank market so as to improve their

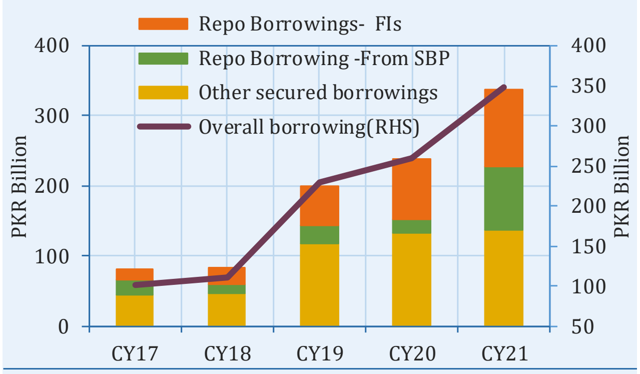
[132]The DFI with the mortgage refinance mandate is in an expansionary phase and has broadened customer base to conventional and Islamic banks, regional banks, microfinance bank, microfinance institution, Modaraba and NBFCs. Moreover, the DFI has developed a working model with banks where it will fund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

[133] LTFF and TERF show a combined increase of around PKR 3 billion in textile related businesses of DFIs during CY21.

[134] DFIs can only raise term deposits through issuance of Certificates of Investments (COIs).

margin as the secured borrowings are generally economical.

Chart 6.1.5.Borrowings increased sharply in CY21

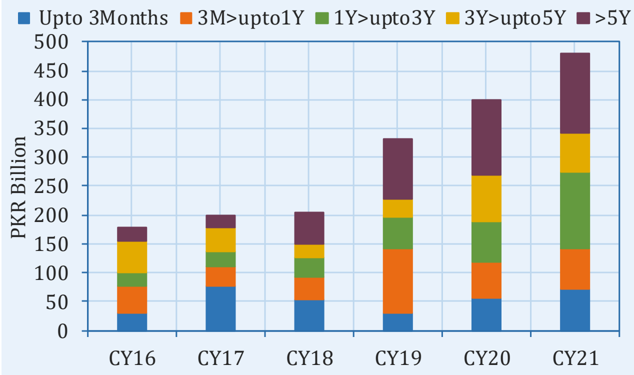


Source: SBP

The lack of stable funding sources result in wide maturity mismatches ….

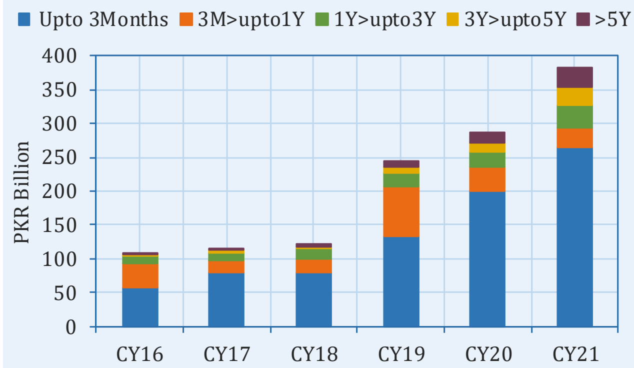
More than 75 percent of liabilities (borrowing and deposits) had a maturity of up to one year, whereas only 29.4 percent of assets (advances and investments) matured within a year, creating a huge maturity mismatch in up to one-year bucket. Moreover, 42.7 percent of assets maturing beyond three years were financed by only 14.2 percent of funds with similar maturity. The high cushion of equity though provided ample safeguard against rollover and refinance risks. However, the sector may need to make efforts to raise funding from stable sources including the capital market. The access to stable funding will also help the sector in efficient utilization of its capital, as the sector maintained quite high capital adequacy ratio. **(Chart 6.1.6 A & B).**

Chart 6.1.6A: Maturity wise breakup of earning assets



Source: SBP

Chart 6.1.6B: Maturity-wise breakup of funding sources



Source: SBP

Deceleration in interest as well as non-interest income squeezed profitability…

The profitability (after tax) of the DFIs amounted to PKR 12 billion in CY21 (PKR 13 billion in CY20). The contraction in profitability was mainly due to lower **NII** and non-interest income coupled with higher operating expenses[135] **(Chart 6.1.7).** The decline in NII reflected the impact of lower interest rate environment which prevailed in most part of CY21 that translated into slowdown in interest earnings on investments and advances.

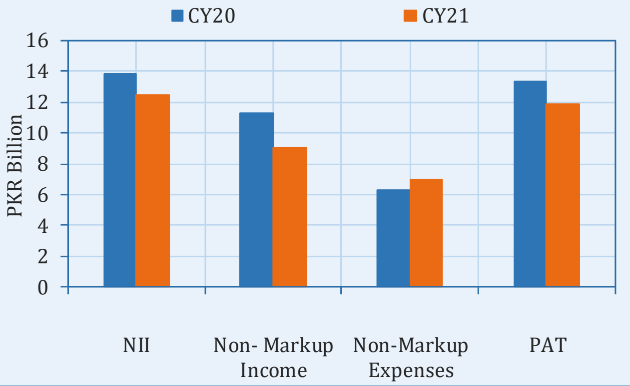
Besides, non-interest income also decelerated mainly owing to losses on trading of securities[136] as the increase in interest rates (in

135 The cost to income ratio inched up to 32.5 percent in CY21 compared with 25.2 percent in the same period last year.
136 DFIs recorded PKR 2.3 billion gain on sale of securities in CY20 (when interest rate witnessed significant cut in the wake of COVID pandemic) against net loss of PKR 0.1 billion in CY21 due to rise in interest rates toward the end of the year.

Q4CY21) resulted in revaluation losses on fixed income securities while equity prices also came down towards the end of the year.

Accordingly, earnings indicators also moderated in CY21. The after-tax ROA of DFIs contracted to 2.4 percent in CY21 from 3.3 percent in CY20, while ROE declined to 8.9 percent from 10.7 percent a year earlier.

Chart 6.1.7: Profitability decelerated in CY21

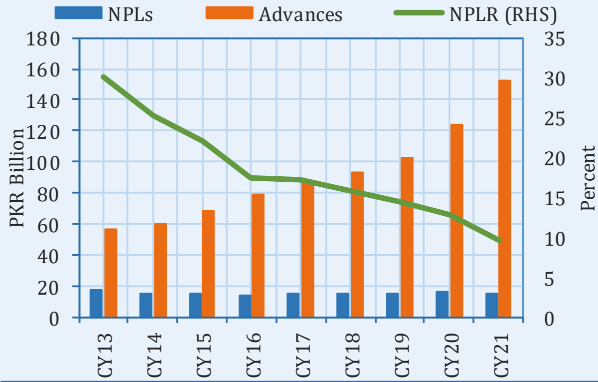


Source: SBP

Assets quality improved during the reviewed year…

The stock of NPLs decreased by PKR 1.2 billion to PKR 14.5 billion during CY21 (increase of PKR 0.8 billion in CY20). Resultantly, the infection ratio declined to 9.5 percent from 12.8 during the reviewed year due to relatively higher growth in advances and sluggish pace of NPLs. **(Chart 6.1.8)**. Moreover, improved earnings and repayment capacity of the corporate sector[137] and recovery of loans deferred /restructured under SBP's pandemic relief measures contributed to the decline in the infection ratio. Remarkably, provisions to NPLs ratio improved to 84.9 percent from last year's level of 77.8 percent.

Chart 6.1.8: Asset quality continues to improve



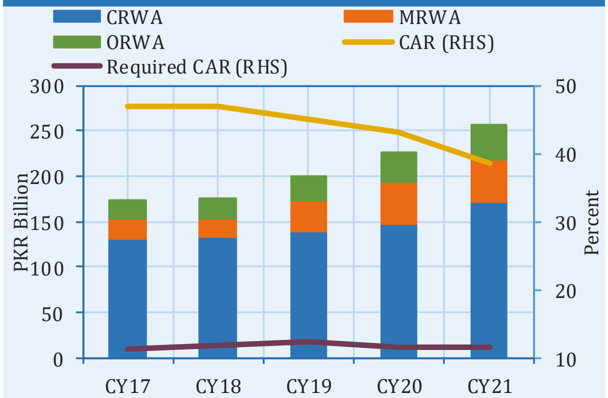
Source: SBP

Although CAR declined, however it remained far above the regulatory benchmark

The CAR of DFIs declined to 38.7 percent in CY21 from 43.1 percent in CY20. This contraction resulted from slow increase in Eligible Capital (2.08 percent growth in CY21) vis-à-vis noticeable expansion in **TRWA**.

Further analysis indicates that credit risk accounted for the major part of DFIs' regulatory capital requirement, as the **CRWA** constituted 66.6 percent of total RWA **(Chart 6.1.9).** CRWA increased significantly by 23.8 percent during CY21 due to pick up in financing activity.

Chart 6.1.9: CAR well above the required benchmark



Source: SBP

[137] Corporate sector posted robust growth in earnings (46.5 percent growth in profit) and debt repayment capacity during CY21. Please refer Chapter 7 for details.

There is a need to redefine the role of DFIs in economic growth…

DFIs were created to finance long-term infrastructure projects and facilitate the capital formation process in the economy. However, due to a number of reasons - both demand and supply side- most of the DFIs remain focused on investment and trading in marketable securities. The absence of stable sources of funding due to multiple structural issues (e.g. limited outreach of DFIs to capital market, etc.) and resultant reliance on costly interbank funding is a major hindrance in DFIs' project finance prospects. Moreover, the DFIs have gradually lost their competitiveness vis-à-vis banks to attract and retain investment and project finance professionals. While there is a need to shift DFIs' focus from investing activities to sustainable private sector project financing and investment banking, there is also a need to redress the underlying structural issues including development of capital market and promotion of saving and investment culture in the society through effective financial literacy programs. In order to remain viable, it is of utmost importance for DFIs to explore and build economical sources of stable funding and develop necessary investment banking expertise. These initiatives will not only aid in reviving their core business but also help in efficient utilization of capital and optimization of risk-return matrix.