Chapter 6.2: Non-Bank Financial Institutions

As economic agents adapted to living with the pandemic in its second year, most Non-Bank Financial Institution (NBFI) sectors were able to expand their asset base. The money market funds continued to drive growth in the asset management (AM) segment, which has the predominant share in the NBFI sector. After facing stress in the wake of the pandemic last year, lending NBFIs too posted revived performance as their assets expanded rapidly while delinquencies in their credit portfolio declined. Going forward, the emerging macro financial conditions especially in terms of economic activity, interest rates, and exchange rate dynamics will determine the growth and performance of NBFI sectors

NBFI sectors registered strong and broad-based growth in CY21, as the economy continued its struggle against the COVID-19 pandemic ...

NBFI sectors posted an increase of 19.0 percent in asset base during CY21. In line with their dominant market share and performance of last year, mutual funds and portfolios were the main drivers of the increase in the asset base of the NBFI sector[138]. Moreover, unlike last year's contraction in their asset base, NBFIs involved in the financing business[139] grew with Non-Bank Microfinance Companies (**NBMFCs**) and Investment Finance Companies (**IFCs**) mainly contributing to the increase. (**Table 6.2.1**).

The **AM**[140] segment continued to dominate the NBFI sector, and the market share of assets under management (**AUM**)[141] inched up from 78.5 percent in CY20 to 79.3 percent in CY21.

Table 6.2.1: Asset Profile of NBFIs

	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21
			PKR billion		
AMCs/IAs (own assets	**40**	**40**	**44**	**45**	**46**
Mutual Funds	724	802	985	1,087	1,192
Pension Funds	30	31	36	40	40
Portfolios	226	229	314	338	374
Total AUMs	**980**	**1,062**	**1,335**	**1,465**	**1,605**
RMCs	6	6	6	7	8
REITS	50	49	54	54	67
PE & VC Firms	0	0	0	0	0
PE Funds	7	7	8	7	10
Modarabas	54	51	51	54	57
Leasing Companies	11	11	6	5	5
Housing Finance Compa	-	-	-	-	0
IFCs	66	65	66	63	78
NBMFCs	126	122	129	137	146
Total Assets	**1,339**	**1,412**	**1,700**	**1,839**	**2,023**

Source: SECP

Asset Management (AM) Segment

Money market funds continued to dominate the Mutual Funds sector ...

The mutual fund sector is steadily growing as AUM grew by 21.0 percent in CY21. The growth in AUMs was due to both higher level of returns as

138 NBFIs for the purpose of this analysis include NBFCs, Real Estate Investment Trusts (REITs), and Modaraba Companies. As per the surviving section 282A of the repealed Companies Ordinance, 1984 (wherein Part VIIIA – consisting of sections 282A to 282N – does not stand repealed under the Companies Act 2017 and continues to be applicable on NBFCs), 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.

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

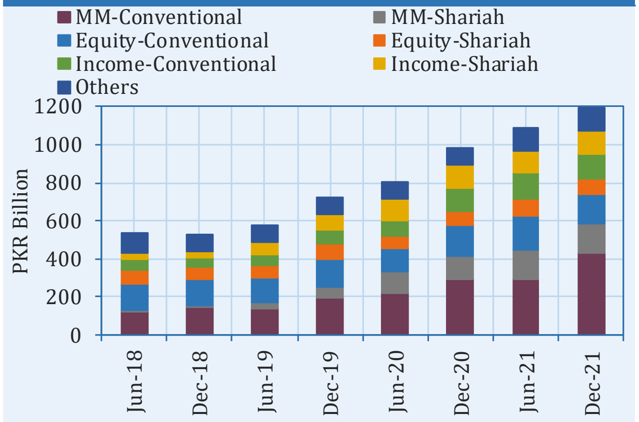
140 The Asset Management (AM) segment includes: Asset Management Companies (AMCs), Investment Advisors (Ias), REITs, Mutual Funds, Pension Funds, Private Equity (PE) Funds, and Discretionary/ Non-discretionary Portfolios.

141 Assets under Management (AUM) include assets of mutual funds, pension funds, and portfolios under management of AMCs/ Ias.

well as new investments as indicated by the increase in net sales in CY21. The sector still constitutes a relatively lower share of the overall financial sector (3.0 percent at end Dec-21) while the capital market has limited outreach, indicating that there is ample room for further growth.

The number of asset management companies/ investment advisors (**AMCs/IAs**) increased from 23 to 26 over the year under review and their own asset base grew from PKR 44 billion in CY20 to PKR 46 billion in CY21. On the other hand, a number of funds and plans, managed by these AMCs/IAs, increased from 227 to 285 in CY21 while the total AUM increased by PKR 206 billion to PKR 1,192 billion in CY21 mainly on the back of increases in money market funds. The trend of this growth was in line with the increased issuance of government securities to meet the fiscal needs as well as the beginning of monetary tightening in H2CY21. (**Chart 6.2.1**)

Chart 6.2.1: Composition of Mutual Funds

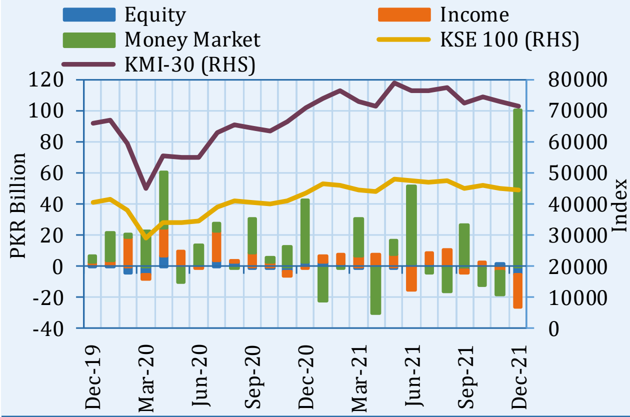


Source: SECP

Accordingly, the share of money market funds, in total AUM further increased to 49.2 percent in CY21 (41.9 percent in CY20).

While income funds also registered growth, equity funds declined by 2.7 percent (or PKR 6 billion) to PKR 235 billion in CY21 as indicated by its net sales. The fall in equity funds was consistent with trend of key indices such as KSE-100 index, which recorded upward movement in H1CY21 but declined in H2CY21. Even growth in Income Funds decelerated from 52.6 percent (or PKR 82 billion) in CY20 to 6.6 percent (or PKR 16 billion) in CY21; income funds stood at PKR 253 billion as of Dec-21. (**Chart 6.2.2**)

Chart 6.2.2: Net Sales of top three mutual funds

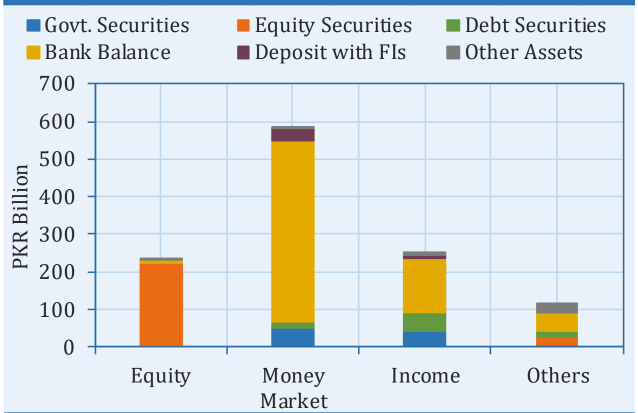


Source: MUFAP & PSX

The performance of KSE-100 Index remained mixed within CY21. While the market performance was encouraging in H1CY21, it declined in H2CY21 on the back of rising CAD and increasing inflationary expectation, which resulted in reversal in monetary policy by the central bank. Accordingly, as equity prices came under stress, equity funds registered a decline.

Overall risk profile of the mutual funds remained low…

Chart 6.2.3: Asset Allocation of Mutual Funds in CY21



Source: SECP

The asset allocation of mutual funds indicated that bank balances form a major portion of money market and income funds. Given the high share of bank balances, government securities, and fixed income bonds in money market funds, income funds, and other funds; the potential for buildup of systemic risk in the sector was minimal, as the domestic banking sector has strong capital and liquidity buffers to withstand stress scenarios (see the Chapter 3 and 4 on banking sector and its resilience against adverse situations for further details). (**Chart 6.2.3**)

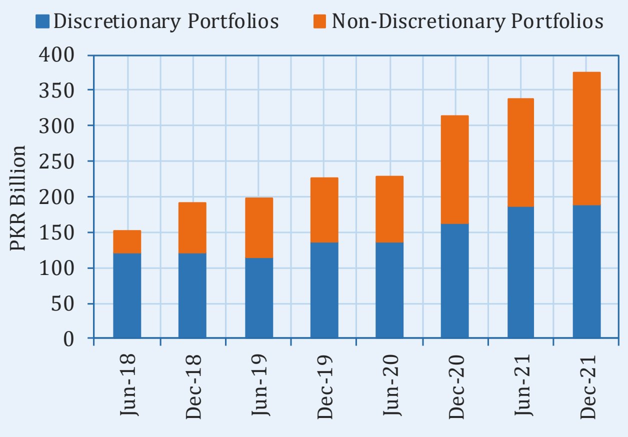
Furthermore, individuals constituted only 31.7 percent of total investments in the mutual fund sector during CY21; the rest was mostly contributed by institutional investors such as banks, insurers, other corporates, etc. Most institutional investors have a time-bound view on stocks along the investment portfolio is marked to market in their books. Thus, these investors can be more sensitive to the performance and stability of funds, implying that any unidirectional strategy on the part of such investors in the face of significant macroeconomic shocks may add to the volatility in the market. Nevertheless, mutual funds are subject to prudent concentration limits and risk management requirements from the regulators, which effectively check the buildup of concentrations and systemic risk.

The share of discretionary portfolios in total portfolios continued to decline…

Portfolios (Under Management)[142] increased by 19.2 percent to reach PKR 374 billion in CY21 (with increases in both discretionary and non-discretionary portfolios).

The rising momentum of economic activity after the pandemic again led to a decline in share of discretionary portfolios from 52.1 percent in CY20 to 50.4 percent in CY21. (**Chart 6.2.4**)

Chart 6.2.4: Portfolios classified by investment decision making



Source: SECP

Considerable activity was observed in the REIT sector …

Due to prioritization of the construction and housing sector by the government, along with more favorable regulation and streamlining of tax rates, there were encouraging developments in the Real Estate Investment Trust (**REIT**)[143] sector. Six new REIT schemes have been approved since Jun-21, bringing the total number of approved schemes to seven by end of CY21. Besides a rental REIT scheme which was registered in 2015, two new development REIT schemes offered units to investors and acquired properties in CY21.

However, since the two new schemes are development REITs, they will take some time to generate distributable income. The aggregate fund size of the three REIT schemes stood at PKR 67 billion as of Dec-21.

[142] 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.

[143] REITs are investment schemes that own and most often actively manage income-producing real estate. Through such schemes, investors may own, operate or finance income-generating property across various categories of real estate. (For further details, please see: REIT FAQs). (Accessed on April 18, 2022)

Table 6.2.2: Key heads of REIT Earnings

Description	Jun-19	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21
	PKR Billion					
Total Assets (Stocks)	47.0	49.5	52.0	54.4	58.1	60.0
Rental Income (HY)	1.7	1.7	1.1	1.4	1.5	1.7
Profit b/f change in fair value of Investment property (HY)	1.6	1.6	1.1	1.3	1.4	1.5
Change in fair value of property (HY Flows)	1.0	2.4	3.0	2.1	3.8	1.8
Profit b/f tax (HY)	2.5	4.0	4.1	3.4	5.2	3.2

Source: Financial Statements of REIT

The one rental REIT scheme navigated the pandemic successfully, which was reflected in the 23.2 percent increase in profit (before change in fair value of investment property) in CY21. This growth was in contrast to the 26.1 percent decrease in CY20 when management had to renegotiate tenancy contracts and offer rental waivers to their tenants to reduce turnover in the wake of mobility restrictions imposed to curb the spread of the pandemic (Please see previous FSR). Accordingly, the REIT was able to keep its occupancy levels above 90 percent in CY21 as well. In addition, the other key performance indicator i.e. weighted average lease expiry (**WALE**)[144] was around 3.2 years (3.3 years in the previous year). (**Table 6.2.2**)

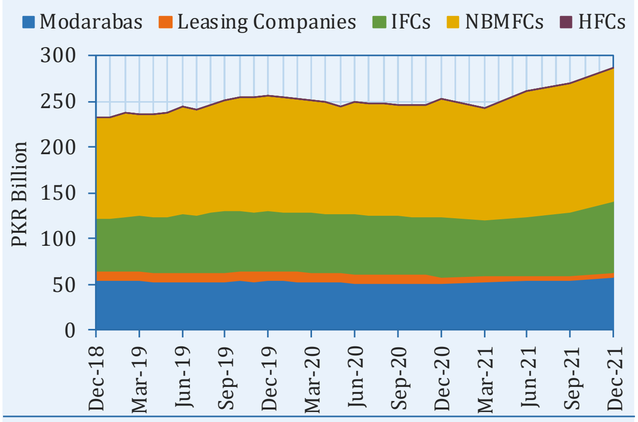
The REITs are prone to rising interest rate scenario, which makes yields competitive, delinquencies in the underlying rental portfolio, liquidity risks, and legal risks. Accordingly, the employment of effective risk management strategies remains important to contain the materialization of possible business risks.

Lending NBFIs Segment

The advances portfolio of Lending NBFIs was dominated by NBMFCs …

Lending NBFIs are the other segment of NBFI sector, holding 14.2 percent market share in the sector. This segment increased its asset base by 13.6 percent to PKR 287 billion in CY21. NBMFCs and IFCs were the main drivers of growth; these sectors also hold the leading market share of lending NBFIs at 50.9 percent and 27.2 percent, respectively. (**Chart 6.2.5**)

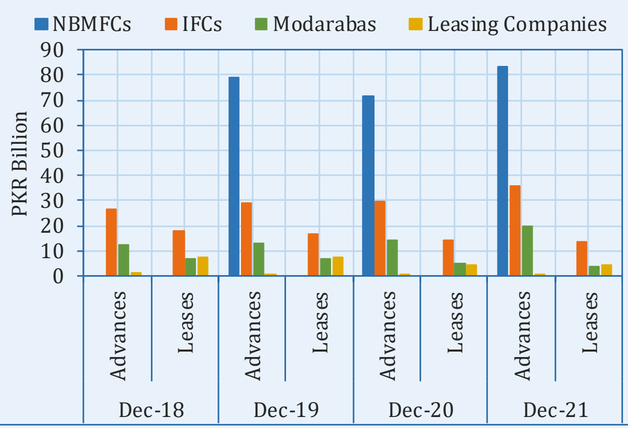
Chart 6.2.5: Assets of Lending NBFIs



Source: SECP

NBMFCs dominated the advances portfolio of lending NBFIs. The advances portfolio registered a growth of 19.7 percent in CY21. On the other hand, the leasing portfolio has been gradually tapering over the years. It may be noted that NBMFCs are not involved in the leasing business. (**Chart 6.2.6**)

Chart 6.2.6: Advances and Leases of Lending NBFIs



Source: Karandaaz and SECP

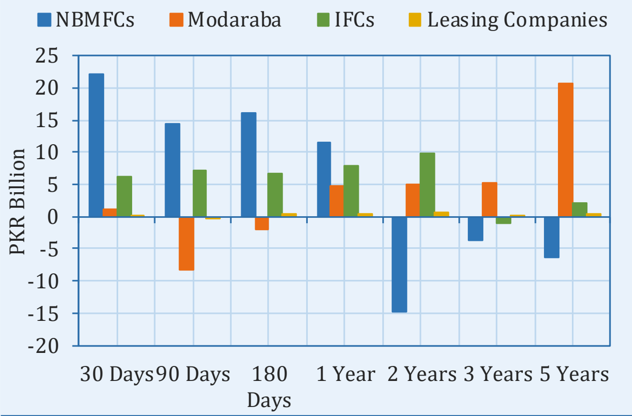
Lending NBFIs in general had comfortable liquidity profile …

Since lending NBFIs generally have limited access to ready market funding for asset-liability management, liquidity risk remained an important factor for the stability of these firms.

[144] 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

However, the maturity profile of assets and liabilities indicated that most of the sectors had comfortable maturity profile. Amongst lending NBFIs, Modarabas faced negative asset-liability mismatch within 90 days tenor; however, the extent of this gap was quite contained. Moreover, the Modarabas which mainly faced the gaps have adequate access to financing and backing of financially strong associates. (**Chart 6.2.7**)

Chart 6.2.7: Maturity Gap of Lending NBFIs



Source: SECP

A closer look at maturity mismatches for NBMFCs and IFCs implied that they were following a relatively risk-averse approach to cope with liquidity risks. NBMFCs may be constrained in their investment decisions due to the restrictions imposed on certain funds made available to them.

Borrowings mainly financed the growth in NBMFCs...

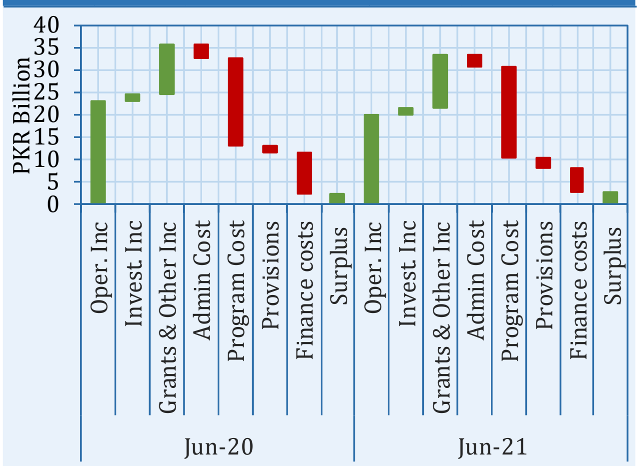
NBMFCs are non-deposit taking companies categorized under the Lending NBFI segment.

NBMFCs increased their asset base by 13.2 percent to PKR 146 billion in CY21. Their microcredit loans increased by 15.9 percent to PKR 83 billion aided by easing of lockdowns and other mobility restrictions in CY21, as economic activities resumed in the backdrop of effective pandemic control measures and promising traction in the vaccination drive during the year. As NBMFCs are unable to raise deposits, the increase in the asset base of PKR 17 billion was financed by an increase in borrowings and equity of PKR 11 billion and PKR 4 billion, respectively.

The classified assets of NBMFCs remained stable around PKR 5.2 billion in CY21; given the increase in credit over the year, the classified assets to outstanding financing ratio declined to 5.8 percent in CY21 (9.4 percent in CY20). The internal composition of the classified assets, however, changed over the year. The share of loss category - which requires 100 percent provisioning requirement - in classified assets increased to 56.3 percent (24.8 percent in CY20). Accordingly, NBMFCs provided higher amount of provisioning. Resultantly, the provisioning coverage ratio of the sector stood above 90 percent in CY21, thus indicating the reduced risk to the solvency of the sector from delinquent credit portfolio.

Despite the higher provisioning expense and program costs along with lower operating income, Surplus for the NBMFC sector remained stable at PKR 2.5 billion for the year ended Jun-21 (same for Jun-20) as it was supported by a decline in finance costs and increase in grants. (**Chart 6.2.8**)

Chart 6.2.8: Income & Expenditure for NBMFCs



Source: Financials of NBMFCs

The reversal in monetary policy stance towards the end of CY21 might have led to increased finance costs at the end of the year. If monetary tightening continues in the near term, it will lead to higher finance costs for NBMFCs, which may put pressure on the bottom line in the future.

In spite of the presence of around 30 companies in the NBMFC sector, it was heavily concentrated with three entities holding more than 60 percent market share (in terms of assets) in the sector. This difference in size of firms was, in part, due to the scope of the firms in terms of range of activities and extent of geographical outreach to various districts of Pakistan. Some entities were limited to one or two districts, others operated on a national level.

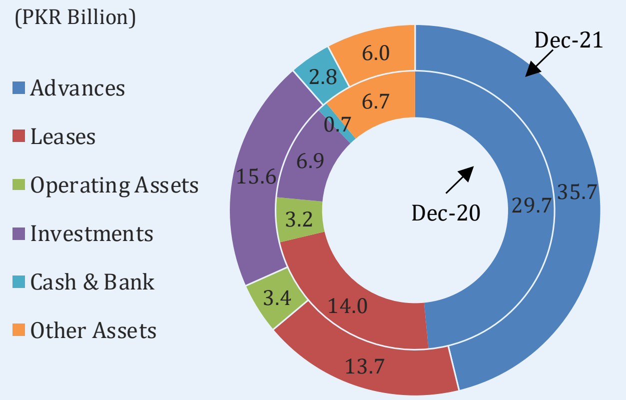
The SECP being the apex regulator continually strives to strengthen the regulatory framework for NBFMCs so that they can operate in a sustainable manner. In this regard, SECP issued enhanced guidelines on risk management for such large NBMFCs which have a gross loan portfolio of PKR 500 million or more. These guidelines, inter alia, included the requirement to formulate funding and liquidity management policies to ensure the achievement of NBMFCs' performance objectives in a sustainable manner, which, in turn, ensured financial soundness of the sector.[145]

IFC sector continued to be dominated by a couple of companies ...

The asset base of the IFC sector increased by PKR 16 billion (25.7 percent) to PKR 78 billion in CY21 (PKR 0.4 billion increase in CY20). Investments and advances, which increased by PKR 9 billion and PKR 6 billion, respectively, were the main contributors to the assets' growth.

While some new players entered the IFC sector, it was still dominated by a couple of firms, which hold around 80 percent of the market share of the sector. Accordingly, these firms were also the main drivers of growth in the sector during the reviewed year.

Chart 6.2.9: Break-up of Assets of IFCs



Source: SECP

Most of the sector's assets were concentrated in earning assets i.e. advances, investments, and leases, which together accounted for 84.1 percent of total assets. (**Chart 6.2.9**)

To finance their asset base, IFCs mainly relied on borrowings and equity, which increased by 50.5 percent and 20.5 percent to PKR 27 billion and PKR 38 billion, respectively. Their reliance on deposits remained quite limited as only one firm raised significant deposits over the years. Its deposit-to-equity ratio stood at 61.2 percent in CY21. Most other firms in the sector were not utilizing this funding option, which required regulatory permission that is only be granted after certain regulatory conditions are met[146].

Consequently, the debt-to equity (**D/E**) ratio was 0.96 times in CY21, signifying that the IFCs had lower leverage and faced lower risks as most activities were financed through shareholders' funds.

Modarabas[147]appreciably improved their performance over the previous year...

The Modarabas are Islamic institutions, which are permitted to conduct financing business, provided it is Shariah-compliant and approved by the Religious Board of Modarabas.[148] For example, Modarabas can undertake Ijarah (leasing), Murabahah (cost-plus sale), Musharaka

[145] SECP's SRO1605 (I) 2021 – Notification for amendments to NBFC&NE Regulations, 2008-NBMFCs and Housing Standards. (Accessed on March 16, 2022)
[146] Please see sections 4, 14, 15A, 17A of Non-Banking Finance Companies and Notified Entities Regulations, 2008
[147] The financial year for Modarabas ends on June 30
[148] JamaPunji's Knowledge Centre-Modaraba. (Accessed on April 26, 2022)

(partnership), Diminishing Musharaka, Salam (deferred delivery sale) and Istisna financing activities; invest in the stock market; trade halal commodities; conduct project financing activities; manufacture items; among other activities.

The asset base of the Modarabas increased from PKR 51 billion to PKR 57 billion in CY21 (growth of 11.4 percent), which was broad-based with increases in advances, operating assets, and bank balances.

In the second year of the pandemic, the Modaraba sector was able to turn around its performance. The financing portfolio climbed significantly by PKR 5 billion to PKR 19 billion in CY21. While classified assets for the sector declined from PKR 4 billion in CY20 to PKR 3.5 billion in CY21. Thus, infection ratio also lowered in CY21.

Revenue for the year increased from PKR 14.5 billion in Jun-20 to PKR 16.5 billion in Jun-21.

Along with better cost management and efficiency in operations, the increased revenue led to a turnaround in the bottom line. Expense-to-revenue ratio declined from 42.1 percent in Jun-20 to 36.0 percent in Jun-21 as operating and administrative expenses slightly declined during the year. Resultantly, as against a loss (before tax) of PKR 2 billion for the year ended June 30, 2020, the Modaraba sector posted aggregate pre-tax profit of PKR 1.4 billion for the year ended June 30, 2021.

Table 6.2.3: Key Financial Soundness Indicators of Modaraba sector

Description	Jun-20	Jun-21
	Percent	
Equity to Assets	34.6	47.9
Return on Asset (BT)	-3.9	2.6
Return on Equity (BT)	-10.8	6.3
Net Profit Margin	-14.0	7.5
Current Ratio	68.2	94.6
Debt to Equity Ratio	188.2	107.7
Expense to Revenue Ratio	42.1	36.0

Source: Financial Statements of Modarabas

Consequently, ROE (before tax) improved to 6.3 percent in Jun-21. (**Table 6.2.3**)

While not all Modarabas are subject to minimum equity or capital adequacy requirements, nevertheless, the aggregate equity-to-asset ratio of the sector increased further as some payables to associated entities were converted into equity,[149] indicating the strengthening in the Modarabas' cushion to absorb losses.

Going forward, the withdrawal of tax exemption on Modaraba sector in 2021will affect the sector's profitability and dividend distribution to the shareholders, which may have a bearing on the future outlook of the sector and possible implications for future investments in the sector's certificates.[150]

The government's initiatives to promote low-cost housing led to the introduction of housing finance companies ...

Given the unmet housing demand in the country and the government's initiative to promote the housing sector, three housing finance companies were established over the last two years to cater to housing finance needs. The asset base of the sector stood at PKR 0.2 billion as of Dec-21 as the companies gradually became operational. The government's supportive policies in this area can lead to significant growth in the housing finance sector over the coming years.

[149] See Regulation 17 of Modaraba Regulations, 2021

[150] Finance Act, 2021

Interconnectedness between the NBFIs and the banking sector remained contained…

Table 6.2.4: Asset Management segment's flow of funds & exposure to the banking sector

Description	Dec-19			Dec-20			Dec-21		
	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)
	PKR billion		Percent	PKR billion		Percent	PKR billion		Percent
1. Equity of AMCs/ IAs	29	14	50.5	32	17	53.4	33	17	53.0
2. Assets Under Management of AMCs/ IAs	980	762	77.7	1,335	1,026	76.9	1,605	1,257	78.3
3. Mutual Funds size	724	13	1.8	985	16	1.6	1,192	22	1.8
4. Mutual Fund exposure in Financial Institutions	358	343	95.8	541	510	94.3	724	674	93.0
5. Mutual Funds exposure in top 20 equity securities	81	6	7.9	76	9	12.1	75	9	12.5
6. Mutual Funds exposure in top 10 debt securities	17	6	32.2	20	6	29.6	20	7	36.7
7. Top 20 holders of mutual fund units	97	6	6.2	359	205	57.2	194	14	7.1

*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

Source: SECP

The Banking sector continued to have significant stake in the mutual fund sector in terms of equity in associated AMCs/IAs. Given the relative size of the banking sector and its ample equity to withstand shocks vis-à-vis the size of AUM of AMCs/ IAs and the nature of the mutual fund sector's risk profile, any probability of buildup and transfer of systemic risk from AM segment to banks remained minute.[151] On the other hand, given that banks owned controlling stakes in AMCs/IAs and a significant share of AUM was placed with banks, the stability of banks, along with their continued sponsorship support to their affiliated AMCs/IAs, remained crucial for the stability of the AM sector. Incidentally, since banks having associated AMCs/ IAs were adequately capitalized and the banking industry in general had ample capital and liquidity cushions (with CAR at 16.7 percent and liquid assets to deposits ratio of 76.7 percent as of Dec-21), the probability of emergence and transfer of any systemic risk to the AM segment was minimal. (**Table 6.2.4**)

The ratio of mutual funds' exposure in banks to total mutual fund assets rose from 51.8 percent in CY20 to 56.5 percent in CY21 – almost all of the exposure was in adequately capitalized banks. While the mutual fund exposure in NBFIs in terms of total mutual fund size was insignificant i.e. 0.5 percent in Dec-21.

Investments in mutual funds by their associated banks, DFIs and AMCs constituted 3.6 percent of total investments as of Dec-21. Similarly, Other banks/DFIs' investment in mutual funds as percentage of total investment in mutual funds was only 1.1 percent as of Dec-21.

In addition, concentration risk in terms of mutual funds reliance on a few large investors (gauged by the share of top 20 investors in MF units) was minimal (around 12 percent) in the AM segment.

One other channel of interconnectedness between NBFIs and banks was a microfinance intermediary, categorized as an IFC, which partly borrows from banks and provides financing to NBMFCs. Since the quantum of NBMFCs' classified assets as well as banks'

[151] Banks' asset size of PKR 30.0 trillion and equity base of PKR 1.7 trillion against AUM' total size of PKR 1.6 trillion

exposure on this intermediary IFCs was quite contained vis-à-vis ample capital cushions of banks, the possible transfer of cross-sectoral vulnerabilities to the banking sector was minimal. In addition, NBMFCs have adequate cushion to absorb losses (equity to assets ratio at 22.0 percent in CY21).

Going forward, the performance of NBFIs sector depends on the trajectory of global commodity prices, geo-strategic tensions in Eastern Europe, domestic political stability, and monetary policy changes in advanced economies (in response to rising inflation). These key factors will have discernable bearing on macro financial conditions such as interest rate and exchange rate as well as the level of economic activity in the county. In the face of elevated interest rates, the mutual fund business may continue to witness more activity in money market and income funds. Similarly, the performance of lending NBFIs will mainly depend upon the domestic economic conditions, especially the policy rate and level of economic activity which will influence the demand for credit as well as the repayment capacity of their borrowers.