Chapter 6.1: Development Finance Institutions (DFIs)

Asset base of DFIs witnessed significant expansion on the back of substantial borrowing led investments in government securities, as the access to OMOs injections opened up a new avenue of liquidity for DFIs. Advances portfolio also maintained growth momentum as the SBP refinance schemes supported the lending capacity of DFIs. However, the overall asset mix further skewed towards risk-free government securities. DFIs recorded considerable growth in profitability owing to their improved net-interest income and non-interest income. Due to the stronger increase in risk-weighted assets vis-à-vis capital base, CAR of the sector marginally contracted; however, the ratio remained well above the regulatory benchmark.

DFIs registered phenomenal expansion in asset base on the back of record borrowings that were mainly invested in government securities …

The asset base of DFIs more than doubled (165.7 percent growth) during CY22 - considerably higher than the 22.6 percent growth witnessed in previous year **(Table 6.1.1)**. The sharp increase in asset base was mainly due to investment in government securities financed through borrowings from SBP and other financial institutions, while deposits showed meager growth.

SBP's permission for DFIs to participate in OMOs[132] was a significant development, which facilitated the sector's investments. Moreover, funding of the DFI sector was augmented by borrowing from commercial banks, as they substantially increased their lending to non-bank financial sector towards the end the year to improve their advances to deposit ratio[133]. The OMO facility can facilitate the day-to-day asset-liability management of DFIs as they face quite a constrained funding sources due to limited mandate on deposit mobilization[134], limited outreach of capital market, and low savings rates in the country. These factors, along with other structural issues, are the leading reason behind DFIs' inability to perform their primary objective i.e. to contribute in the capital formation and economic development of the country by extending long-term financing. Accordingly, the DFIs in general focus on investment in securities, interbank and capital market activities, and limited financing business, while equity and borrowings remain the mainstay of funding.

Table 6.1.1: Key Variables & Financial Soundness Indicators

	CY19	CY20	CY21	CY22	Growth for CY22
	PKR Billion				Percent
Investments (net)	240.2	287.0	338.4	1,168.0	245.1
Investments in Govt. Securities	183.2	220.7	263.1	1,085.5	312.5
Advances (net)	91.9	111.2	140.4	188.0	33.9
Total Assets	377.1	439.3	538.7	1,431.0	165.6
Borrowings	229.0	260.5	348.3	1,223.0	251.1
Deposits	12.0	27.4	34.0	38.1	12.0
Equity	117.0	131.7	136.4	145.0	6.3
NPLs	15.0	15.8	14.5	14.6	0.8
	Percent				
CAR	44.9	43.1	38.7	36.5	
NPLs to Advances	14.5	12.8	9.5	7.3	
Net NPLs to Net Advances	4.2	3.1	1.6	0.9	
ROA (After Tax)	2.7	3.3	2.4	1.6	
ROE (After Tax)	7.2	10.7	8.9	10.1	
Cost to Income Ratio	32.4	25.2	32.5	26.9	
Liquid Assets to ST Liabilities	97.6	97.5	98.0	98.2	
Advances to Deposits	763.8	405.1	412.6	493.4	

Source: SBP

132 SBP allowed all DFIs to participate in Open Market Operations through DMMD Circular No. 11 of 2022.
133 Government of Pakistan, through Finance Act 2022 had imposed higher tax for investment in government securities by banks, linking it to ADR. (ADR<40 percent; 55 percent tax rate, ADR40 -<50 percent; 49 percent tax rate, ADR>50 percent; 39 percent tax rate). This tax policy has been withdrawn for tax year 2024.
134 Unlike commercial banks, DFIs cannot raise demand deposits.

DFIs posted phenomenal growth in their investment portfolio as the fresh investment mainly flew to short-term government securities ….

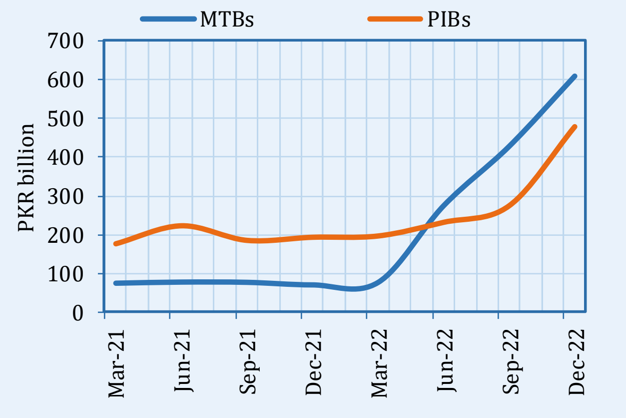
Investments displayed phenomenal growth of 245.1 percent during CY22 and their share in asset base rose to 81.7 percent (62.8 percent in CY21). Almost the entire fresh investment (99.1 percent of the increase) went to government securities which grew by 312.5 percent to PKR 1,085.5 billion and their share in total investment increased to 92.6 percent (76.8 percent in CY21). On the other hand, investment in equity stock grew by 12.2 percent to PKR 50.1 billion.

Substantial amount of investment was made in MTBs and floating rate PIBs due to short-term nature of underlying borrowings and rising interest rate environment….

Further analysis shows that the major increase in government securities occurred during later part of CY22 and MTBs accounted for two third of this increase followed by floating-rate PIBs. This development reflected both (a)- the access to short-term OMOs and bank funding that necessitated the investment in matching short-term bills to minimize liquidity risk, and (b)- rising interest rate scenario (interest rate increased by 625 bps over the year) that entailed revaluation losses on longer term fixed investments bonds. Therefore, DFIs preferred to invest in MTBs and floating rate PIBs that have relatively lower sensitivity to changes in interest rates.

The portfolio of MTBs posted a massive increase of PKR 537.1 billion to reach PKR 607.3 billion by end Dec-22; while, with an increase of PKR 286.1 billion, overall stock of PIBs touched PKR 478.2 billion **(Chart 6.1.1)**. Accordingly, the portion of MTBs in overall federal government securities investment jumped to 55.9 percent in CY22 from 26.7 percent reported in CY21.

Chart 6.1.1: Stock of MTBs and PIBs

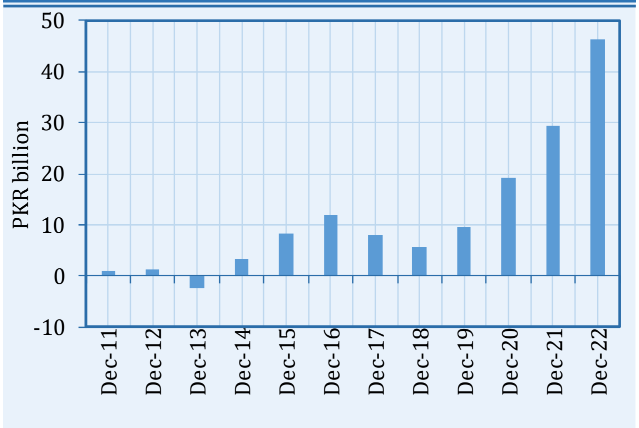


Source: SBP

Advances grew at an accelerated pace as the SBP refinance schemes augmented the liquidity and lending capacity of DFIs….

Growth in advances in CY22 accelerated to 33.9 percent compared to 26.3 percent seen in CY21 **(Chart 6.1.2)**. Although advances increased by PKR 47.6 billion over the year to PKR 188.1 billion, their share in the overall asset base declined to 13.1 percent (26.1 percent in CY21) due to higher growth in investments. The increase in advances was mainly supported by SBP's long-term refinance schemes with fresh funding under LTFF (PKR 20.7 billion), Renewable Energy (PKR 3.8 billion) and TERF (PKR 8.0 billion).

Chart 6.1.2: Flow in Advances (net)



Source: SBP

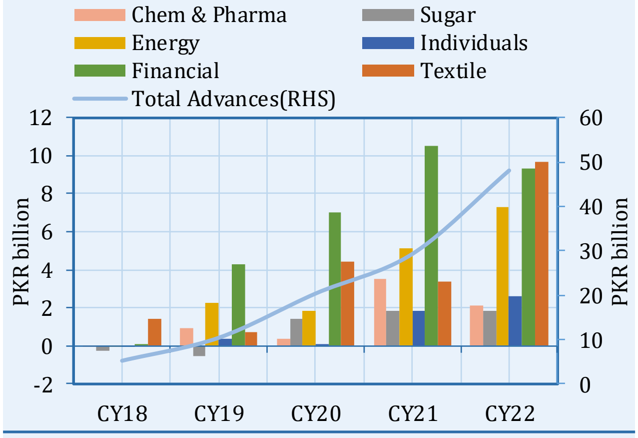
Corporate sector received the major share in financing…

In line with its share in overall loan portfolio of DFIs (70.2 percent), corporate sector remained the major user of loans extended by DFIs during the year under review. Large corporate firms availed additional financing of PKR 35.4 billion during CY22 – around 64 percent of the fresh loans were obtained by corporate sector for fixed investment purposes followed by working capital, as the working capital needs were also augmented by higher inflation and commodity prices.

Growth in advances remained broad based …

Sector wise assessment depicted that rise in advances was contributed by different sectors. Textile was the major contributor followed by Financial, Energy, Chemical & Pharmaceuticals, Sugar and Cement **(Chart 6.1.3)**.

Chart 6.1.3: Sector-wise flow in advances



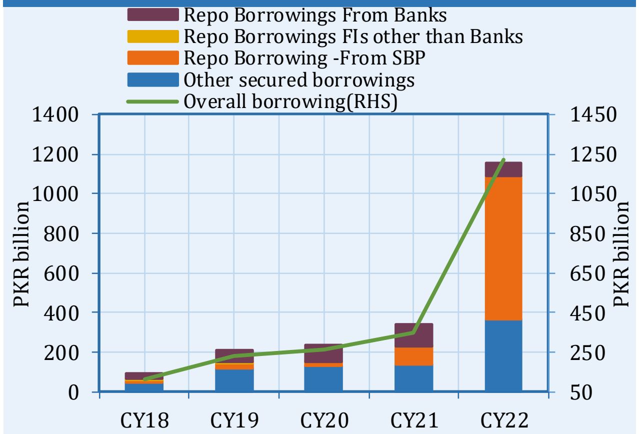
Source: SBP

Borrowing was the predominant source of funding to finance the expansion in asset base ……

For their funding needs, DFIs generally rely on interbank markets to finance their assets. However, with the availability of financing through OMOs during CY22, DFIs availed significant amount of this facility towards the end of the year. Resultantly, total borrowing from SBP surged to PKR 760.9 billion by end CY22 compared to a mere PKR 114.8 billion in CY21.

During the year under review, borrowings from financial institutions witnessed significant increase, particularly in H2CY22. The interbank repo borrowing from banks and financial institutions dropped by 41.9 percent to PKR 63.7 billion during the year. However, DFIs' other secured borrowing phenomenally increased (by 194.0 percent) to PKR 332.2 billion, as commercial banks extended substantial loans to the non-bank financial sector including DFIs to improve their ADR. **(Chart 6.1.4)**.

Chart 6.1.4: Composition of borrowings of DFIs

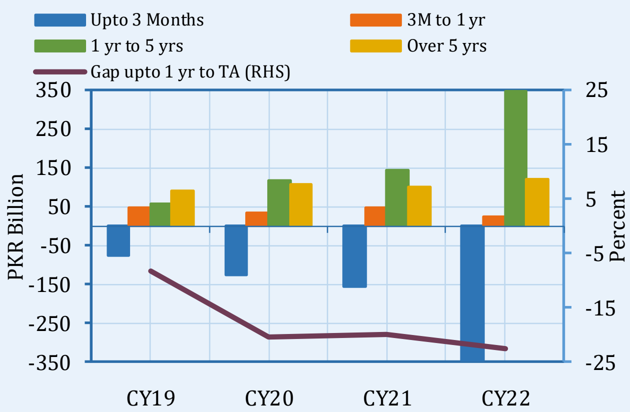


Source: SBP

Liquidity indicators of the DFIs sector witnessed improvement, though the maturity mismatch slightly increased …

Maturity-wise breakup reveals that major part of assets and liabilities have shorter maturity, i.e. around 57 percent of assets and 90 percent of liabilities mature within one year. The maturity mismatch in this time bucket slightly increased over the year to 22.5 percent of total assets (from 20 percent in CY21) as the sector heavily relied on short-term borrowing to finance the asset base **(Chart 6.1.5)**. However, ample availability of liquidity cushion in the form of low-risk assets abated the concerns of maturity mismatch, as the share of liquid assets in total assets increased significantly to 77.9 percent (54.7 percent in CY21). Furthermore, liquid assets to short-term liabilities ratio largely remained stable at 98.2 percent.

Chart 6.1.5: Maturity gaps between assets & liabilities



Source: SBP

While majority of earning assets had longer maturity, their repricing maturity was relatively shorter, indicating lower sensitivity to interest rate changes ...

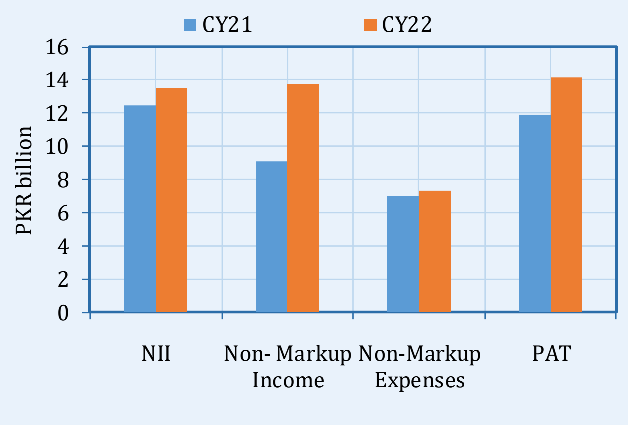
Segment wise break up of loans showed that the fixed investment loans to large corporate firms and SMEs were around 53 percent of total loans while 44 percent of government securities comprised PIBs at end Dec-22. However, maturity analysis in terms of remaining time to repricing of assets revealed that a major portion of the loans and investments had relatively shorter maturity. That is, 52.3 percent of advances were repricing within three months and 11.3 percent in three months to one year, while 73.6 percent of investments were repricing within three months and 20.4 percent in three months to one year.

Profitability surged by virtue of robust growth in both net interest and non-interest incomes ...

Profit after tax (PAT) of DFIs increased by 18.8 percent to PKR 14.1 billion in the year under review (PKR 11.9 billion in CY21), owing to growth in both net interest income and non–interest earnings. While gross income posted strong growth of 26.5 percent, operating expenses grew at a muted pace i.e. 4.9 percent. However, tax charges of the sector on aggregate basis inched up to 23.3 percent of pre-tax profit (20.2 percent in CY21).

Detailed analysis shows that major boost to gross income came from non-interest income which accelerated by 51.1 percent – particularly supported by a significant rise in dividend income and trading gains on stocks and PIBs. Net Interest Income (NII) posted relatively contained growth as growth in the asset base mainly occurred during the latter part of CY22 and its impact had not fully materialized in income by the end of the year. On the other hand, interest expense grew at a faster pace as the impact of rise in interest rates translated onto short-term borrowings and deposits relatively early as compared to assets (especially loans and long-term investments), which reprice according to their respective terms and conditions **(Chart 6.1.6).** Accordingly, net interest margin (NIM)[135] of the DFI sector contracted over the year to 1.6 percent from 2.6 percent in last year.

Chart 6.1.6: Earnings of DFIs in CY22



Source: SBP

Since the growth in income was volume driven, bottom line indicator ROA showed contraction, while ROE improved ...

With substantial buildup in asset base vis-à-vis earnings, after tax return on assets (ROA)

135 NIM is defined as = NII / average earning assets.

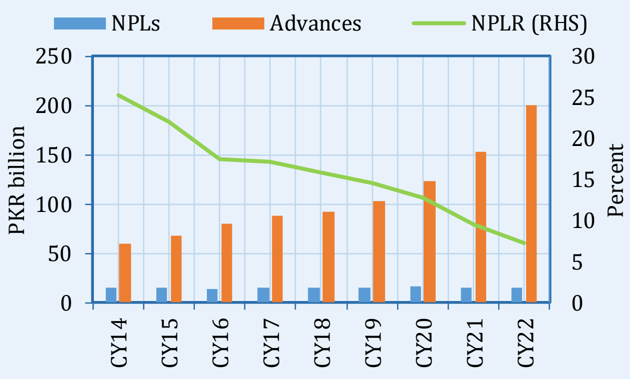
declined to 1.6 percent during current year (2.4 percent in CY21).

On the other hand, return on equity (ROE) improved to 10.1 percent during the reviewed year (8.9 percent in preceding year) due to robust earnings and modest growth in equity, as the growth in asset-base was mainly in risk-free assets, which enabled DFIs to support this strong expansion with relatively slower growth in capital base.

Asset quality indicators improved owing to increase in advances and contained growth in NPLs ...

Infection ratio of the DFI sector, over the years, has shown improvement on the back of growth in advances, contained delinquencies and recoveries of non-performing loans (NPLs). NPL to loans ratio maintained its improving (i.e. declining) trajectory during reviewed year and shrunk to 7.3 percent from 9.5 in CY21 **(Chart 6.1.7)**. As against a marginal 0.8 percent increase in NPLs to PKR 14.6 billion, DFIs set aside higher amount of provisioning to cover loan losses. Thus, the provisioning coverage improved to 87.9 percent by end CY22 (84.9 percent in last year). Accordingly, Net NPL to net loans and capital impairment ratios declined over the year to 0.9 percent (from 1.6 percent) and 1.2 percent (from 1.6 percent), respectively.

Chart 6.1.7: Asset quality improved amid growth in advances



Source: SBP

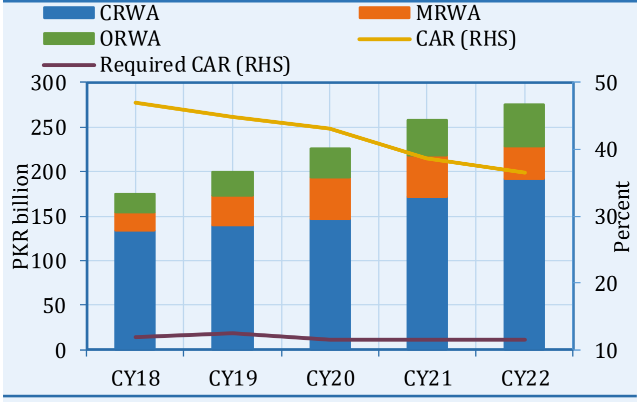
CAR of DFI sector posted a nominal decline, however, the ratio still remained considerably higher than the minimum regulatory benchmark...

CAR of DFI sector normally remains well above the required benchmark due to strong capital base and risk averse business strategy as DFIs mainly rely on investment in risk-free government securities vis-à-vis financing.

During the year under review, CAR decreased slightly to 36.5 percent (38.7 percent in previous year). Nonetheless, the ratio remained considerably higher than the regulatory requirement of 11.5 percent **(Chart 6.1.8)**. The marginal decrease in CAR was apparently due to faster increase in RWAs (i.e. 7.0 percent) vis-à-vis the increase in eligible capital (i.e. 1.1 percent).

Further analysis of RWAs reflects positive momentum in financing activity, as credit RWAs increased by 12.1 percent. In tandem with growth in business volume and incomes, operational RWAs also surged by 18.1 percent because of expansion in gross income. However, market RWAs decreased by 20.8 percent owing to shift in investment pattern of DFIs towards short-term securities and floating PIB which have lower sensitivity to interest rate risk and entail lower capital charge. Relative share of credit, operational and market risks in RWAs remained 69.8 percent, 16.7 percent and 13.4 percent, respectively.

Chart 6.1.8: CAR stays well above the required benchmark



Source: SBP

...Way forward for DFIs – a need to redefine the role

DFIs were set up with the objectives of development finance and promotion of capital formation in the economy. However, due to a number of challenges, DFIs are constrained to follow a conservative business strategy of investing and trading in risk-free and marketable securities. Besides, idiosyncratic business considerations of the institutions, these challenges include some deep-rooted structural issues as well e.g., restricted outreach of capital market, low saving rate in the country, tough competition from banks and limited mandate for deposit mobilization, absence of funding support from government or international development agencies, and relatively low demand for long-term financing in the market due to prevailing economic challenges and uncertainties.

During the year under review, DFIs showed some growth in long-term financing with support of SBP's refinance schemes. However, with the decision of linking LTFF rate to policy rate[136] and subsequent instruction for reduction in the gap between both rates[137], the repayment capacity of borrowers and the asset quality of DFIs may face pressures.

136 SBP linked LTFF rate to policy rate through IH&SMEFD Circular No. 11 of 2022.

137 Gap between policy rate and LTFF reduced by SBP through IH&SMEFD Circular No. 13 of 2022.