# 4 Performance of Non-Bank Financial Institutions

The Non-Banking Financial Institutions (NBFIs) work parallel to the banking sector to mobilize savings in the economy as well as to provide specialized financing facilities. Financing activities of this sector have grown by 20.1 percent in FY03 as compared to a mere 5.4 percent in FY02, supplying an incremental assets of Rs 42.9 billion. The share of NBFIs assets in the total assets of the financial sector is around 6.3 percent.

In its efforts to strengthen the regulatory framework and provide an enabling operating environment for the NBFIs under its purview, SECP has worked towards restructuring the NBFIs sector since it took over regulatory responsibilities from SBP. One of the major objectives of the restructuring plan was the creation of the NBFC concept. A Non-Banking Finance Company[1] can undertake all business activities relating to financial services, except for core commercial banking functions and insurance, subject to fulfillment of the prescribed criteria particularly with respect to minimum equity. The main objective of the implementation of the NBFC concept was to consolidate the NBFIs sector by allowing multiple business activities under one umbrella so that a whole variety and range of financial products tailored to the needs of the customers can be offered through a one-window operation.

Needless to say, a well-developed NBFI sector is an important component of developing an efficient financial system.

## 4.1 Structure of NBFIs

The consolidation process which was initiated in FY00 is still in progress as organizations across and within each sector continued to strengthen their capital base by joining hands with each other.

NBFIs have traditionally been categorized into 8 groups, according to their main business focus. The list of these NBFIs in their respective groups is given in **Annex 1.2**. Wide variations exist within and across these groups in terms of their size. The asset shares of all these institutions in overall NBFIs assets are presented in **Table 4.1**.

**Table 4.1: Assets of NBFIs**

| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| Assets (billion Rs) | 240.0 | 202.2 | 213.1 | 256.1 |
| Growth rate (percent) | | -15.8 | 5.4 | 20.1 |
| Share in assets of financial sector | 8.1 | 6.5 | 6.0 | 6.3 |
| ***Asset shares (percent)*** | | | | |
| DFIs | 38.1 | 30.2 | 32.2 | 30.9 |
| Leasing companies | 17.0 | 23.7 | 21.7 | 17.9 |
| Investment banks | 17.3 | 13.9 | 12.7 | 13.5 |
| HFCs | 9.3 | 11.7 | 10.5 | 8.4 |
| Modarabas | 6.4 | 7.7 | 8.2 | 6.3 |
| Mutual funds | 10.7 | 12.0 | 13.8 | 21.9 |
| VCCs | 0.4 | 0.2 | 0.1 | 0.3 |
| Discount houses | 0.8 | 0.7 | 0.7 | 0.8 |

The skewed distribution of assets with respect to DFIs has changed significantly since FY90,[2] however given its scale of operations and large capital base,[3] it is still the largest group in terms of assets and has continued to retain this position in FY03, though the actual share tends to fluctuate (see **Table 4.1**). DFIs are followed by mutual funds whose share in total assets has shown a healthy growth over FY02, due to which they have taken over the second place from leasing companies. Investment banks retained their fourth place in FY03 whereas the share of housing finance companies has declined during the year under review. Modarabas which ranked sixth in terms of asset size in FY00 have shown considerable rise until FY02 before recording a decrease of 1.9 percentage points during FY03, whereas venture capital companies have shown nominal incremental activity in FY03. Apart from business activities, on-going process of mergers/acquisitions is one of the contributing factors to the changes in assets share of these institutions.

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[1] NBFCs include all NBFIs except DFIs and Modarabas.
[2] Details in 'Pakistan: Financial Sector Assessment 1990-2000'.
[3] Interestingly enough, Modarabas have a comparable capital base but a smaller share in total assets as compared to DFIs.

On the other hand, an analysis of the loans and advances for NBFIs show the biggest share to be that of leasing companies with DFIs and housing finance companies in the second and third place respectively (see **Table 4.2**).

In terms of mobilization of resources, the deposit base of the NBFIs is detailed in **Table 4.3**, showing that deposits have registered a healthy growth of 13.9 percent in FY03 compared to only 2.2 percent in FY01. The funds mobilized by NBFIs form 2.4 percent of the total deposits of the financial sector.

**Table 4.2: Advances of NBFIs**

| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| Advances (billion Rs) | 107.6 | 80.5 | 73.6 | 74.2 |
| Growth rate (percent) | | -25.2 | -8.6 | 0.8 |
| Share in advances of financial sector | 10.8 | 8.1 | 7.4 | 6.3 |
| **Advances shares (percent)** | | | | |
| DFIs | 41.8 | 25.4 | 25.0 | 23.9 |
| Leasing companies | 25.0 | 39.4 | 41.1 | 44.9 |
| Investment banks | 18.6 | 15.5 | 13.7 | 10.4 |
| HFCs | 10.6 | 14.3 | 14.3 | 14.9 |
| Modarabas | 4.0 | 5.4 | 5.9 | 5.9 |

**Table 4.3: Deposits of NBFIs**

| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| Deposits (billion Rs) | 84.2 | 40.9 | 41.8 | 47.6 |
| Growth rate (percent) | | -51.4 | 2.2 | 13.9 |
| Share in deposits of financial sector | 5.9 | 2.7 | 2.4 | 2.4 |
| **Deposit shares (percent)** | | | | |
| DFIs | 51.6 | 26.7 | 30.5 | 32.6 |
| Leasing companies | 12.6 | 35.2 | 32.6 | 29.8 |
| Investment banks | 30.5 | 26.4 | 25.0 | 28.0 |
| HFCs | 0.2 | 0.2 | 0.05 | 0.03 |
| Modarabas | 5.2 | 11.5 | 11.8 | 9.6 |

### 4.1.1 Mergers & Acquisitions

The consolidation activities that were formalized from January 01, 2003 to December 31, 2003 are shown in **Table 4.4**.

Crescent Investment Bank was merged with Mashreq Bank in June 2003. In the Leasing industry, NDLC and IFIC joined hands to form NIB[4]. First General Modaraba and Industrial Capital Modaraba were merged to form First Dawood Investment Bank in July 2003, and a few mutual funds were merged to form the Abamco Stock Market Fund in December 2003.
Individual analysis of the 8 NBFI sub-sectors is discussed in detail in the sections ahead.

**Table 4.4: List of Mergers & acquisitions in the NBFI Sector**

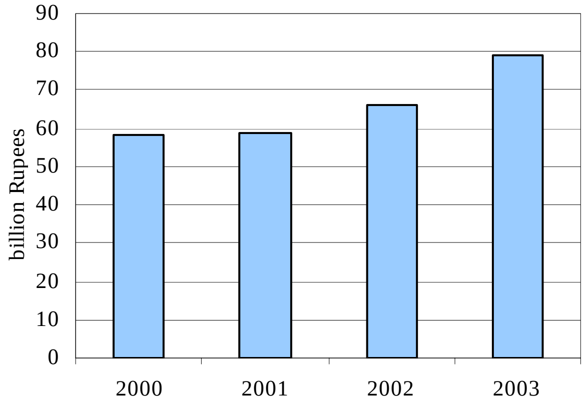
| Name | Merged into | Date |
|---|---|---|
| **Investment Banks** | | |
| Crescent Investment Bank Ltd | Mashreq Bank Pakistan Ltd | 10-June-03 |
| **Leasing Companies** | | |
| NDLC | IFIC Bank | 17-September-03 |
| **Modarabas** | | |
| First General Leasing Modaraba | First Dawood Investment Bank Ltd. | 1-July-03 |
| Industrial Capital Modaraba | First Dawood Investment Bank Ltd | 1-July-03 |
| **Mutual Funds** | | |
| 21st, 23rd, 25th ICP mutual funds | Abamco Stock Market Fund | 31-December- 03 |

[4] NDLC-IFIC Bank.

## 4.2 Development Finance Institutions (DFIs)

DFIs have come a long way in terms of the restructuring and consolidation process, although their total asset base has declined, but in terms of asset quality these institutions have improved considerably. With an asset base of Rs 51.2 billion in FY90 which increased to Rs 91.5 billion in FY00, this group is now operating with an asset base of Rs 79.2 billion (see **Figure 4.1**). Six DFIs are currently in operation, out of which four are joint ventures, one is a 'financial supermarket' and one company was established to cater to the financial needs of small and medium enterprises.

**Figure 4.1: Assets of Existing DFIs**




During FY03, DFI assets registered an increase of Rs 12.9 billion, entirely due to higher investments of these institutions in shares and government securities. In FY03, DFIs capitalized on both; (a) the boom in the stock market, and (b) the declining interest rates in the money market to maximize their earnings. As a result, all the institutions registered higher net profits in FY03, with the exception of SME Bank.

Financing activities of these institutions, however, remained unimpressive and the overall advances declined by Rs 0.5 billion in FY03 against an increase of Rs 1 billion in the preceding year. During the past four years, the asset composition of the DFIs has changed considerably, given that their portfolio has gradually shifted away from advances and is now skewed towards investments, especially in PIBs and shares. Key statistics regarding the financial health of these institutions are reported in **Table 4.5**.

The capital to liability ratio has improved considerably during FY03. This was due to a strong growth in DFIs' equity on the basis of higher profits booked by these institutions. The growth rate of capital, however, seems weaker in FY03 as compared to FY02, which was mainly due to the increase in capital base of the DFIs with the establishment of Pak Oman Investment Company in FY02.

**Table 4.5: Key Indicators of DFIs**[5]

percent

| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| ***Capital adequacy*** | | | | |
| Capital to liability ratio | 21.2 | 21.5 | 35.7 | 46.6 |
| Growth rate of capital | 7.9 | 1.8 | 67.7 | 44.3 |
| Growth rate of assets | -10.0 | 0.6 | 12.9 | 19.5 |
| ***Asset quality*** | | | | |
| Equity to total asset (TA) | 17.5 | 17.7 | 26.3 | 31.8 |
| Earning assets (EA)/ TA | 74.6 | 75.2 | 81.0 | 87.2 |
| Lease finance to EA | 0.6 | 1.6 | 2.7 | 0.0 |
| Advances to EA | 60.3 | 46.0 | 34.0 | 25.6 |
| Investments to EA | 38.6 | 45.9 | 53.1 | 60.6 |
| Inv in Govt Securities to EA | 2.2 | 10.5 | 11.8 | 21.4 |
| Inv in Govt bonds to inv. | 5.6 | 23.0 | 22.2 | 35.3 |
| Inv. in shares to total inv | 28.7 | 28.0 | 28.2 | 32.7 |
| ***Management*** | | | | |
| Expense to income | 54.4 | 62.4 | 61.2 | 37.3 |
| Intermediation cost (ID) | 2.3 | 2.7 | 4.5 | 4.3 |
| ID with provision | 6.9 | 5.7 | 2.4 | 5.8 |
| Admin expense/ total expense | 18.3 | 19.5 | 53.3 | 42.4 |
| Provisions to total expense | 36.3 | 22.3 | -24.5 | 14.6 |
| ***Earning and Profitability*** | | | | |
| Return on average assets | 1.5 | 1.7 | 5.9 | 8.0 |
| Return on average equity | 9.6 | 9.6 | 26.5 | 27.5 |
| Interest rate spread | 4.4 | 6.0 | 4.9 | 2.8 |
| Net Interest Margin | 4.3 | 6.0 | 5.8 | 4.1 |
| ***Liquidity and Sensitivity*** | | | | |
| Loans to deposit ratio | 340.8 | 268.8 | 166.7 | 128.4 |
| RSA to RSL | 98.4 | 100.7 | 119.4 | 141.6 |
| Gap to asset ratio | -1.2 | 0.5 | 13.2 | 25.6 |

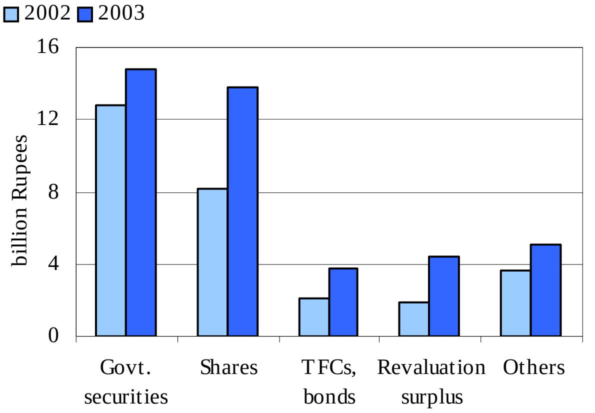
[5] Figures presented in Table 4.5 will not tally with those reported in 'Pakistan: Financial Sector Assessment 2001-2002' as it only represents the data of the DFIs operating at end-FY03.

Adjusted for this institution, the growth of capital is only slightly lower, from 49.8 percent in FY02 to 48.7 percent in FY03.

The ratios of equity to total assets and earning assets to total assets have registered an improvement in FY03. In fact, after going through a strenuous reform process, especially with respect to the liquidation and mergers of the big loss-making institutions, asset quality of the DFIs has started to improve. It should be noted that in the presence of those big institutions, earning assets to total assets ratio had reduced to 74.6 percent in FY00. Even at that time, PICIC and the three joint-venture companies were performing well, but their performance was over-shadowed given their small share in the total size of the DFIs[6].

One reason for concern in terms of the asset quality of these institutions is the composition of investments that shows a significant increase in the share of equity which exposes these institutions to market volatility (also see **Figure 4.2**). SBP, in its new prudential regulations (see **section 1.2.1** for details), has placed a limit on banks'/DFIs' investments in shares at 20 percent of their equity. However, DFIs which do not mobilize funds through deposits / COIs have been exempted from this restriction[7], and only two institutions currently fall in this category. Besides, for DFIs which do mobilize funds, the limit has been increased to 35 percent.

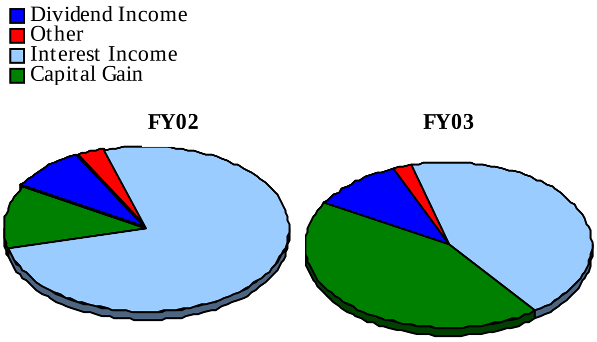
**Figure 4.2: Outstanding Investments of DFIs**




From a management perspective, DFIs seem to have made concerted efforts in FY03, given that all the respective indicators have shown an enormous improvement, especially the expense to income ratio which has declined by 23.9 percentage points.

It is interesting to see that in FY03, DFIs earned an after tax profit which was Rs 2.0 billion higher than FY02, despite a decrease of Rs 1.9 billion in net interest income. Interest income declined in FY03 due to the historically low interest rates both on lending and investments. However, the same factor helped them earn a Rs 4.5 billion higher non-interest income in FY03. DFIs earned huge capital gains (of Rs 5 billion) on their investments in FY03, which ensured handsome earnings for these institutions. As shown in **Figure 4.3**[8], in contrast to FY02 when 75 percent of the DFIs' earnings consisted of interest income, capital gains constituted a large part in FY03.

**Figure 4.3: Income Distribution for DFIs**




[6] See 'Pakistan: Financial Sector Assessment 1999-2000' for details.
[7] See BPD Circular No. 39 dated November 10, 2003.
[8] This includes gross interest and non-interest income.

## 4.3 Investment Banks

A traditional investment bank (in a developed financial sector) is an entity which underwrites capital restructuring, such as initial public offerings, new issues, mergers, acquisitions and leveraged buyouts. Most investment banks also maintain broker/dealer operations, and offer portfolio management and advisory services to investors. Additionally, investment banks have a large role in facilitating private equity placements.

Investment banks have been functioning in the Pakistan financial sector since the late 1980s[9], however they generally had limited success, primarily due to the lack of a conducive economic environment, and to some extent also due to a lack of relevant expertise and acumen.

When these banks first started business, market conditions were quite favorable and contributed to their rapid growth, specially in the early 1990s when the more prominent investment banks played an active role in infrastructural projects such as the Civil Aviation Authority's Lahore Airport Terminal, Karachi International Container Terminal, Kot Addu Power project etc. However, subsequent to the nuclear sanctions imposed on Pakistan in 1998, economic activities generally slowed down and the role of these banks was largely reduced to syndicating term-loans when possible, and maintenance of their existing loan portfolios, instead of financing lucrative green field projects. This was also due to the relatively weak performance of the capital markets at that time, due to which even their advisory role was curtailed to a large extent.

As the analysis of this industry for FY03 will show, there are only a few banks which are currently focused on continuing their functions as investment finance companies and are trying to strengthen their equity base and business activities, while others have planned to merge themselves with commercial banks with the exception of two institutions which are facing winding-up proceedings filed by SECP.

### 4.3.1 Regulatory Environment

Investment Banks are now classified as Non-Banking Finance Companies under the regulatory purview of the SECP which issued the Non-Banking Finance Companies (Establishment and Regulation) Rules in April 2003. These rules provide an enhanced framework of operations for Investment Banks and have considerably widened their scope of business.

Given this NBFC umbrella and generally limited activities in the traditional investment banking business, Investment Banks have started to focus their attention on becoming multi-business entities instead of retaining their specialized business status in order to remain commercially viable. This is also evident from the fact that a few Investment Banks in the industry also have permission for conducting lease-finance business, and some have plans to expand as an NBFC by obtaining licenses for housing finance, asset management etc.

### 4.3.2 Size and Consolidation

There are currently 10 Investment Banks in operation[10], out of which 3 hold around 44 percent share of assets. The current minimum paid-up capital requirement for Investment Banks as laid down by SECP is Rs 300 million, which has given rise to some mergers / acquisitions across the industry, of the smaller Investment Banks with a weak capital base. Following on from the details of such mergers / acquisitions reported in 'Pakistan: Financial Sector Assessment 2001-2002', one more such transaction was formalized in FY03 when Crescent Investment Bank was merged with Mashreq Bank (see **Table 4.4**), and two more merger approvals are in process.

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[9] SRO 585 (1)/87 dated. July 13, 1987

[10] Additionally, 2 are in the process of winding-up operations, and another 2 have merged with a modaraba and 3 leasing companies respectively.

Two of these 10 banks are currently non-compliant in terms of capital adequacy with respect to Investment Banking operations[11]. The size of the industry is shrinking rapidly given that the existing Investment Banks are turning to more lucrative areas of the financial sector e.g., commercial banking -- two strong players in the industry (with over 21 percent share of assets) have decided to merge with a private bank in order to form a new commercial bank[12].

### 4.3.3 Performance of Investment Banks[13]

In terms of generating fresh business during the year, one of the leading players in the sector with its focus solely on Investment Banking has completed the largest securitization transaction in the history of the country's capital markets in FY03. Moreover, debt syndications and other capital transactions also continue to add to this industry's profitability.

With the objective of diversifying revenue streams by offering a wider product range, another leading investment bank plans to expand business activities by launching an open-end fixed income mutual fund. Moreover a few companies have acquired licenses to undertake money market and foreign exchange brokerage, as well as the membership of the country's first commodity exchange.

Investment Banks with the exception of four institutions remained adequately capitalized in FY03 on an overall basis, despite the dismal performance of two banks in the industry. The capital to liability ratio remained stable over the period of assessment, and has even registered a marginal increase in FY03 (see **Table 4.6**). As compared to FY02, capital has grown by almost 40 percent. However, on adjustment of the two banks which have merged to form a commercial bank, the growth rate is around 30.7 percent. The major contributors of this growth are 3 strong players in the industry which collectively hold over 57 percent share of the total capital base.[14]

After registering a negative growth in FY02, assets have increased by 37 percent in FY03 (see **Figure 4.4**). While the earning assets to total assets ratio has been maintained at a considerably high level and has increased to

**Table 4.6: Performance of Investment Banks**
percent

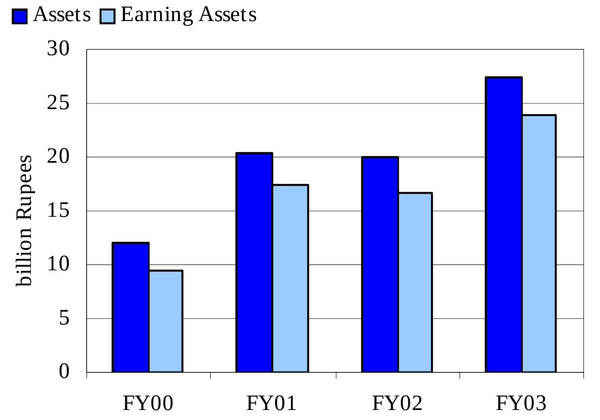
| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| ***Capital adequacy*** | | | | |
| Capital to liability ratio | 16.3 | 14.1 | 15.8 | 16.2 |
| Growth rate of capital | | 49.0 | 8.1 | 39.7 |
| Growth rate of assets | | 69.0 | 2.3 | 37.0 |
| ***Asset quality*** | | | | |
| Equity to total asset ratio (TA) | 14.0 | 12.3 | 13.6 | 13.9 |
| Earning assets (EA) to TA | 77.4 | 85.0 | 83.7 | 87.4 |
| Lease finance to EA | 12.7 | 33.6 | 29.2 | 18.3 |
| Short term finance to EA | 23.8 | 13.6 | 12.8 | 8.9 |
| Investments to EA | 49.9 | 44.0 | 52.0 | 67.0 |
| Long term investments to EA | 9.0 | 4.1 | 10.4 | 16.1 |
| Short term investments to EA | 18.3 | 21.0 | 27.8 | 39.5 |
| ***Management*** | | | | |
| Expense to income ratio | 96.3 | 94.2 | 93.4 | 67.9 |
| Expense to income ratio (with provisions) | 100.0 | 97.9 | 99.2 | 88.3 |
| Operating expense to total expense | 19.6 | 16.1 | 17.4 | 22.3 |
| Intermediation cost | 3.7 | 3.2 | 3.5 | 3.1 |
| Intermediation cost with provisions | 4.4 | 4.0 | 4.8 | 7.2 |
| ***Earning and profitability*** | | | | |
| Return on average assets | | 0.3 | 0.4 | 2.8 |
| Return on average equity | | 2.4 | 3.5 | 20.8 |
| Interest rate spread | 2.5 | 0.9 | 1.3 | 4.1 |
| Net Interest margin | 2.3 | 1.7 | 2.3 | 5.7 |
| ***Other indicators*** | | | | |
| Long-term liabilities to total liabilities | 27.9 | 36.0 | 35.4 | 31.6 |
| Long-term assets to total assets | 25.2 | 36.3 | 38.5 | 36.9 |
| Long-term liabilities to long-term asset ratio | 95.2 | 86.9 | 79.5 | 73.8 |
| Short-term liabilities to short-term asset ratio | 82.9 | 88.1 | 90.7 | 93.3 |

[11] One of these banks has been issued a show cause notice by SECP which makes its status as a going concern quite doubtful. The other bank has been incurring losses for a few years which has eroded its capital base. However the management is in the process of negotiations for a merger and injection of fresh equity by prospective investors.
[12] Trust Investment Bank and Fidelty Investment Bank have joined hands with the Pakistan branches of Doha Bank to form Trust Commercial Bank.
[13] This is based on the existing 10 banks in operation; however there is only six-monthly (reviewed) data available for one of the banks which has been annualized for the purpose of a consolidated analysis.
[14] Without taking into account the capital base of the two banks which are opting out of the Investment Banking sector

87.4 percent in FY03, the composition of the total asset base is rapidly tilting towards investments at 67 percent of earning assets, both short and long-term, with lease finance occupying the second place. This is another clear evidence of the fact that Investment Banks are relying on investments and lease finance to remain commercially viable. This also has strong bearings for the future outlook of these banks.

Investment Banks traditionally rely on fee-based income due to the nature of their business, however an analysis of the income components of the currently operating investment banks shows that in line with the asset composition, over 70 percent of their income comes from interest on investments, profit on sale of investments and interest on lease finance. This shows that fee-based financial activities of the Investment Banks to capital market investors and the corporate sector remain limited.

**Figure 4.4: Assets of Investment Banks**




The performance of one of the leading players in the industry needs to be specially mentioned as it has recorded an increase in profit of almost 20 times that of FY02, on the basis of return on investments and placements combined with a gain on sale of investments, as well as capital gains realized on securities.

The expense to income ratio has been brought down, given that financial charges have been substantially reduced by the leading players in the industry. Except for one bank which has made a massive loss in FY03, net profit on a consolidated basis has registered an increase in FY03, whereas for the past 3 years a net loss was recorded for the industry as a whole[15].

On the liabilities side it seems that this sector might face a funds mismatch problem given the declining trend of the long-term liabilities to the long-term assets ratio, since FY00. However, the short-term assets are largely covered by short-term liabilities, inching gradually towards 100 percent coverage.

At this point in time, there are 6 strong players in the industry, 3 of which would like to take advantage of the NBFC framework in terms of expanding their operations in diversified businesses, while the other 3 are strongly focused on Investment Banking operations. Moreover, a new Investment Bank by the name of First Dawood Investment Bank Ltd was formed in May 2004, as a result of a merger between First General Leasing Modaraba and Industrial Capital Modaraba.

Given the favorable economic conditions, there is considerable potential for increased business activities for Investment Banks, however only those institutions with a strong capital base and a commitment to this business will be in a position to take advantage of this opportunity.

## 4.4 Leasing Companies

Since the inception of the first leasing company in the mid-1980s, leasing has been an important segment of the financial sector in Pakistan. Initially, the business focus of leasing companies was on

[15] It is important to point out that net loss on a consolidated basis was due to the net loss incurred for the past few years by Islamic Investment Bank. Exclusion on this organization from profit and loss calculations shows that the sector made a net profit as a whole.

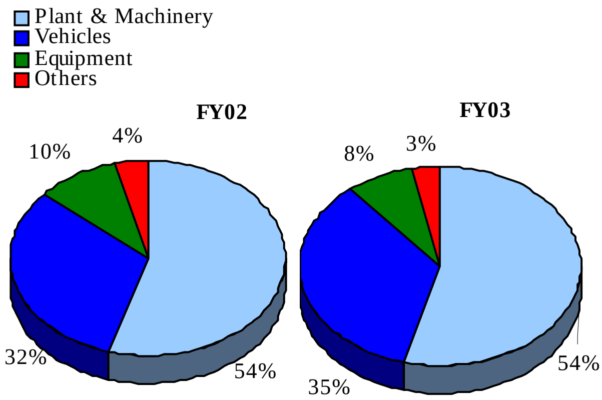
meeting the needs of the corporate sector. However, given the slow economic growth and the general slump in business activities for NBFIs in the late 1990s, a shift in business focus was imperative to sustain profitability, and for some, survival. Hence the continued resilience of this sector can be attributed to strategic management in adapting to the constantly evolving environment of the financial sector in the last few years which has led to an array of diversified product offers from the leasing industry.

FY03 was characterized by a difficult environment for the leasing industry, created largely due to aggressive competition by the large commercial banks in the consumer and auto lease sector. Commercial banks have a competitive edge over leasing companies in terms of their extensive branch network and a low cost of funds. However, the leading performers in the industry withstood the challenge as is evident from the results. The industry has handled a larger volume of business during FY03 as compared to the previous year and has shown a substantial increase in profits.

### 4.4.1 Business-wise break-up of Lease Finance

A comparative analysis of lease finance disbursements in FY02 and FY03 (see **Figure 4.5**) shows that the composition of disbursements has largely remained unchanged. Whereas plant and machinery has maintained its share, auto financing has increased by only 3 percentage points since FY02. This area is currently inundated with intense competition, as it is a viable business for commercial banks as well as leasing companies and modarabas. In order to grow its asset base and maintain its competitive stance, the leasing sector needs to develop a multi-product capability and develop niche markets by targeting the largely untapped segments such as agriculture, SMEs etc.

**Figure 4.5: Break-up of Lease Finance**




### 4.4.2 Consolidation Process in FY03

The last two years have witnessed increased consolidation across the industry in line with the increased minimum paid-up capital requirements for leasing companies specified by the SECP, due to which it is more feasible for smaller companies to join hands to achieve economies of scale and strengthen their capital base. This process continued in 2003, albeit the pace slowed down considerably as shown in **Table 4.4**, which shows only one formalized merger transaction of National Development Leasing Corporation Ltd with IFIC Bank in September 2003[16]. The sector still has several small and financially weak companies and further merger/acquisition deals are in the offing, and are expected to materialize in CY04.

As of December 31, 2003, the leasing industry is made up of 27 companies, which are listed in **Annex**. In February 2003, SME Leasing Ltd started operations with a minimum paid up capital of Rs 200 million. Full year results for this entity will be available for analysis next year.

### 4.4.3 Policy and Regulatory Developments

Regulation of leasing companies is an evolving process. The direction it would take will, to a large extent, depend on the way leasing companies are managed.

[16] The merger of International Multi Leasing Corporation Ltd with Capital Asset Leasing Corporation Ltd which was reported in 'Financial: Sector Assessment 2001-2002' is still in process, the matter is currently before the Supreme Court.

If the sector demonstrates that it can credibly self-regulate itself, need for intrusive supervision may not arise.[17]

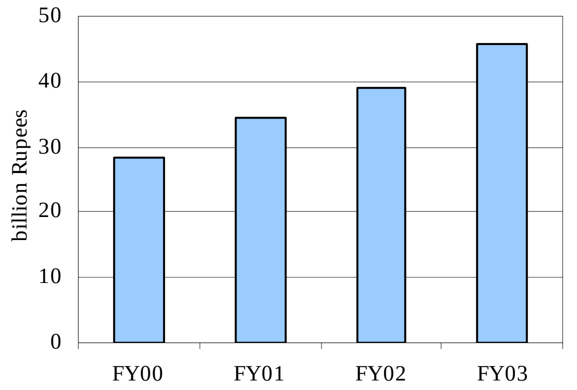
With the introduction of the NBFC concept, leasing companies have now been re-categorised as Non-Bank Finance Companies and their affairs are now regulated in accordance with the Non-Banking Finance (Establishment and Regulation) Rules, 2003[18].

### 4.4.4 Performance of Leasing Companies[19]

Overall assets of the leasing companies have increased by over 17 percent to Rs 45.8 billion. Four of the historically top 10 performers of the industry[20] have contributed 77 percent of this increase, as a result of their professional management. **Figure 4.6** shows the trend in asset growth since FY00. It can be seen from the figure that the growth rate of assets slowed down in FY02, however it picked up pace again in FY03.

It is to be noted however that the contribution of lease finance in asset growth shows a downward trend as compared to long-term investments.

**Figure 4.6: Assets of Leasing Sector**




Key indicators of the financial health of the leasing industry are given in **Table 4.7**.

Financial results for FY03 show that out of the 27 companies functioning in the industry, 6 companies are still not in compliance[21] and have a weak and eroding capital base, mainly due to excessive provisions made on account of non-performing leases, as well as an ongoing inability to generate funds to finance new lease business in the current operating environment. However, given the performance of the leading companies of the industry, the capital to liability ratio has registered a marginal improvement in FY03 and capital itself has grown by 21.3 percent as compared to 3.3 percent in FY02. This acceleration in growth is mainly attributable to the top 3 players which collectively hold 40 percent of the total capital base of this sector. In addition to an increase in paid-up capital, improved net profits of these companies have increased their reserve base in line with Prudential Regulation 2 (Part III).[22]

This is despite the weak equity position of the 6 non-compliant companies referred to above. Given this performance, leasing companies have maintained their historically high capital to liability ratio which only went below 20 percent in FY90[23], and to some extent in FY02, indicating their sustained resilience in terms of absorbing unanticipated losses.
Earning assets to total assets have shown a substantial increase over the last 3 years at 82.3 percent, which indicates an improvement in the earnings base of the industry.

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[17] As discussed in 'Leasing Association of Pakistan Yearbook 2003'.
[18] Details in Chapter 1, Section 1.2.4 Leasing Company Rules 2000 stand repealed with the issuance of these new rules for NBFCs.
[19] Performance analysis includes the 27 companies in operation as at December 31,.2003.
[20] On the basis of assessment of asset figures for the year 2000.
[21] 3 more companies which are currently non-compliant are in the process of finalizing merger approvals with other leasing companies and modarabas
[22] Issued on January 21, 2004 for NBFCs. Please see section 1.2.4 for details.
[23] Given availability of data from FY90.

Lease finance stands at 82.8 percent of all earning assets, showing a decreasing trend since FY01. On the other hand, long-term investments as a percent of earning assets are increasing gradually.

**Table 4.7: Key Indicators of Leasing Companies**
percent

| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| **Capital Adequacy** | | | | |
| Capital to Liability ratio | 26.0 | 22.0 | 19.8 | 20.5 |
| Growth rate of capital | | 6.6 | 3.3 | 21.3 |
| Growth rate of assets | | 21.8 | 13.0 | 17.6 |
| **Asset Quality** | | | | |
| Growth rate of lease finance | | 26.2 | 13.5 | 12.7 |
| Growth rate of long-term investments | | 94.4 | 55.7 | 57.0 |
| Earning assets (EA) to total assets | 67.3 | 69.2 | 68.7 | 82.3 |
| Long term earning assets to EA | 70.7 | 73.0 | 75.8 | 62.9 |
| Lease finance to EA | 89.6 | 89.7 | 88.2 | 82.8 |
| Investments to EA | 5.9 | 8.5 | 9.1 | 11.7 |
| **Management** | | | | |
| Expense to income ratio (exc provision) | 79.6 | 85.0 | 86.0 | 76.3 |
| Expense to income ratio (inc provision) | 87.0 | 94.5 | 96.8 | 82.5 |
| Financial expenses to income | 62.4 | 65.3 | 65.5 | 53.1 |
| Operating expenses to income | 14.9 | 15.5 | 16.6 | 17.1 |
| Administrative expense to total expense | 17.2 | 16.4 | 17.1 | 20.7 |
| **Earnings and Profitability** | | | | |
| Growth in profits | | -13.7 | 18.9 | 65.6 |
| Return on average assets | | 0.46 | 0.28 | 2.16 |
| Return on average equity | | 2.4 | 1.6 | 12.8 |
| **Liquidity and Sensitivity** | | | | |
| Liquid assets to total assets | 49.9 | 46.5 | 44.4 | 45.1 |
| Current ratio | 1.4 | 1.3 | 1.2 | 1.4 |
| Net working capital (mln Rs) | 4,374 | 3,546 | 3,217 | 6,097 |
| **Other Indicators** | | | | |
| Total assets/Net worth | 4.8 | 5.5 | 6.1 | 5.9 |
| Earning Per Share | 4.4 | 0.6 | 0.3 | 1.8 |
| Revenue Per Share | 8.8 | 9.4 | 9.2 | 8.1 |
| Dividend Per Share | 0.8 | 0.5 | 0.5 | 0.6 |
| Break-up value (NAV) | 15.3 | 14.6 | 13.4 | 14.6 |

There has been a remarkable reduction in the total expenses of the leasing sector, as evidenced by the expense to income ratio which has gone down by 14.3 percent in FY03 over FY02, financial expenses being the main contributor of this decrease.

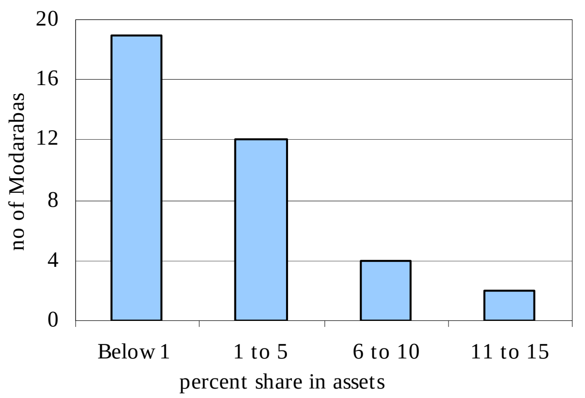
Net profit has sharply increased by 65.6 percent during FY03, compared with only 18.9 percent in FY02 and a decline of 13.7 percent in FY01. The weak performers have ridden on the back of the top 10 players in the industry to benefit from this growth, as they have managed to counter the unfavorable trends in their operating environment as evidenced by the improved profits in FY03. This situation is in sharp contrast to FY02 when return on assets was only 0.28 percent as compared to 2.16 in FY03.

The increased capital adequacy requirements have enhanced the leasing companies' potential for resource mobilization and has also improved their resilience to external shocks. Current ratio continues to remain strong whereas net worth has increased by 89.5 percent, and liquid assets have been maintained at an average of 46.5 percent from FY00-FY03.

### 4.5 Modarabas

Modarabas, providing effective support in the Islamization of the economy, constitute the largest group in terms of number of entities in the overall NBFI sector. However, the share of modarabas in total assets of NBFIs is only 6.5 percent. At end-June 1990, the total number of Modarabas was 10, which increased to 45 at end-June 2000. This expansion was due to broad-based financial liberalization measures, robust growth in the stock markets and the fiscal incentives given to this industry until the late 1980s and early 1990s. However, since the late 1990s, the increased competition with leasing companies and investment banks and the withdrawal of tax-free status in 1992, has led to a slowdown in their business activities. As a result, assets of the

**Figure 4.7: Structure of the Modaraba Industry**



modarabas increased by only Rs 2 billion from FY95 to FY03, at an annual average rate of 3.7 percent.

At present there are 37 modarabas operating in the country. The structure of the modarabas in terms of size is highly skewed towards small modarabas which do not even have a one percent share in the total assets of the industry (see **Figure 4.7**). Ten modarabas do not even have a capital base of Rs 100 million. Hence more mergers and acquisitions are envisaged in the near future to ensure the soundness of this sector.

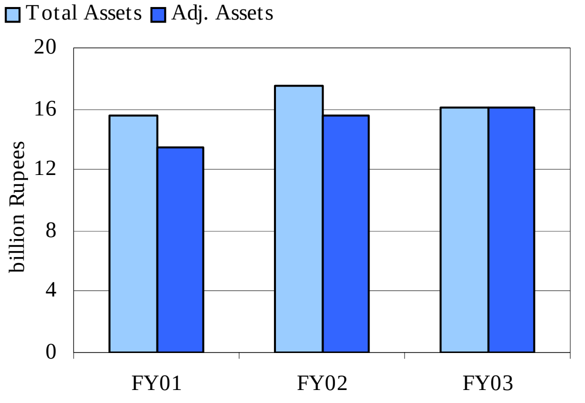
***Developments since Jan-2003***

- With an aim to solving the issue of resource mobilization of the Modarabas, these institutions have been given permission to issue Term Finance Certificates (TFC) based on Musharika. During 2003, Al-Zamin Leasing Modaraba launched the first ever Islamic TFC worth Rs 300 million. The issue was oversubscribed by both the general public and institutional investors.
- SECP on January 08, 2004 issued prudential regulations for modarabas, covering areas like limits on modarabas' exposures in corporate borrowings, individual borrowings, corporate governance and minimizing various risks associated with the business (see **section 1.2.4** for details).

### 4.5.1 Performance of Modarabas during 2003

Taking into account the currently operating modarabas, their assets have increased by Rs 0.4 billion in FY03 against a rise of Rs 1.9 billion in FY02 (see **Figure 4.8**).[24]

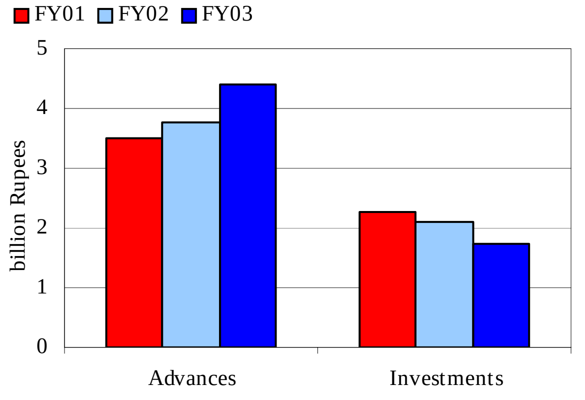
**Figure 4.8: Assets of Modarabas**




This weak growth in assets during FY03 is despite of a Rs 0.6 billion increase in advances against Rs 0.27 billion during FY02 (see **Figure 4.9**). This is due to a sharp decline of two and a half times in investments, specifically long-term investments. In fact, this decline came from only one Modaraba which has encashed a certificate of investment worth US$5 million of a financial institution. Adjusting for this institution, investments have also increased by Rs 0.14 billion during FY03.

To measure the overall soundness of this sector, key financial and management ratios of operating modarabas are given in **Table 4.8**.

**Figure 4.9: Asset Portfolio of Existing Modarabas**




Among capital adequacy indicators, capital to liability ratio significantly improved, given the profits incurred by most of the modarabas and the robust performance of the stock markets. These profits strengthened the equity base of these institutions and thus improved their financial soundness. Growth rate of capital, however, slowed down in FY03, but this was only because of the entry

[24] Adjusted assets exclude the data of three modarabas from FY01 and FY02 that were not operative in FY03.

of a new modaraba in the industry during FY02 which inflated the capital growth rate in FY02. Adjusting for this, growth rate of capital was actually higher during FY03. The same holds true for the lower growth rate of assets during FY03.

**Table 4.8: Key Indicators of Modarabas**
percent

| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| **Capital Adequacy** | | | | |
| Capital to Liability ratio | 51.1 | 45.8 | 47.2 | 50.0 |
| Growth rate of capital | 6.8 | -7.9 | 22.0 | 9.5 |
| Growth rate of assets | 0.9 | 2.8 | 18.2 | 3.4 |
| **Asset Quality** | | | | |
| EA to total assets | 81.5 | 83.4 | 73.4 | 73.0 |
| Long-term earning to EA | 67.5 | 68.6 | 74.3 | 69.9 |
| Lease finance to EA | 53.2 | 57.2 | 57.5 | 60.4 |
| Morab. & Mushar. to EA | 22.3 | 19.5 | 22.4 | 23.5 |
| Investments to EA | 21.4 | 19.5 | 17.1 | 13.4 |
| **Management** | | | | |
| Exp. to inc. ratio (exc. prov.) | 69.6 | 72.5 | 79.1 | 76.5 |
| Exp. to inc. ratio (incl. prov.) | 76.9 | 98.2 | 81.1 | 74.7 |
| Admin. Exp. to total exp. | 11.7 | 8.5 | 10.8 | 10.4 |
| **Earnings and Profitability** | | | | |
| Return on average assets | 3.8 | -1.3 | 3.1 | 7.1 |
| Return on average equity | 7.6 | -2.8 | 6.6 | 14.7 |
| **Liquidity and Sensitivity** | | | | |
| Liquid assets to total assets | 6.6 | 7.0 | 8.2 | 6.9 |
| Current ratio | 1.5 | 1.3 | 1.2 | 1.1 |
| Net working capital (million Rs) | 1802 | 1155 | 1022 | 610 |
| **Other Indicators** | | | | |
| Total assets/Net worth | 2.0 | 2.2 | 2.1 | 2.0 |
| Earning Per Share | 1.2 | 0.1 | 0.9 | 1.4 |
| Revenue Per Share | 3.9 | 4.2 | 3.5 | 3.8 |
| Dividend Per Share | 0.9 | 0.8 | 0.7 | 0.8 |
| Break-up value (NAV) | 10.1 | 9.1 | 8.9 | 9.8 |

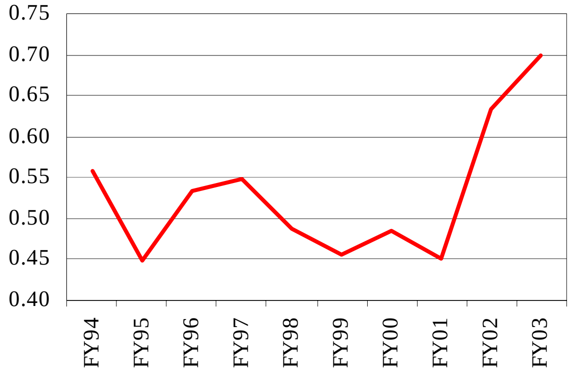
Earning assets to total assets which fell sharply from 83.4 percent in FY01 to 73.4 percent in FY02, marginally declined further to 73 percent in FY03. However, the composition of earning assets has changed significantly with an increasing share of lease finance. The share of investments declined in total earning assets due to a sharp decline in investments of one modaraba, as mentioned earlier.

From a management perspective, modarabas have improved in terms of expense (including provisions) to income ratio. This is despite of an increase in total expenses, and is mainly due to a sharp rise in the income of these institutions.

Total expenses increased by Rs 0.2 billion in FY03 against a decline of Rs 0.3 billion in the preceding year. In fact, this is the expense on amortization/depreciation of the fixed assets which constitutes the largest portion of overall expenses. These expenses have shown an upward trend over the period of assessment and stood at Rs 2.3 billion at end-FY03 (see **Figure 4.10**).[25] Moreover, administrative expenses also increased slightly but the ratio of administrative to total expenses declined in FY03.

Modarabas earned a Rs 0.6 billion higher (after tax) profit during FY03 as compared to FY02. Not only the lease income, which constitutes 70 per cent of the total income, showed a higher increase; capital gains on investments also went up. As a result, profitability indicators improved considerably and ROE and ROA have almost doubled. Moreover, the modaraba industry has achieved the highest ever after tax profit of over Rs 1 billion in FY03, despite all-time low interest rates and increased competition. At a micro level too, performance in terms of profitability remained far better in FY03.

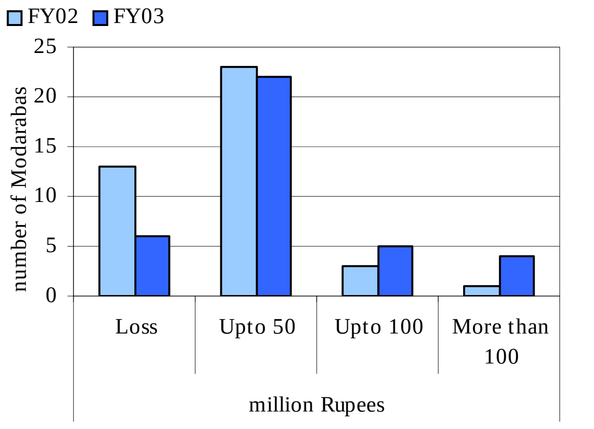
**Figure 4.10: Depreciation/Amortization to Total Expense**




[25] In fact, in FY02 budget first year depreciation was allowed that resulted in the sharp increase in depreciation allowance during the year.

As shown in **Figure 4.11**, the number of loss-making modarabas has reduced considerably and only 6 modarabas incurred losses during FY03. In line with FY02, most of the modarabas have earned profits up to Rs 50 million in FY03. However, the number of modarabas earning profits up to and over Rs 100 million has increased. Four modarabas registered a net profit of more than Rs 100 million during FY03 against only one in the preceding year.

**Figure 4.11 Magnitude of Profits**




### 4.6 Housing Finance Companies

House Building Finance Corporation (HBFC) has remained the most prominent player in this sector since its inception in 1952. HBFC was initially grouped with DFIs and it continued to enjoy a monopoly status[26] until the early 1990s, when three more such companies came up in the private sector in the wake of financial liberalization reforms, subsequent to which separate rules for Housing Finance Companies were issued. Specifically, these companies are authorized to extend loans for the construction, reconstruction, repair and purchase of houses.

HFCs have had a rather gradual asset growth since the early 1990s, which is an indicator of the limited success of their operations, particularly due to a large percentage of non-performing loans in their asset portfolios. As a result of this, the size of this sector has remained small with currently only 3 institutions functioning as housing finance companies[27]. Moreover HBFC has continued to enjoy a near monopoly status, given that the share of the other entities has remained nominal.

Until 1998, SBP did not allow commercial banks to undertake housing finance. However the National Housing Policy approved by the Federal Government at that time envisaged an active role of the commercial banks in this area. Hence to facilitate banks in developing and marketing housing finance facilities, SBP then issued a specific credit policy for this purpose in the year 2001[28]. With the recent boom in consumer financing and SBP's encouraging stance on mortgage loans, a number of commercial banks have come up with exclusively branded mortgage finance products which pose a serious threat to HBFC in terms of a gradual erosion of its market share. However it goes to HBFC's credit that it has risen to the challenge and has in the recent past launched two branded schemes which have quickly gained prominence[29].

#### 4.6.1 Performance of Housing Finance Companies[30]

A performance analysis of the HFCs is essentially just an analysis of the financial health of HBFC and its future prospects given that the market share of the other company under assessment is less than 1.5 percent.

Even then on a consolidated basis, housing finance companies have remained adequately capitalized with the capital to liabilities ratio having registered a marginal increase of 2.3 percentage points in FY03 over FY02. Given that total liabilities have decreased over the assessment period, this increase comes from a growth rate of 3 percent in capital due to an increase in reserves for HBFC.

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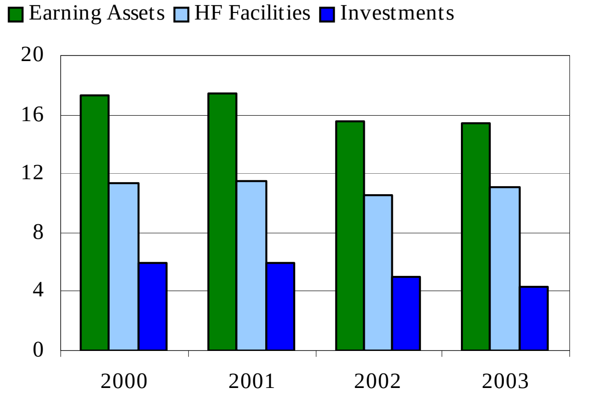
[26] Given that commercial banks were not allowed to undertake housing finance.
[27] Citi Housing Finance is in the process of winding up its operations.
[28] Initially BSD Circular Letter No. 16 dated July 13, 2001 was issued which was then superceded by a revised Credit Policy in BPD Circular Letter No. 18 dated June 13, 2003.
[29] Shandar Ghar scheme and Ghar Aasan scheme - both are Shariah Compliant schemes.
[30] This takes into account full year results for House Building Finance Corporation and International Housing Finance Ltd.

Assets however have declined by 3.5 percent at Rs 21.4 billion, given the increased competition from commercial banks in targeting the housing finance market since 2001 (see **Table 4.9**)
Earning assets to total assets ratio which declined from 78.7 percent in FY00 to 69.8 percent during FY02, registered an increase of 2.0 percentage points and rose to 71.8 in FY03 (see **Figure 4.12**).

**4.12: Assets of HFCs**




Earning assets as a proportion of total assets have reduced by around 7 percentage points from FY00 to FY03, with a marginal increase of 2 percent in the last year. While advances to earning assets ratio witnessed an increase, investment to earning ratio reduced during FY03 which indicates that resources are being utilized to generate income from the core business, instead of investments. It needs to be kept in mind that HBFC heavily relies on secured lines of credit from SBP on a profit and loss sharing basis to extend fresh loans. Therefore, it is difficult for HBFC to rapidly enhance its business activities.

Non-performing loans continue to be a problem for HBFC however the recent incentives announced in the federal budget 2004-05 allow borrowers to repay these loans in 36 equal installments such that the balance of their total loans outstanding has been frozen as at June 30, 2004. This is expected to expedite the recovery process and bring about an improvement in the asset quality.

Whereas the borrowing to advances ratio has gone down by 31 percent since FY00, the borrowing to liabilities ratio also shows a reasonable reduction, from 92.1 percent in FY00 to 78.5 percent in FY03, indicating a more efficient utilization of borrowed resources. Return on assets has however declined even further at 0.8 for FY03, due to a gradual decrease in income as well as in earning assets.

Given HBFC's strong capital base and a competitive stance with respect to commercial banks, along with its increased focus on reducing NPLs, it is expected to retain its dominant position in the NBFI sector.

**Table 4.9 : Housing Finance Companies**

percent

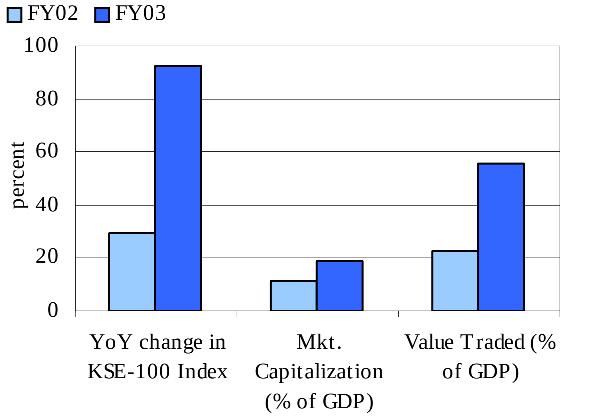
| | FY00 | FY01 | FY02 | FY03 |
|---|---|---|---|---|
| ***Capital Adequacy*** | | | | |
| Capital to liabilities ratio | 19.9 | 22.9 | 26.6 | 28.9 |
| Growth rate of Capital | 9.3 | 19.5 | 7.0 | 3.0 |
| Growth rate of assets | 2.0 | 6.3 | 4.8 | -3.5 |
| ***Asset Quality*** | | | | |
| Earning assets to total assets | 78.7 | 74.4 | 69.8 | 71.8 |
| Advances to earning assets | 65.5 | 66.1 | 67.9 | 71.9 |
| Investment to earning assets | 34.5 | 33.9 | 32.1 | 28.1 |
| ***Management*** | | | | |
| Expense to income ratio | 29.8 | 60.7 | 66.1 | 70.6 |
| Operating expense to total expense | 88.6 | 46.6 | 53.6 | 59.9 |
| Provisions to total expense | 0.0 | 1.2 | 0.02 | 0.02 |
| ***Earning and Profitability*** | | | | |
| Return on average assets | 4.7 | 3.7 | 1.4 | 0.8 |
| Return on average equity | 51.2 | 35.8 | 13.3 | 7.5 |
| Interest rate spread | 4.1 | 2.3 | 7.0 | 7.3 |
| Net interest margin | 4.1 | 2.3 | 7.1 | 7.3 |
| ***Liquidity*** | | | | |
| Liquid assets to total assets | 35.1 | 36.9 | 37.4 | 33.4 |
| Borrowing to advances ratio | 148.9 | 135.8 | 136.9 | 117.9 |
| Borrowing to liabilities | 92.1 | 82.0 | 82.1 | 78.5 |

## 4.7 Mutual Funds

In developing economies, where investors have a limited knowledge awareness of the available investment options, and the associated risks, mutual funds play an important role. This is because mutual funds lower the investment risk considerably by providing a diversification of investment to the small investors. In doing so, not only do they provide investors an access to the whole market, but they also add liquidity to the stock market.

In Pakistan, mutual funds were introduced with the establishment of NIT and ICP in 1962 and 1966, respectively. NIT enjoyed a monopoly status as an open-end mutual fund for 40 years and ICP as a closed-end mutual fund for 17 years. During 1983, the first closed-end mutual fund was established in the private sector; and by end-June 2004, 18 private closed-end mutual funds are operating in the country. Open-end mutual funds were established in the private sector in 1997, and by end-June 2004, 13 private open-end funds are operating in the country.

**Figure 4.13: Performance of Stock Market**




FY03 was an eventful year for the mutual funds sector as the country's equity market exhibited one of the best performances in the world[31] (see **Figure 4.13**). The KSE-100 Index recorded a new all time high to reach 3402.5 points at end-June 2003. This was due to the expectations of an increase in corporate earnings and early privatization of profitable companies (e.g. PSO, OGDC, etc), soaring market liquidity and declining interest rates.

**Table 4.10: Assets of the Mutual Funds**

billion Rupees

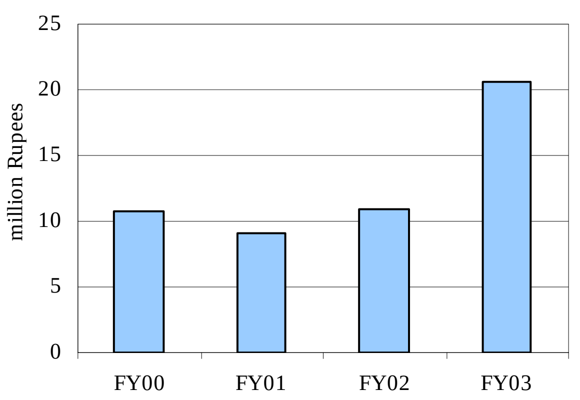
| | Total Assets | | Net Assets | |
|---|---|---|---|---|
| | **FY02** | **FY03** | **FY02** | **FY03** |
| ***Open-end Mutual Funds*** | | | | |
| ***Public Sector*** | 20.7 | 35.4 | 17.4 | 31.6 |
| ***Private Sector*** | 1.7 | 8.4 | 1.5 | 7.7 |
| ***Closed-end Mutual Funds*** | | | | |
| Private Sector | 1.5 | 2.7 | 1.4 | 2.4 |
| Privatized Sector | 5.5 | 9.7 | 4.8 | 8.7 |
| ***Total Mutual Funds*** | **29.4** | **56.2** | **25.1** | **50.5** |

As a result of this robust performance of the stock market, mutual funds generated profits through higher dividends and realized / unrealized capital gains. Total assets and net assets increased significantly mainly due to the establishment of eight new mutual funds in the private sector and the substantial growth witnessed by NIT (see **Table 4.10**). For a more specific analysis of the performance of mutual funds, open-end and closed-end funds will be discussed separately.

### 4.7.1 Open-end Mutual Funds

During FY03 and FY04 nine more open-end mutual funds were established in the private sector, including; (a) Dawood money market fund (managed by Pakistan Venture Capital Limited); (b) United Money Market Fund (managed by United Asset Management Company); (c) UTP Islamic Fund (managed by ABAMCO); (d) UTP Income Fund (managed by ABAMCO); (e) Metro Bank-Pakistan Sovereign Fund; (f) Atlas Income Fund; (g) Crosby Dragon Fund; (h) Faysal Balanced Growth Fund; and (i) Meezan Islamic Fund.

**Figure 4.14: NAV of NIT**




[31] For details see SBP Annual Report 2002-2003.

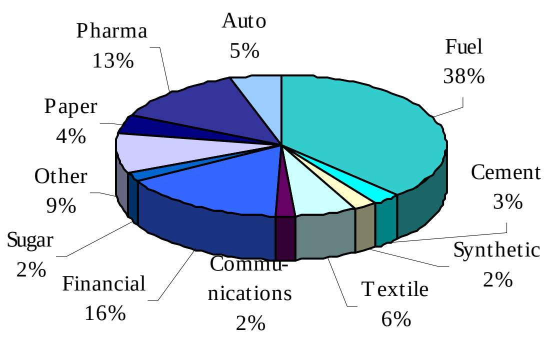
Subsequent to the establishment of these funds, the share of NIT in the total assets of the open-end mutual funds reduced to 80 percent in FY03 against 92 percent in FY02.

The performance of NIT during FY03 becomes clear from **Figure 4.14** which shows that the Net Asset Value (NAV) of this fund has almost doubled and is also twice the par value (Rs 10).

NIT's profit for FY03 registered a fourfold increase from FY02 at the back of strong dividend income and realized/unrealized capital gains on investments. As a result, dividend payouts also increased from Rs 1.2 per unit in FY02 to Rs 1.75 in FY03.

The asset portfolio of NIT shows a much diversified holding of securities within various sectors, with the largest share of the fuel and energy sector (see **Figure 4.15**); the top 10 holdings of the trust include shares of PSO, SSGC, SNGC, National Refinery, etc.

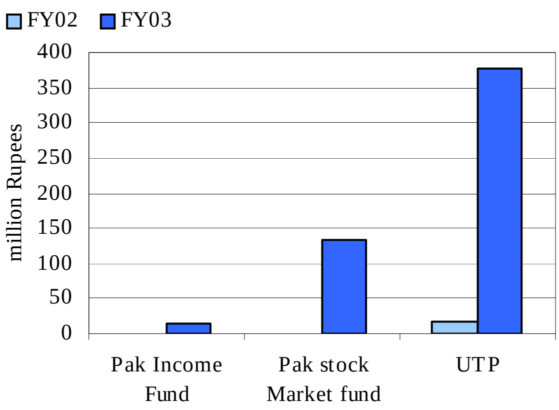
**Figure 4.15: Break-up of NIT's Portfolio**




Other open-end mutual funds (in the private sector) also performed better in FY03. The dividend payout of UTP has also increased significantly from 15 percent of par value of units in FY02 to 25 percent. NAV of UTP, Pakistan Stock Market Fund (PSMF) and Pakistan Income Fund (PIF) also increased significantly during FY03.

The improvement in the earnings of these private sector funds is shown in **Figure 4.16**. Since UTP is a balanced fund[32], its earnings come from investments both in the stock market as well as corporate & government securities. For PSMF, the major source of earning during FY03 was the dividend income and gain on sale of investments in the stock market. On the other hand, PIF benefited only from TFCs and PIBs.

**Figure 4.16: Realized/Unrealized Capital Gains**




### 4.7.2 Closed-end Mutual Funds

Five new closed-end mutual funds were established during FY03 and FY04 in the private sector, which includes Pakistan Capital Market Fund and ABAMCO Composite Fund. The other three were established as a result of merger of the privatized ICP mutual funds (except 4th ICP Mutual Fund and ICP SEMF).[33]

[32] There are three kinds of mutual funds: (1) Growth Funds, which invest in stocks and offer potential for appreciation in share value. (2) Income Funds, which invest in government paper, corporate debts and shares of utility companies. These offer regular income but little potential for growth: and (3) Balanced Funds, which invest both in stocks and in government paper and corporate debts. These funds offer both moderate appreciation in share value and current income. (Source: Mutual Funds Association of Pakistan www.mufap.com)

[33] 1st, 3rd, 8th, 11th, 12th, 15th, 19th and 20th ICP Mutual Fund merged with ABAMCO Capital Fund, with effect from Mar 13, 2004. Whereas, 21st, 23rd and 25th ICP Mutual Fund merged with ABAMCO Stock Market Fund with effect from Feb 07, 2004. Lastly, 2nd, 5th, 6th, 7th, 9th, 10th, 13th, 14th, 16th and 17th ICP Mutual Fund merged with PICIC Investment Fund with effect from Jun 07, 2004.

These include the ABAMCO Stock Market Fund (ABAMCO SMF), ABAMCO Capital Market Fund (ABAMCO CF), and PICIC Investment Fund. Besides these, Arif Habib Investments took over the management of KASB Premier Fund, and renamed it as Pakistan Premier Fund.

***Privatized Mutual Funds***

The performance of the ICP funds managed by ABAMCO SMF improved considerably during FY03. Net Assets of these funds increased further, mainly in the fuel and energy sector. Overall profit of these funds has improved as reflected in higher dividend payouts during FY03 (see **Table 4.11**).

On the other hand dividend payouts of the ICP funds managed by ABAMCO CF registered a decline in dividend payouts. It is interesting to see that this is in contrast to the last four years, when the management of these funds was in the hand of the public sector and almost all of these funds showed a continuous increase in dividends.

Lastly, ICP funds managed by PICIC also registered a significant rise in their net assets. However, like other ICP funds, dividend payouts during FY03 were lower than FY02.

***Private Closed-end Mutual Funds***

NAV of most of the private sector closed-end mutual funds increased (see **Table 4.12**), and at end-Jun 2003, 4 mutual funds have net asset values higher than their par values. Relative to interest rates on bank deposits and government securities, the stock market continues to be a source of attractive earnings. Therefore, it is expected that the business of closed-end mutual funds is expected to flourish further especially given the growing competition following the entry of new companies in the sector.

**Table 4.11: Privatized Closed-end Mutual Funds**

Rupees

| | Par Value | Net Assets Value | | Dividend Payouts (percent) | |
|---|---|---|---|---|---|
| | | FY02 | FY03 | FY02 | FY03 |
| 1st ICP | 10.0 | 12.86 | 24.66 | 17.00 | 16.00 |
| 2nd ICP | 10.0 | 10.93 | 20.4 | 18.00 | 10.00 |
| 3rd ICP | 10.0 | 15.56 | 30.7 | 29.00 | 20.00 |
| 4th ICP | 10.0 | 31.66 | 58.58 | 45.00 | 42.00 |
| 5th ICP | 10.0 | 12.58 | 24.16 | 17.00 | 10.00 |
| 6th ICP | 10.0 | 22.99 | 41.45 | 30.00 | 25.00 |
| 7th ICP | 10.0 | 13.94 | 25.3 | 9.00 | 10.00 |
| 8th ICP | 10.0 | 20.07 | 31.34 | 48.00 | 32.50 |
| 9th ICP | 10.0 | 17.45 | 31.12 | 165.00 | 40.00 |
| 10th ICP | 10.0 | 12.93 | 32.9 | 18.00 | 15.00 |
| 11th ICP | 10.0 | 16.45 | 33.15 | 28.00 | 24.00 |
| 12th ICP | 10.0 | 15.69 | 27.4 | 23.00 | 18.00 |
| 13th ICP | 10.0 | 34.11 | 62.68 | 35.00 | 33.00 |
| 14th ICP | 10.0 | 13.18 | 23.34 | 13.00 | 10.00 |
| 15th ICP | 10.0 | 13.80 | 27 | 17.00 | 17.50 |
| 16th ICP | 10.0 | 10.33 | 18.9 | 10.00 | 10.00 |
| 17th ICP | 10.0 | 14.08 | 25.14 | 16.00 | 10.00 |
| 18th ICP | 10.0 | 10.46 | 18.72 | 12.00 | 10.00 |
| 19th ICP | 10.0 | 16.76 | 30.9 | 23.00 | 21.00 |
| 20th ICP | 10.0 | 16.66 | 30 | 21.00 | 21.00 |
| 21st ICP | 10.0 | 4.82 | 7.53 | 9.00 | 6.20 |
| 22nd ICP | 10.0 | 8.92 | 16.08 | 11.00 | 10.00 |
| 23rd ICP | 10.0 | 4.64 | 8.13 | 0.00 | 5.00 |
| 24th ICP | 10.0 | 5.15 | 8.62 | 0.00 | 12.00 |
| 25th ICP | 10.0 | 8.59 | 15.8 | 7.50 | 11.00 |
| SEMF | 10.0 | 26.95 | 48.7 | 26.00 | 35.00 |

**Table 4.12: Private Sector Closed-End Mutual Funds**

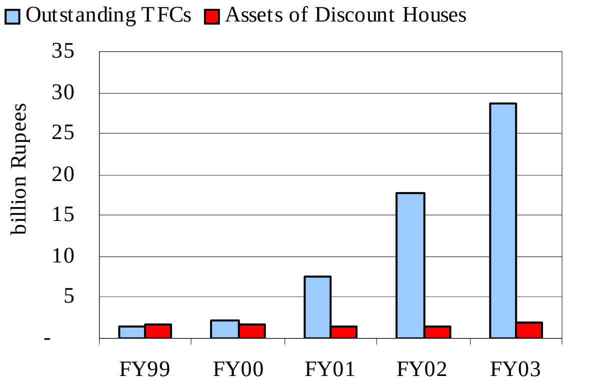
| | Net Asset Value (in Rs) | | Dividend Payout (in %) | |
|---|---|---|---|---|
| | FY02 | FY03 | FY02 | FY03 |
| Al-Meezan Mutual Fund | 10.7 | 18.6 | 16.0 | 20.0 |
| Asian Stocks Fund | 3.5 | 5.8 | 0.0 | 0.0 |
| BSJS Balanced Fund | 12.4 | 19.5 | 15.0 | 15.0 |
| First Capital Mutual Fund | 5.7 | 6.5 | 0.0 | 25 |
| Golden Arrow Stock Fund | 5.4 | 6.4 | 0.0 | 22.0 |
| Investec Mutual Fund | -0.1 | 2.67 | 0.0 | 0.0 |
| Pakistan Premier Fund | 9.0 | 16.3 | 5.0 | 0.0 |
| Prudential Stock Fund | 3.1 | 4.2 | 2.5 | 0.0 |
| Safeway Mutual Fund | 3.2 | 16.9 | 0.0 | 0.0 |
| Tri-Star Mutual Fund | 3.2 | 5.0 | 0.0 | 1.0 |
| Dominion Stock Fund | 3.2 | 3.4 | 3.2 | 2.0 |

Note: Data does not include the information of the two newly established mutual funds as the same were floated subsequent to FY03.

**4.8 Discount Houses**

Discount houses provide discounting/rediscounting services in government securities and/or corporate bonds, which makes them an easy and quick source of short-term funds. But such arrangements prosper in economies with a robust bond market, with a large number of tradable securities. In Pakistan, the corporate bond market is at an emerging stage. Although Pakistan's first corporate bond was issued by WAPDA in 1988, the first public sector TFC was listed on the stock exchange in FY95. From FY95 to FY00, only 10 companies issued their TFCs. However from FY01 to FY03, a number of financial institutions, textile companies, sugar and chemical companies issued their TFCs. At end-FY03, TFCs of Rs 28 billion have been issued thus providing a considerable depth to the bond market. For discount houses, such developments are positive given that they provide a spurt to their business activities.

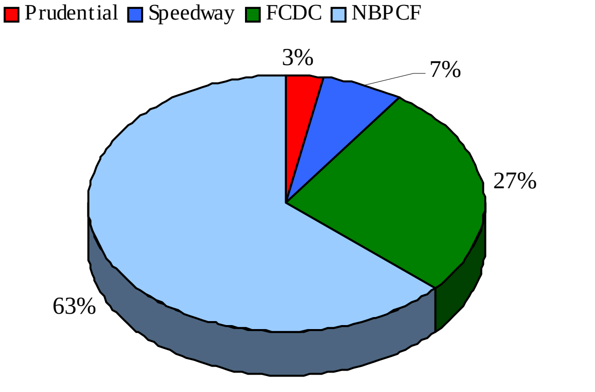
Figure 4.17: Performance of Discount Houses




In the past, the poor performance of discount houses in the country was owed to the lack of development of the bond market. At that time it was expected that the issuance of the new corporate debt instrument would add to the business activities of these institutions.

Although the corporate debt has reached around 2 percent of GDP by end-FY03, the business of discount houses remains rather squeezed (see **Figure 4.17**). This is due to the fact that commercial banks with better financial health and a large clientele also provide discounting facilities, as a result of which discount houses were unable to establish a significant market niche for themselves.

Figure 4.18: Asset Share of Discount Houses




At present, there are four discount houses operating in the country. Out of these, only one discount house constitutes 63 percent of total assets (see **Figure 4.18**). In fact, its share was 41 percent last year but after its acquisition by National Bank of Pakistan, its' business activities picked up pace.

***Performance during FY03***

During FY03, total assets of the existing four discount houses increased only by Rs 0.6 billion, which was again only due to the NBP Capital Fund (NBPCF), assets of which have more than doubled. The 10th issue of WAPDA bonds, TFCs issued by PIA and Pakistan Mobile Services Limited constituted the asset portfolio of NBPCF during FY03. Rest of the companies registered a decline in their asset base, out of which, two companies are under liquidation[34].

Contrary to FY02, earnings of the discount houses deteriorated and two companies (under liquidation) booked losses. NBPCF incurred higher profit compared to FY02 mainly due to the strong returns on TFCs. On the other hand, profit of First Credit and Discount Corporation (FCDC) decreased slightly. This was due to the decline in investments of FCDC in WAPDA bonds in FY03 which resulted in lower returns and commission earned on the purchase and sale of these bonds as compared to FY02.

## 4.9 Venture Capital Companies (VCCs)

Venture capital financing is widely believed to be significant for new innovative companies. "Conventional venture capital can best be defined by considering what venture capitalists do;

1. Create new business or re-vitalize existing ones.

[34] Speedway Fondmetal Limited and Prudential discount and Guarantee House are under liquidation.

2. Invest in high risk / high reward business options.
3. Carry out intensive analysis and investigation before making investments.
4. Participate directly and actively in investee operations, thereby providing a great deal of value addition to their investments.
5. Take a long-term orientation towards their portfolio companies because of the general illiquid nature of venture capital investments".[35]

**Box 4.9.1: What Literature says about Venture Capital**[1]
Literature explains four major difficulties that arise while taking up venture capital business. These include:

a. ***Lack of appropriately skilled people***
A venture capitalist must be entrepreneurially motivated, patient, realistically optimist, persuasive and able to skillfully evaluate business. Experienced people from outside are difficult to attract and retain, without special compensation packages which are almost impossible to structure.

b. ***Inadequate time horizon***
A venture capital usually experiences its losses and problems early, with successes taking more time to develop than anticipated. Unless a firm commitment is made for at least seven to ten years, a corporate venture fund is generally terminated in its early years

c**. *Contradictory rationales***
A corporate venture capital program may find it difficult to act in the best interests of both the investee company and the venture group. For instance, the desire of continuous profit increases by the parent may also be incompatible with the normal results of a venture operation.

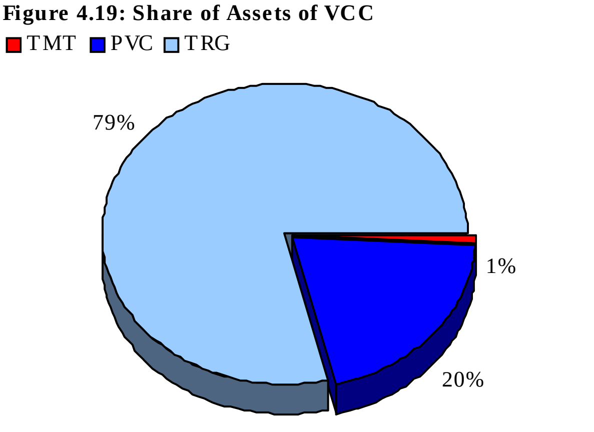
d**. *Legal Problems***
Several corporations have left the field incorrectly believing that they could not get the strategic benefits they wanted out of a venture activity because of legal strictures.

[1] The Role of Venture Capital in Corporate Development, by Kenneth W. Rind. Published in Strategic Management Journal, Vol. 2, No. 2, (Apr-Jun 1981)

For a developing economy, the existence of venture capital companies is as important as that of other financial institutions. This is because banks and other financial institutions rarely invest in new businesses; and more importantly they generally do not have the required expertise for monitoring newly started operations.

In Pakistan, the history of venture capital companies dates back only to the early 1990s when two such companies were established with a total asset base of Rs 105 million. The business of these companies did not expand as was desired and as was exhibited by other NBFIs established in the same decade. Although the nature of venture capital business itself presents a difficult proposition (see **Box 4.9**), the overall slow economic growth during the 1990s has been the root cause of the slower expansion of the VCCs.

**Figure 4.19: Share of Assets of VCC**



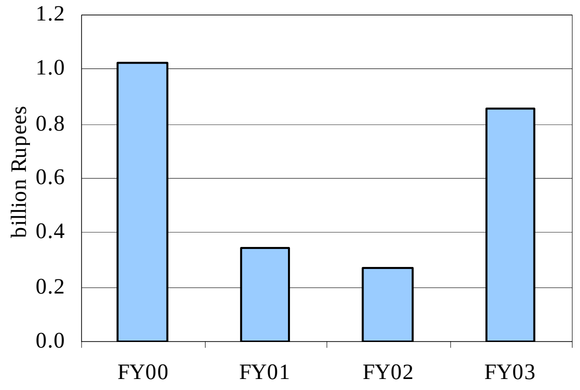

At present there are 2 Venture Capital Companies and 1 Venture Capital Fund operating in the country. In fact, Pakistan Venture Capital Company (PVCL), previously operating as a VCC, has changed its business objective duirng FY03 and is now only licensed to undertake asset management services. **Figure 4.19** shows that only one company constitutes 79 percent of the total assets of the sector. This company was licensed in FY02 to directly /indirectly acquire, manage and maintain the business of call centers and other business process outsourcing companies[36].

[35] The Role of Venture Capital in Corporate Development, by Kenneth W. Rind. Published in Strategic Management Journal, Vol. 2, No. 2, (Apr-Jun 1981).
[36] However, all the funds raised by the company are to be deployed in a venture project incorporated in Bermuda.

***Performance during FY03***

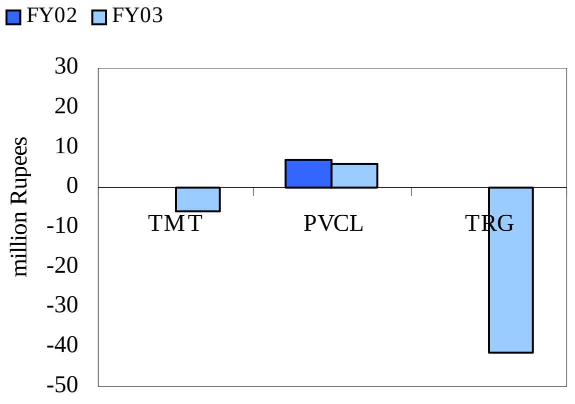
The asset base of the VCCs increased significantly during FY03 despite the liquidation of the Pakistan Emerging Venture Capital with an asset base of Rs 130 million (see **Figure 4.20**). This liquidation was more than offset by the establishment of a new company TRG Pakistan Limited with an asset base of Rs 673 million during the year.

**Figure 4.20: Assets of Venture Capital Cos.**




Assets of one of the existing companies increased whereas that of the other decreased slightly. The increase in the assets of PVCL is due to its investment in Dawood Money Market Fund (an open-end mutual fund) which it floated with a core capital of Rs 300 million during FY03. Besides that, PVCL invested in TFCs of various companies including financial institutions, chemical and cements companies. On the other hand, the assets of TMT declined due to a charging-off of the pre-operating expenses (deferred cost) to the profit and loss account. Adjusting for this entry, assets of TMT have actually increased during FY03.

**Figure 4.21:Net Profit of VCCs**




Profitability indicators, however, reflect a poor performance of VCCs during FY03 (see **Figure 4.21**). Out of three, two companies have incurred losses. In fact, the pre-operating expenses of TRG of Rs 43 million more than offset its operating profit of Rs 1.5 million. However, in the absence of such expenses in the future, it is expected that the performance of this company will improve. On the other hand, profit of PVCL decreased due to lower income from investments.