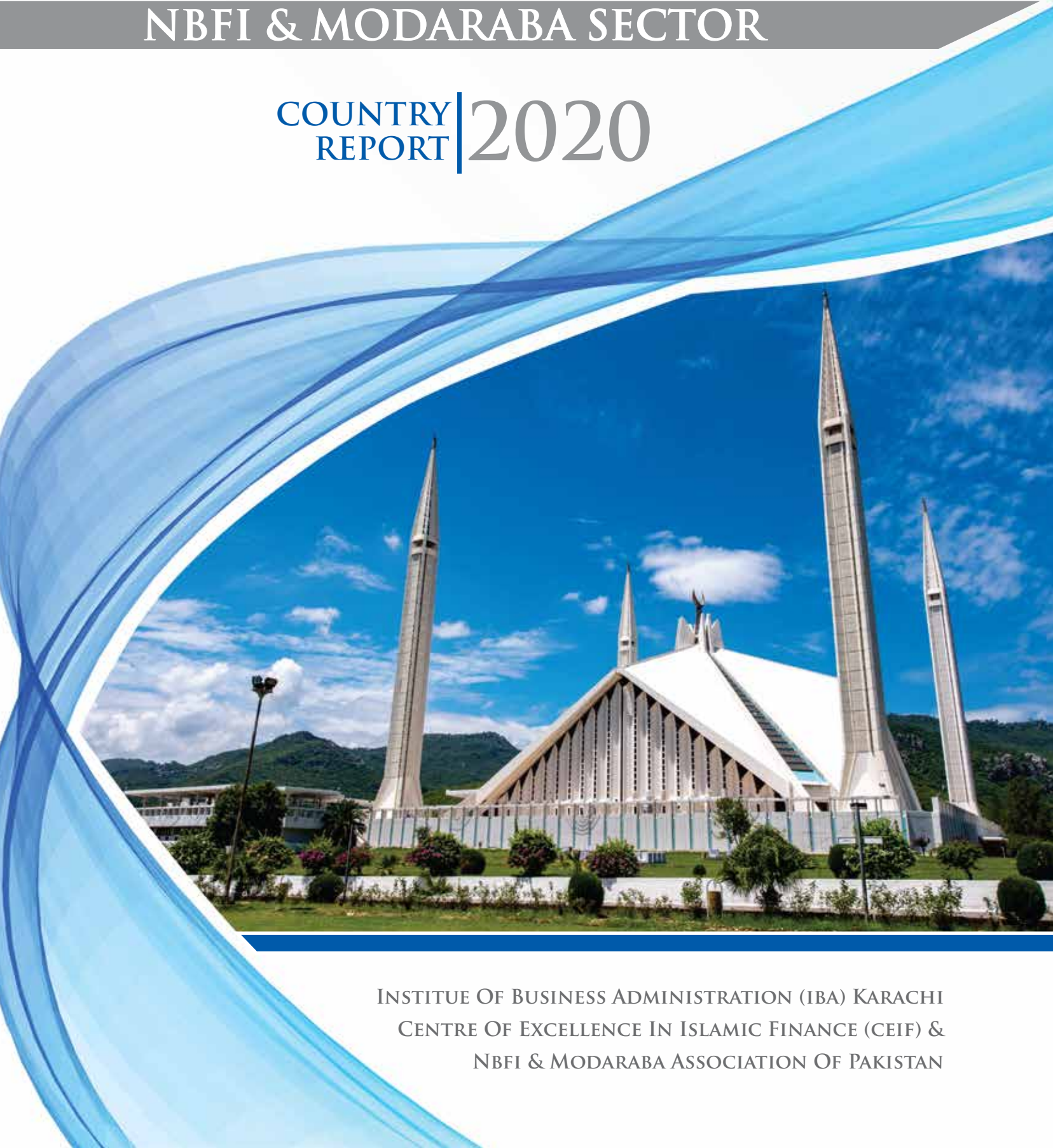


# NBFI & MODARABA SECTOR

## COUNTRY REPORT | 2020



INSTITUTE OF BUSINESS ADMINISTRATION (IBA) KARACHI  
CENTRE OF EXCELLENCE IN ISLAMIC FINANCE (CEIF) &  
NBFI & MODARABA ASSOCIATION OF PAKISTAN

# ACKNOWLEDGEMENT

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The success and final outcome of this project required a lot of guidance and assistance from many people. We would like to express our deepest appreciation to all those who provided us the possibility to complete this report. A special gratitude we give to Secretary General, Mr. Muhammad Samiullah, whose contribution to stimulating suggestions and encouragement, helped us to coordinate this project especially in writing this report.

We are also grateful to Mr. Bashir A. Chowdry, Mr. Shoaib Ibrahim, Mr. Raheel Q. Ahmad Mr. Murtaza Ahmed Ali, Mr. Shaheen Amin, Mufti Irshad Ahmed Aijaz and Mr. Muhammad Samiullah who provided insight, comments, and expertise that greatly enhance the report. We thank all the members of the NBF & Modaraba Association of Pakistan who have contributed to the completion of this important project.

Furthermore, we would also like to express gratitude to Ms. Bushra Aslam (Registrar Modaraba), Mr. Shahid Naseem (Executive Director) and Mr. Kashif Ghani (Additional Joint Director) from the Securities and Exchange Commission of Pakistan (SECP) for sharing invaluable information with us during the course of preparing this report.



A View of MoU signing ceremony

Mr. Muhammad Samiullah & Dr. Irum Saba exchanging the documents

In the background Dr. Ishrat Hussain, Advisor to Prime Minister, Mr. Raheel Q. Amad, CEO, ORIX Modaraba and others.



The Institute of Business Administration (IBA) is a premier business school in Pakistan, established in 1955 with over 50 years track record of producing undergraduates and postgraduates for developing practitioners, generating innovative ideas and promoting creative solutions that address the needs of Pakistan and the global community.

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# NBFI & Modaraba

## Association of Pakistan

NBFI & Modaraba Association of Pakistan (The Association) was incorporated on 29th July, 2010 by merging Modaraba Association of Pakistan (MAP) and Leasing Association of Pakistan (LAP).

The Trade Organization Rules, 2007 and Trade Organization Ordinance, 2007 were promulgated simultaneously on 7th June, 2006 and 14th December, 2007 respectively, in terms of which every existing association has to obtain a fresh license as an existing trade body. MAP was incorporated on 17th April, 1994 and LAP was incorporated on 22nd June, 1995 under Section 42 of the Companies Ordinance, 1984. In order to comply with the Trade Organization Ordinance, 2007 MAP and LAP applied for fresh license separately as an existing Trade Body and completed all the requirements under the Ordinance.

The Director General, Trade Organization (DTO) Islamabad declined the requests of both MAP and LAP for grant of

license. According to DTO there were four associations in the Non-banking Finance Sector in the fields of leasing, Modaraba, mutual funds and investment banks, having identical functions and representing the same and significantly similar trading sector and operate under the control of Securities and Exchange Commission of Pakistan (SECP) as Non-banking Finance Companies. It was advised to merge these associations in terms of Section 33 of the Trade Organizations Ordinance, which read as under:-

“Section 33: Merger of Trade Organizations: Notwithstanding anything contained in any other law for the time being in force or provisions in Memorandum and Articles of Association of any trade organization, the Federal Government may, by notification in official gazette, direct any number of trade organizations to merge if each of them is invoked in the same or significantly similar trade, industry or services or any combination thereof.”



The DTO required merger of these associations and directed to submit an agreed proposal with regard to the issuance of license of the representatives of the said trade, industry and services.

The Executive committees of MAP and LAP in their respective meetings approved the merger of both the Associations with and into each other while Mutual Funds Association took the plea that the business activities of the members of the Mutual Funds were quite different from the other three Associations. Accordingly MUFAP succeeded in getting a fresh license as an existing trade body under the Trade Organization Ordinance, 2007. Initially Investment Banks' Association of Pakistan agreed to join MAP and LAP for merger but subsequently decided to maintain a separate status though some of their members were also the members of the Leasing Association. Consequently the MAP and LAP were merged with and into each other and a new entity named "NBFI & MODARABA ASSOCIATION OF PAKISTAN" was established and Certificate of Incorporation obtained from SECP on 29th July, 2010. By virtue of this merger all the members of MAP and LAP became the members of the newly established Association.

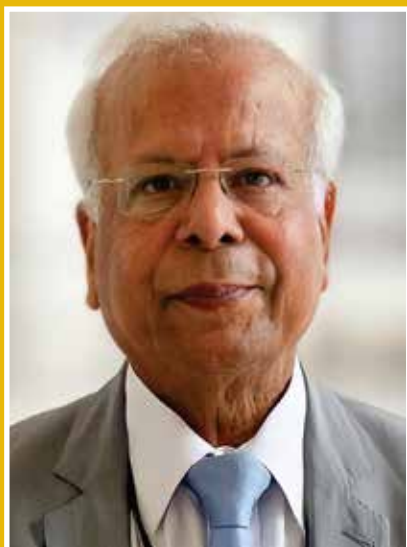
At the time of merger, Mr. Muhammad Samiullah was Secretary General of both the Associations. The Executive Committee decided to appoint him Secretary General of NBFI & Modaraba Association of Pakistan.

With the establishment of this Association, MAP and LAP have been wound up voluntarily and all requirements for members' voluntarily winding up were completed and submitted to Securities and Exchange Commission of Pakistan.

In order to enhance the membership threshold of the Association and make it a true representative body of NBFI & Modaraba Sector, the Memorandum of the Association provided for the inclusion of Modarabas, Leasing Companies, Investment Finance Services, Housing Finance, Investment Advisory Services, Discounting Services, Private Equity/Venture Capital, REITS and such other businesses as permitted to be conducted by the members of the Association. By inviting these entities, the scope of the Association can be widened.

The Association provides a forum to all its members to confer on all issues of common interest and to formulate joint strategies for their operations.

# FOREWORD



## PROF. DR. ISHRAT HUSAIN

Advisor to the Prime Minister for  
Institutional Reforms & Austerity &  
Chairman, IBA Centre of Excellence in  
Islamic Finance, Karachi, Pakistan

**As Pakistan moves forward in its journey towards sustainable development, it is imperative that the financial institutions play its role in delivering long-lasting socio-economic prosperity. Being a developing country, the developmental and complementary roles of Non-Bank Financial Institutions (NBFIs) and Modaraba companies are key to facilitate specific sectors such as, Transport & Communications, Manufacturing, Services, Chemical, Fertilizers & Pharmaceutical, Energy, Food, Tobacco & Beverages, and Trading, as well as specific segments like Small and Medium Enterprises (SMEs).**

Modaraba has established itself as a well understood Shariah-compliant instrument of financing in Pakistan. It has been practiced for the last 40 years and we have gained a lot of experience in its operations and management. We have developed an institutional framework that is acceptable to the scholars and also clarified the initial confusion regarding the regulatory responsibilities. The dual structure between SECP and SBP has given way to a single regulatory agency which is SECP. We had therefore logically expected that Modaraba will provide a transit point in our path towards the Islamic financial system. We thought we could apply the experience gained from this mode of financing and scale it up and replicate it throughout the system. But Modarabas haven't taken off so far in this country

despite such a long-standing and their contribution to the financial sector has been insignificant. Why has the performance of the Modaraba sector been so disappointing?

First, the governance structure of the Modarabas has proved to be inadequate and the interests of the investors and certificate holders have not been adequately protected. The concentration of powers in the hands of managers particularly when the standards of transparency and disclosure are not that rigorous does leave a lot to be desired. It is high time that the NBFIs & Modaraba Association of Pakistan should examine the whole governance structure ab initio in the light of the experience gained during the last three decades and move in a direction which gains the trust and confidence of the investors.

Second, these institutions need much greater transparency in operations to inspire confidence. Liberal use of Central Depository and disclosure standards need to be improved and upgraded so that the ordinary prospective investor is assured that his money is not only safe but is being managed in the most professionally desirable manner. At least institutions should strive to achieve and maintain the same standards of disclosure and transparency which are applicable to other financial institutions in Pakistan. This way this sector will be at par in terms of attracting investment to Modarabas.

Third, the risk management practices in Modarabas should be reviewed to find out if the managers are optimizing the returns for the given level of risk. There is an urgent need to determine if the tools and techniques being adopted by institutions to represent the best practice in the industry keeping the constraint of compliance with Shariah in place. The only credible way to expand this mode of financing is by demonstrating that the reward-risk relationship under Modaraba is not inferior compared to other instruments.

Fourth, although the regulatory dualism has been sorted out by giving the SECP the exclusive responsibility for regulation over the Modarabas I believe that the oversight has not always been exercised with utmost vigilance. The Registrar has too many powers and in my view, too much discretion and I would like to question whether this is the right regulatory model. Shouldn't we at least consider some alternative such as some elements of market-based regulation combined with self-regulation.

Fifth, the Modarabas have not been able to diversify their products or differentiate from other market players such as Leasing companies. Almost 75% of their business is concentrated on leasing which does not provide any market niche or comparative advantage to them. The leasing portfolio mostly covers traditional industries such as textiles, light engineering, cement etc. New activities have by-passed the leasing sector so far. Isn't it time to avoid

this herd instinct and develop some other products and services which are uniquely the domain of the Modarabas and also tailored to the demand of the particular customer base which has so far not been able to access financial sector institutions.

Sixth, the Modarabas have to become more competitive in their cost of funding. If they continue to rely on the banks they would always remain at a cost disadvantage. As the tax rates on the banks are gradually reduced, the big banks are privatized and the drag of non-performing assets is softened the banks will be able to outclass the Modarabas in the cost of funding. Institutions have to tap other sources that remain unrealized and do not flow to the banking sector. There are many savers who do not want to use the banking system and are looking for Shariah-compliant products. Institutions should try to attract them and thus add to the overall national savings pool of the country.

Seventh, the Modarabas have very little geographical dispersion outside the big cities such as Karachi, Lahore, and Islamabad. Unless presence in smaller towns is established and have a distribution network that is extensive, I am afraid that asset growth and deposit mobilization would remain lackluster. Small and medium enterprises are looking desperately for finances and consumer financing is also in the stage of infancy. This is an area that can augment profitability by cross-selling for Modaraba sector.

Finally, the minimum capital requirements of the Modaraba sector should also be raised to levels that allow for more rapid asset growth. At the time other non-bank financial institutions are expanding their capital to do more business, it would be to disadvantage of Modaraba sector if this sector is unable to keep pace with them in terms of capital adequacy.

The success of Modarabas will also show us the path to an orderly and smooth transition to the Islamic system of financing.



# MESSAGE BY THE CHAIRMAN



## NBFI & MODARABA ASSOCIATION OF PAKISTAN

### BASHEER A. CHOWDRY

Chairman  
NBFI & Modaraba Association of Pakistan

The financial sector of Pakistan comprises of two major components namely banking sector and non-banking financial sector. Banking sector includes banks (conventional as well as Islamic), DFIs and microfinance banks whereas the non-banking financial sector includes all other entities which are non-banking like leasing companies, modarabas and investment finance services besides securities market related entities. NBFI & Modaraba Association of Pakistan is a representative body of leasing companies, modarabas and some investment finance services entities.

NBFI and Modaraba Sector, though operating in the country for over four decades, has not been able to explore its full potential and diversity due to so many factors including lack of effective awareness of its capabilities and opportunities at pertinent levels. In order to promote an overall awareness of the sector, the NBFI & Modaraba Association of Pakistan has been taking various measures over the past years in various forms. However, a detailed report on the NBFIs and Modarabas was not available other than the Year Book which has been regularly published by the Association dealing mainly with the financial results. The concept to prepare a Country Report on this Sector was given by Mr. Raheel Q. Ahmad, CEO, ORIX Modaraba and former Chairman of the Association and appreciated by the stake holders. Consequently, the task was assigned to IBA-CEIF to compile the report in collaboration with the NBFI & Modaraba Association of Pakistan. It is comforting that the project which was delayed due to spread of COVID-19 Pandemic in the country has been completed now.

Efforts have been made to include in the Country Report various aspects of NBFI and Modaraba sector encompassing its evolution, growth, structure, performance, Shariah compliance and regulatory framework. It is hoped that it will provide a comprehensive coverage of the Sector to the readers.

We are indeed thankful to Prof. Dr. Ishrat Hussain, Advisor to PM for Institutional Reforms & Austerity and the Chairman, IBA-CEIF, Karachi and Ms. Bushra Aslam, Executive Director and Registrar Modaraba SECP for their continuous guidance and encouragement in compilation of the report. We are also thankful to our senior colleagues who contributed their valuable thoughts in their interviews which form a very useful component of the report. We also place on record, with gratitude, our acknowledgment of the concerted efforts made by Dr. Irum Saba, Assistant Professor, IBA - CIEF as the Coordinator of this project and Mr. Muhammad Samiullah, Secretary General of the Association for compilation and completion of this report.



# EXECUTIVE SUMMARY

This report is prepared by the IBA Centre for Excellence in Islamic Finance (CEIF) in collaboration with the NBFI & Modaraba Association of Pakistan. It aims to give a snapshot of the international Non-Banking Financial Institutions (NBFI) and the NBFI & Modaraba Sector in Pakistan. It appeared that the NBFI & Modaraba was neglected from the support of the government and the regulatory authority. The executive survey was conducted from the existing Modarabas, Leasing companies, and Investment finance services. Apart from that, some of the statistics are taken from the yearbooks of the NBFI & Modaraba Association of Pakistan. Moreover, eight interviews were conducted to figure out why this sector is lagging behind and what could be done to develop this sector in a complementary role. It also highlights the importance of the NBFI & Modaraba sector for economic development, SME financing, and financial inclusion in the case of Pakistan. In 2015, four more Modarabas were established that are Awwal Modaraba, Sindh Modaraba, Habib Metro, and Orient Rental. Awwal Modaraba has also acquired KASB, Pak, and Prudential Modaraba. Besides, it explores the challenges experienced by the NBFI & Modaraba sector through an executive survey and exclusive interviews of Shariah scholar, Registrar Modaraba, Chairman & Secretary General of NBFI & Modaraba Association of Pakistan, and practitioners. It also discusses the initiatives taken by the Securities and Exchange Commission of Pakistan (SECP) and the NBFI & Modaraba Association of Pakistan for the development of the sector. For instance, the NBFI & Modaraba Association of Pakistan has moved toward the central bank of incorporation of such Modarabas and Leasing companies who satisfied the required criteria in their several concessional schemes especially those implied for SMEs. The report ends by giving a recommended action plan for the betterment of this industry such as risk-sharing arrangements for all members in collaboration with the Ministry of Finance and the state bank of Pakistan.

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Executive Director and Registrar  
Modaraba,  
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Chairman  
NBFI & Modaraba Association  
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## **Mr. Muhammad Shoaib Ibrahim**

Chief Executive Officer,  
First Habib Modaraba



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## **Mufti Irshad Ahmed Aijaz**

Chairman  
Shariah Advisory Board  
Bank Islami Pakistan Limited



## **Mr. Raheel Q. Ahmad**

Chief Executive Officer,  
ORIX Modaraba



## **Mr. Shaheen Amin**

Chief Executive Officer,  
ORIX Leasing Pakistan Limited



## **Mr. Muhammad Samiullah**

Secretary General,  
NBFI & Modaraba Association  
of Pakistan



## **Mr. Murtaza Ahmed Ali**

Chief Executive Officer,  
Allied Rental Modaraba

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# 1 PAKISTAN AT A GLANCE



# 1. PAKISTAN AT A GLANCE

Pakistan is a developing country that came into existence on August 14, 1947. It is officially called the Islamic Republic of Pakistan. It has 43rd largest<sup>1</sup> economy in the world with respect to purchasing power parity (PPP)<sup>2</sup>. This chapter specifically focuses on the economic environment in Pakistan by means of the fundamental statistics describing the macroeconomic fundamentals, demographic overview, and efforts to improve the economic environment. The chapter ends by giving an economic outlook of Pakistan in 2019.

## 1.1 The Economic Environment

The Gross Domestic Product (GDP) growth rate is presented in Figure 1 for the period 1961-2018. Overall, data shows that the economy of Pakistan has experienced numerous boom and bust cycles over the years. Each boom cycle comprised almost 3 to 4 years of relatively higher GDP growth followed by a crisis that required the stabilization policies and programs. The restoration efforts demand from the financial sector to play its indispensable role by providing medium to long term financing to increase the pace of economic growth.

Figure 1: Pakistan's GDP Growth Rate 1961-2018<sup>3</sup>

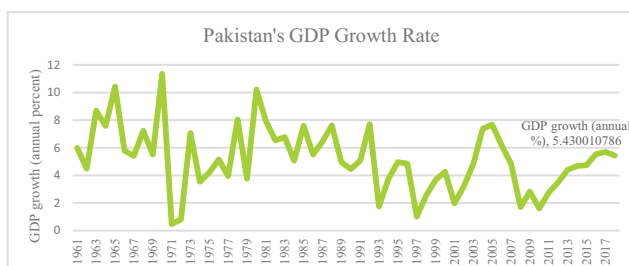
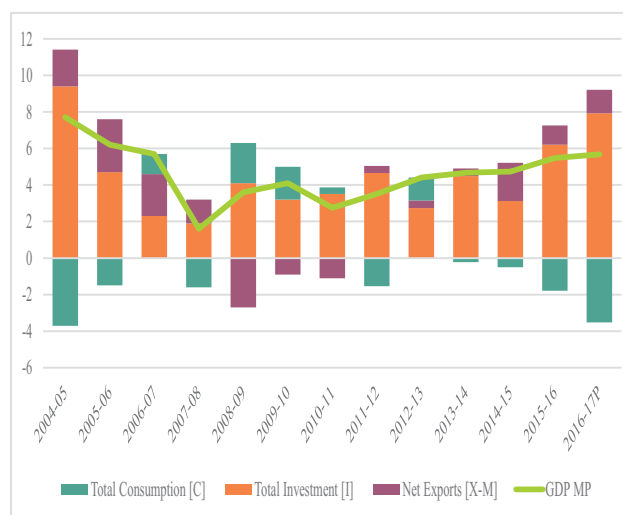


Table 1: Composition of GDP Growth Rate of Pakistan

Period	Consumption	Investment	Net Exports	GDP
2013-14	91.8	14.6	-6.4	118.7
2014-15	90.7	15.7	-6.4	117.1
2015-16	91.3	15.7	-7	116.2
2016-17	93.2	16.2	-9.3	117.6
2017-18	94.2	16.7	-11	119.7
2018-19	94.8	15.5	-10.2	119.9

The GDP growth rate of Pakistan is equal to 3.29 percent in 2018-19 with the sectoral growth 0.85 percent, 1.4 percent, and 4.7 percent for agriculture, industry and services sector respectively.<sup>4</sup> The national savings and investments are 10.7 percent and 15.4 percent of GDP.

Figure 2: GDP Growth along with Components (percentage points)<sup>5</sup>



## 1.2 Macroeconomic Fundamentals

The macroeconomic framework has been envisioned to place Pakistan's economy on a vigorous growth trajectory through macroeconomic management, which will guarantee a stable macroeconomic environment with stable inflation and sound fiscal and current account balances. At present, Pakistan is facing substantial macroeconomic imbalances because of increasing international commodity prices, global financial crises, and domestic supply constraints included energy outages and escalation of the war on terror. Hence, the present-day objective is to consolidate the emerging macroeconomic stability through proper monetary and fiscal measures, intended to crowd in the private investment, mobilizing domestic savings and stimulating the economic growth process.<sup>6</sup>

Pakistan continues to witness macroeconomic challenges regardless of steps taken to reduce internal and external deficit that is the tightening of fiscal and monetary policies, and in this environment, the country's GDP growth is

<sup>1</sup> Source: Projected GDP Ranking (2019-2023):

<http://statisticstimes.com/economy/projected-world-gdp-ranking.php>

<sup>2</sup> Purchasing Power parity (PPP) is a theoretical exchange rate that allows you to buy the same amount of goods and services in every country.

<sup>3</sup> Data Source: World Development Indicators

<sup>4</sup> Source: Pakistan Economic Survey 2018-19 [http://www.finance.gov.pk/survey/chapters\\_19/Overviewpercent20ofpercent20thepercent20Economy.pdf](http://www.finance.gov.pk/survey/chapters_19/Overviewpercent20ofpercent20thepercent20Economy.pdf)

<sup>5</sup> Data for this plot is taken from Pakistan Economic Survey 2010-11 for the period 2004-05 to 2009-10 and for the period 2010-11 to 2016-17, data is taken from Pakistan's Economic Survey 2016-17.

<sup>6</sup> Source: Macroeconomic Framework and Strategy: <https://www.pc.gov.pk/uploads/plans/Ch2-Macroeconomic-framework-and-strategy2.pdf>



expected to slow down to 3.9 percent in 2019. Currently, the monetary value of the trade deficit is \$ 32 billion which is 10.1 percent of GDP. Whereas, the fiscal deficit is 6.5 percent of GDP due to lower revenue collection and higher current expenditure. In this situation, it would be difficult for the government of Pakistan to reduce its budget deficit.

This trend is predominantly due to the increasing cost of imported raw materials, higher energy prices on account of depreciation of Pakistani Rupee, and liquidity constraints due to a higher level of unsold inventories (in POL, steel, autos, fertilizers, electronics and sugar sectors). Though non-manufacturing companies have reduced further expansion with the exception of few industries e.g. power, cement and textile sectors continued to borrow funds for expansion.

### 1.3 Demographic Overview

Demographics are certainly a key determining factor for a country's growth potential. At the global level, working-age population is beginning to fall. In other words, the aging population is increasing while the birth rate is declining. Therefore, the overall economic growth is likely to decrease in the future. However, an increase in productivity can lessen the impact of such population shifts. Productivity boosts are achieved through technological advances but it can eliminate jobs outright. Hence, the economic development of a country relies on the increase in productivity and the labour force. On the contrary, the size of working-age population is rising in Pakistan. According to the Ministry of Finance (MoF), the percentage of working-class in Pakistan is equal to 60.4 percent.<sup>7</sup> Which means that more than 60 percent of people in Pakistan are between 15-64 years of age.

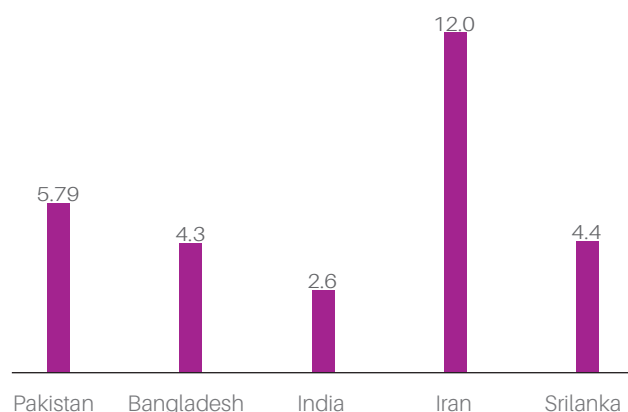


Figure 3: Regional Unemployment Rate<sup>8</sup>

In 2017-18, the unemployment rate has decreased in Pakistan that is 5.79 percent. Pakistan's economy has been dominated by the agriculture sector over the past decades. Services and manufacturing sectors are showing an increasing trend of employment with 37.6 percent and 23.89 percent employment ratio. To further increase employment ratio, particularly through SME financing, financial institutions especially Non-Bank Financial Institutions (NBFIs) and Modarabas are essential. With a growing number of working-class in Pakistan we need more jobs/business to cater the employment needs of the young generation. In Pakistan, we need to improve infrastructure for the startups and business community so that Pakistan could rank high in ease of doing business rankings.

### 1.4 Efforts to Improve Environment

The present government took steps to address fiscal and external account deficit. It has secured \$ 9.2 billion from friendly countries to develop supports and to guarantee timely reimbursement of past debt. The government has additionally increased the energy tariffs in order to avoid the accumulation of circular debt. Moreover, the government has regulated non-essential imports through regulatory duties. The government also decided to withdraw some of the subsidies given in the last budget to stop the deterioration in primary balance.

The government of Pakistan is working on the macroeconomic adjustment policies (e.g. monetary tightening, exchange rate adjustment, expenditure control and enhancement of regulatory duties on non-essential imports) for stability. Besides, the present government has given priority to employment generation by taking the initiative to create 10 million job opportunities and to construct 5 million houses. It also aims to strengthen Small and Medium Enterprises (SMEs), tourism and labor-intensive sectors.

### 1.5 Pakistan's Economic Outlook 2020

Pakistan's economic activity is growing at a slower pace from there on against a backdrop of widening macroeconomic imbalances and low level of savings and investment. Inflation came down in 2018 at around 3.92 percent from 4.15 percent in 2017. Nevertheless, it climbed pointedly due to the currency devaluation and demand-side pressures. On the other hand, currency devaluation ought to help in boosting up exports in later years so the current account deficit could be reduced.

<sup>7</sup> Source: Pakistan Economic Survey 2015-16; [http://www.finance.gov.pk/survey/chapters\\_16/12\\_Population.pdf](http://www.finance.gov.pk/survey/chapters_16/12_Population.pdf)

<sup>8</sup> Source: [http://www.finance.gov.pk/survey/chapters\\_19/12-Population.pdf](http://www.finance.gov.pk/survey/chapters_19/12-Population.pdf)

Table 2:Economic Indicators of Pakistan 2016-19<sup>9</sup>

Main Indicators	2016	2017	2018	2019
Gross domestic product (Constant prices, Annual percent Change)	4.56	5.37	5.22	2.90
Gross domestic product, current prices (billions USD)	278.65	304.95	312.5	278.02
Total investment (percent of GDP)	15.68	16.09	16.42	15.4
Gross national savings (percent of GDP)	13.94	11.95	10.35	10.19
Inflation, average consumer prices (percent)	2.86	4.15	3.92	7.64
Unemployment rate (percent of the Labour Force)	5.96	6.01	6.08	6.14
General government gross debt (percent of GDP)	67.63	66.96	72.13	76.99
Current account (billions USD)	-4.87	-12.62	-18.99	-14.48
Current account balance (percent of GDP)	-1.75	-4.14	-6.08	-5.21

Pakistan's macroeconomic indicators are expected to gradually revert to a steady direction with a package of structural reforms in fiscal management and competitiveness. While the real GDP growth is probably going to stay contained during the process. Specifically, modification on the fiscal side presently can't seem to get in progress. Keeping in view of the revenue generation measures promulgated in the Federal Budget 2019-20 such as an increase in power tariffs and a recent surge in gas prices, the disposable income and the domestic demand are expected to decrease. In the midst of such conditions, the industrial development isn't likely to bounce back outstandingly one year from now. However, the agriculture sector can significantly contribute in GDP growth with better water availability, increasing production area, and up-gradation of crop processing methods. Besides, investment on education and infrastructure (e.g. transportation networks, communication, electricity, gas, water supply as well as various technologies) can likewise

positively affect GDP growth in the fiscal year 2020. With respect to the current account, the government of Pakistan is anticipating the budget deficit to decrease further in 2020 with the expectation of better export performance, control of import payments and continuous flow of remittances. As a matter of fact, an increase in exports to the traditional market may prove challenging due to the aggravated trade tensions between the United States and China and the uncertain situation in Europe. The inception of the IMF Extended Fund Facility program would provide assistance on the financing side. Lastly, in spite of monetary tightening, it is anticipating that inflation will be higher in 2020<sup>10</sup>. At this point in time, raising domestic savings and investment is necessary. Therefore, there is an opportunity for NBFIs and Modarabas to increase incentives on savings and investments of people through services like investment finance, leasing, housing finance, venture capital investment, investment advisory and assets management services.

<sup>9</sup> Source: International Monetary Fund, World Economic Outlook Database, April 2019

<sup>10</sup> Source: The State of Pakistan's Economy, Third Quarterly Report 2018-19, State Bank of Pakistan: <http://www.sbp.org.pk/reports/quarterly/fy19/Third/Complete.pdf>



## EXCLUSIVE INTERVIEW:



## MS. BUSHRA ASLAM

Executive Director and Registrar  
Modaraba,  
Securities & Exchange  
Commission of Pakistan

**1. How did the Modaraba sector emerge in Pakistan's financial system?**

The efforts to bring the conventional banking system into Shariah based banking system started in the 1960s era but, it accelerated during the reign of General Zia-ul-Haq who, started to streamline all segments of life with Islam. In due course, Mr. Zia-ul-Haq amended the complete legal structure of financial and corporate arrangements of the country on June 26, 1980, followed with the issuance of Riba-free instruments of debt financing which were called the Participation Term Certificate (PTC). An Ordinance was issued to allow the establishment of Modaraba management companies and the floatation of Modaraba as entities to raise Islamic-based capital. "Ultimately, amendments were also made in the Banking Companies Ordinance, 1962, and other related laws to include the provision of bank deposits through PLS, mark-up in prices, leasing and hire purchase".

**2. Can you explain briefly about Modaraba sector and its ownership structure? What is the market share composition? Is the industry dominated by few, big Modarabas?**

At the moment, there are 29 Modarabas operating in Pakistan. The total assets of the sector amount to Rs. 51.77 billion, total equity amounts to Rs. 20.63 billion and the cash dividend paid for the year ended June 30, 2019 was Rs. 908 million. Majority of the Modarabas are financial service oriented whereas some of them are rental and trading Modarabas. In terms of total assets and equity, the sector is dominated by five big player, the total assets and equity constitutes Rs.41.93 billion (81percent) and Rs. 13.43 billion (65percent) respectively.

**3. How would you comment on the performance of Modaraba sector in Pakistan over the period of last 10 years?**

The Modaraba sector is certainly

a growing sector. A quick comparison between the figures from 2009 to 2019 evidences encouraging growth patterns. The total assets of the Modaraba sector for the year ended June 30, 2009 were Rs. 23.11 billion, total equity was Rs. 10.83 billion and the paid-up fund was Rs. 8.33 billion. Whereas, for the year ended June 30, 2019, the total assets of the sector are Rs. 51.77 billion, total equity is Rs. 20.63 billion and total paid up fund is Rs. 13.5 billion. The improvement is encouraging however if compared with mainstream Islamic banking sector, there is a lot to be done in terms of financial inclusion, educating the masses about the sector and promoting outreach of Modarabas in rural economy.

#### **4. What is the current enabling environment for NBFIs and Modarabas in Pakistan? And what are the missing elements for the growth of the sector?**

SECP is providing every possible assistance on the regulatory front and was recently nominated as 7th best regulator in the world. SECP always strives for providing ease of doing business and it is clearly evident from the recent development in its legal framework. Major laws were updated or are in the process of upgradation. Regulatory fees were significantly reduced, major processes are being shifted online which means a paperless environment in the future.

Coordination with other regulatory authorities is increasing e.g. FBR and BOI etc.

#### **5. What policy, legislative and regulatory reforms were made in order to promote NBFIs & Modaraba Sector?**

SECP over the years has been providing conducive environment for promotion of the Modaraba Sector. It continually reviews the legal structure, laws, rules and regulations for ease of doing business in consultation with the stakeholders and provides continuous support and guidance for greater financial inclusion. We have initiated various steps for protection of investors through introducing online complaint portal, guidelines for investors through a web portal called Jamapunji. We also conduct 100percent offsite financial review of the Modarabas sector, triggered based On-site inspections etc.

#### **6. What do you see as the strengths and weaknesses of the legal, regulatory, and policy environment for NBFIs and Modarabas?**

The major strengths of Modaraba sector in legal terms is variety of businesses. The Modaraba law does not restrict any business in the Modaraba structure other than businesses in contrast with Shariah. So, Modarabas can engage in literally any business including but not limited to financial services, rental, manufacturing, services, real

estate and agriculture etc. Going forward, major amendments are being proposed in the Modaraba law which will empower the certificate holders to great extent, introduce the concept of unlisted Modarabas and a lucrative remuneration regime for the Modaraba management companies. At the regulatory front, SECP provides utmost assistance to the existing players and potential aspirants for starting businesses in the Modaraba model. We are updating the relevant laws, increasing public interaction and educating the students at Colleges and Universities. Further, the Federal Government has provided tax exemption to the Modarabas if 90percent of its profits are distributed among the certificate holders. Talking of weaknesses, the federal government revoked the tax exemption from trading and manufacturing Modarabas, and the industry fears of more to come. The NBFIs and Modaraba sector does not have access to easy cheap credit in contrast to the Islamic banks. Hence their cost of funds is higher which ultimately leads to second and third tier clientele.

#### **7. Do you have any impact assessment mechanism for the analysis of relevant laws and regulations?**

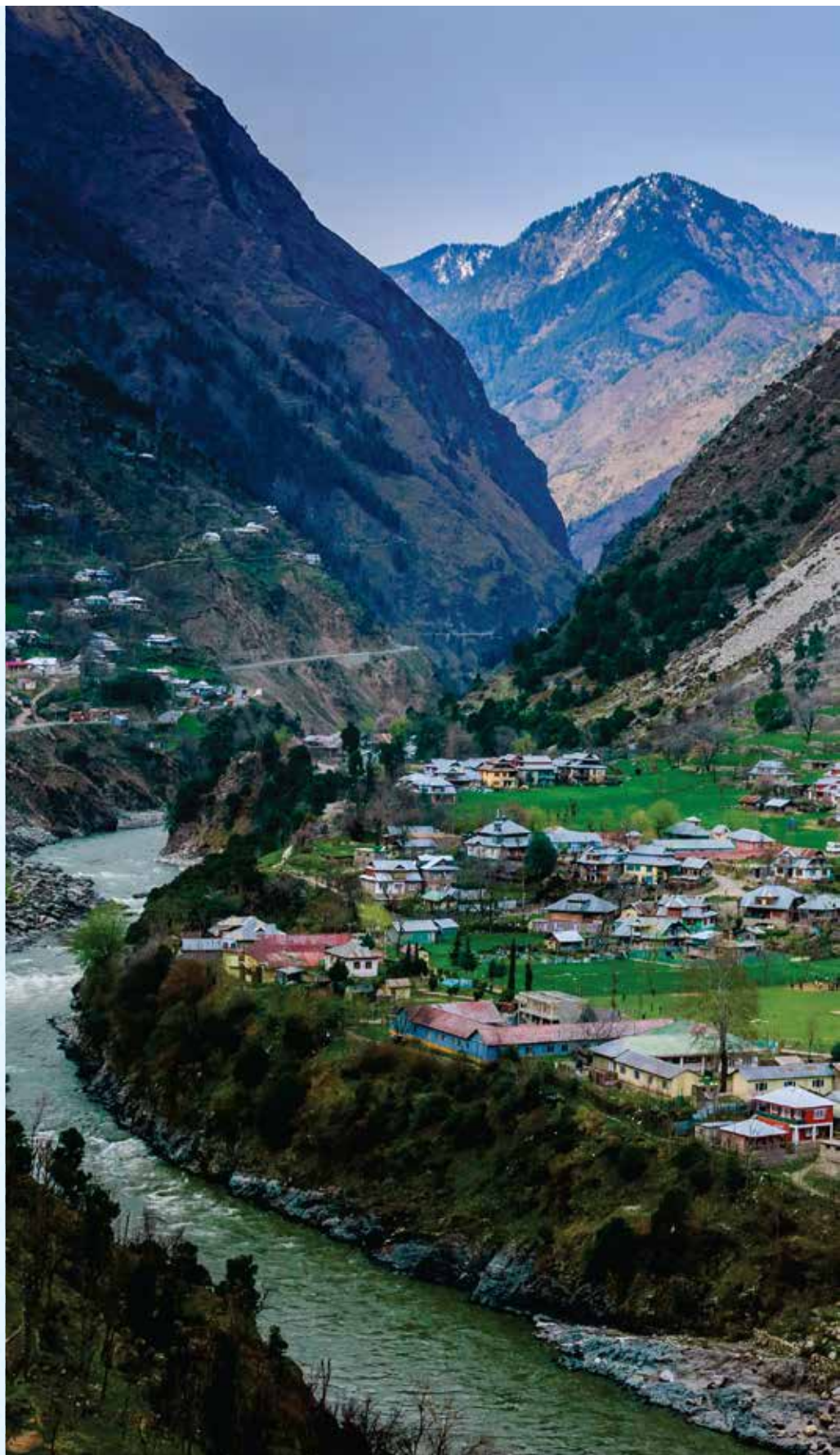
As a matter of fact, all the laws administered by SECP including the Modaraba laws, when drafted or amendments made, are placed



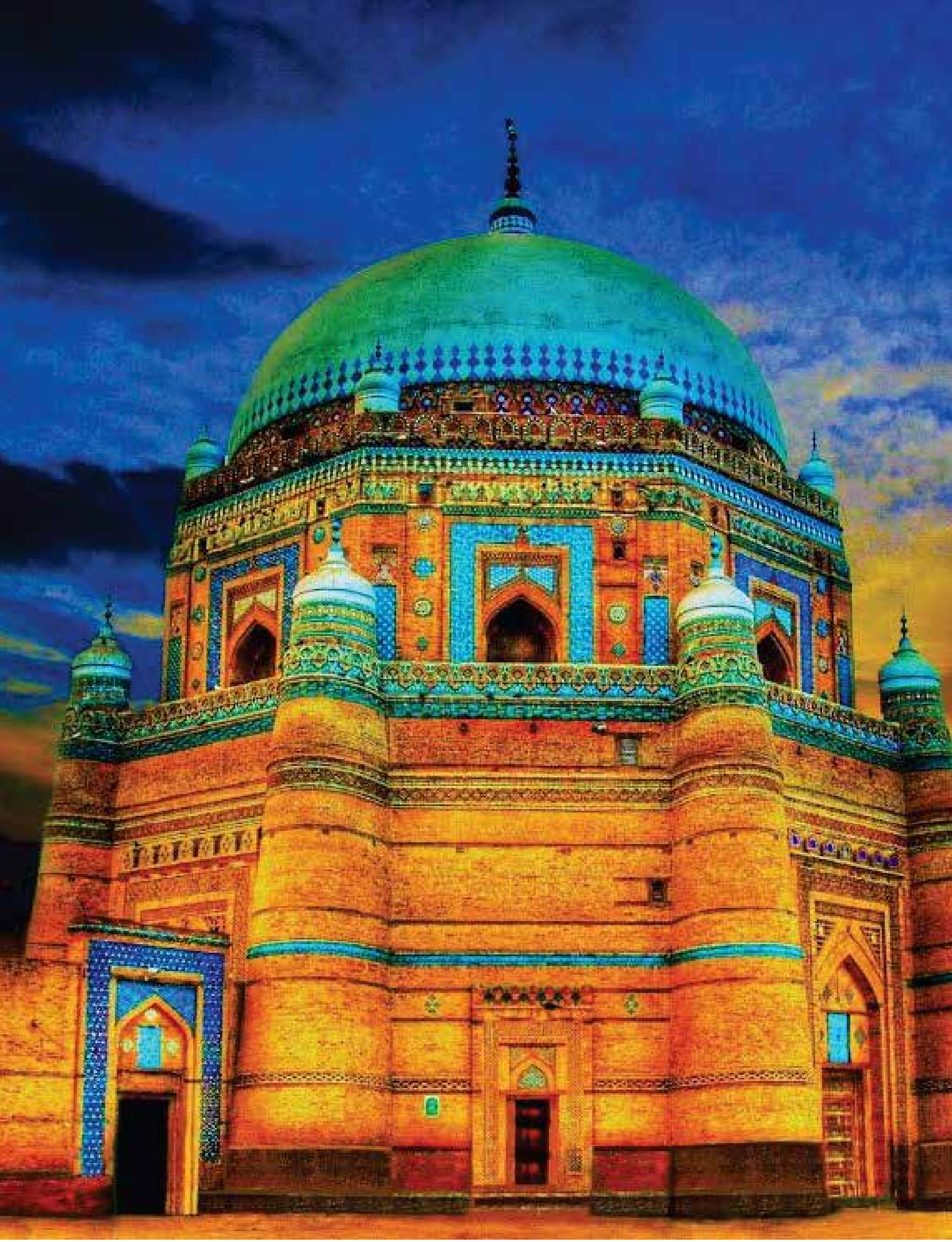
on SECP website and sent to various institutions and stakeholders for public consultations. Detailed discussions are held before finalizing the laws and amendments are made on the basis of public comments. Further, after the promulgation of the laws, if there is any ambiguity or difficulty observed by the stakeholders, the relevant department immediately proceeds for respective amendments.

**8. It is said that NBFIs and Modarabas have strong potential for expanding financial inclusion. What do you see as the main factors contributing to the slow penetration of NBFIs and Modarabas in Pakistan?**

The main factor contributing to the slow penetration include, lack of financial knowledge in general and Islamic finance in particular. Further to that, many of the individuals and institutions are skeptical or are not clear about the Islamic banking concept and see it as a replica of conventional banking. So, educating the masses will certainly improve the situation. Further to that, the majority of our population lives in rural areas, whereas majority of the Islamic banking is situated in urban areas. Hence, effective outreach programs by the Modarabas will be of great importance.







# 2 NBFIS ALL ACROSS THE WORLD



## 2. NBFIS ALL ACROSS THE WORLD

NBFIs are considered as the potential game-changer in the development of the private sector that has a significant role in achieving socio-economic development. NBFIs can complement the banking sector through providing finance in the sectors or projects which require lenders to assume venture-type risks which should not be funded from depositors' funds. Secondly, through providing finance in the projects requiring longer-term financing which are not usually provided by the banks. In view of that, it is being practiced in almost all countries in different parts of the world. Though some countries have greater Non-bank financial institutions assets as compared to the rest. The country rankings<sup>11</sup> on the basis of Non-bank financial institutions assets to GDP in different regions are provided below:

Figure 4: Non-bank Financial Institutions Assets to GDP in Asia (Country Rankings)<sup>12</sup>

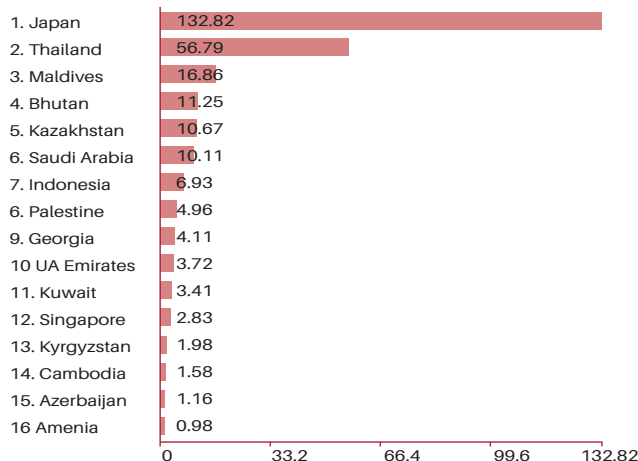


Figure 5: Non-bank Financial Institutions Assets to GDP in Africa (Country Rankings)<sup>13</sup>

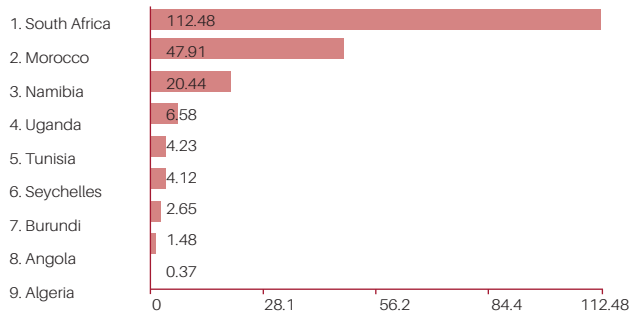


Figure 6: Non-bank Financial Institutions Assets to GDP in Europe (Country Rankings)<sup>14</sup>

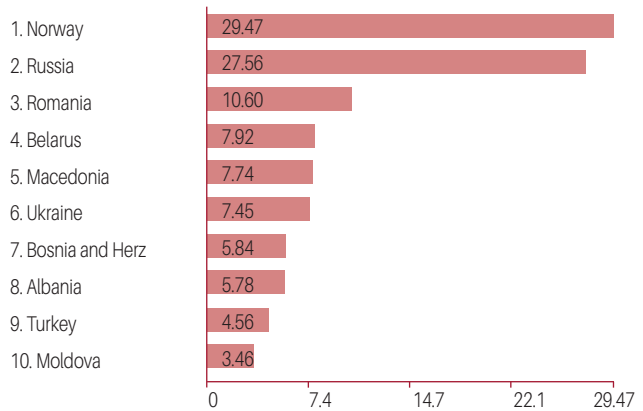


Figure 7: Non-bank Financial Institutions Assets to GDP in North America (Country Rankings)<sup>15</sup>

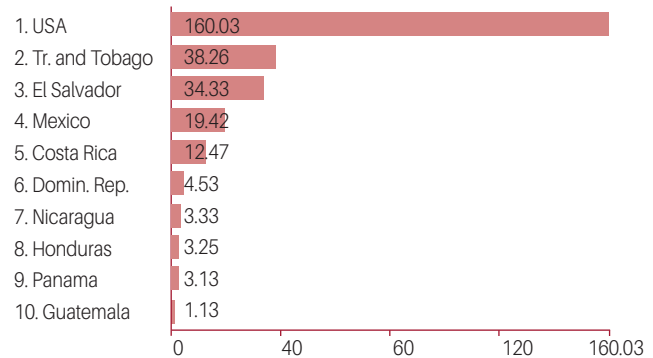
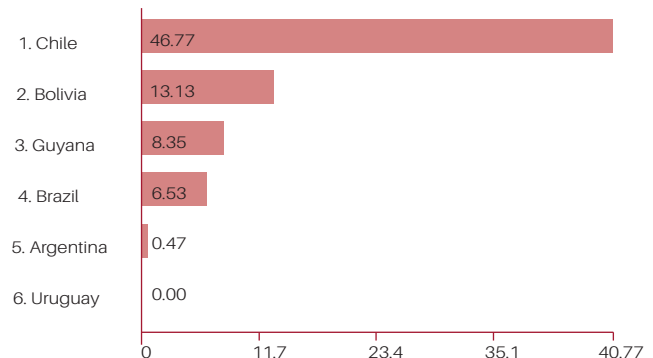


Figure 8: Non-bank Financial Institutions Assets to GDP in South America (Country Rankings)<sup>16</sup>



<sup>11</sup> These rankings are based on the data from 1960 to 2017. Data is not available after 2017.

<sup>12</sup> Source: TheGlobalEconomy.com, The International Monetary Fund, [https://www.theglobaleconomy.com/rankings/non\\_bank\\_financial\\_institutions\\_assets/Asia/](https://www.theglobaleconomy.com/rankings/non_bank_financial_institutions_assets/Asia/)

<sup>13</sup> Source: TheGlobalEconomy.com, The International Monetary Fund, [https://www.theglobaleconomy.com/rankings/non\\_bank\\_financial\\_institutions\\_assets/Africa/](https://www.theglobaleconomy.com/rankings/non_bank_financial_institutions_assets/Africa/)

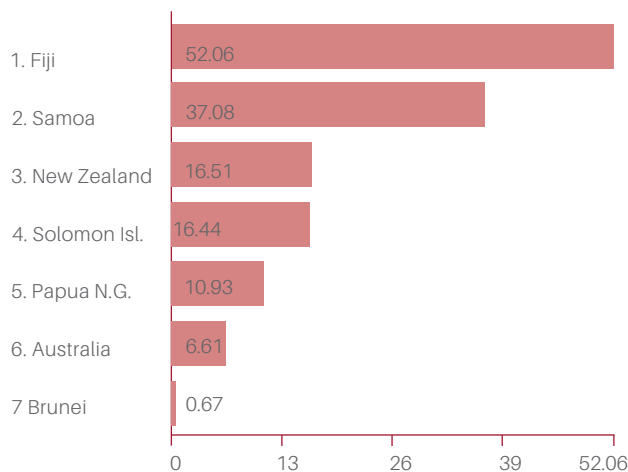
<sup>14</sup> Source: TheGlobalEconomy.com, The International Monetary Fund, [https://www.theglobaleconomy.com/rankings/non\\_bank\\_financial\\_institutions\\_assets/Europe/](https://www.theglobaleconomy.com/rankings/non_bank_financial_institutions_assets/Europe/)

<sup>15</sup> Source: TheGlobalEconomy.com, The International Monetary Fund, [https://www.theglobaleconomy.com/rankings/non\\_bank\\_financial\\_institutions\\_assets/North-America/](https://www.theglobaleconomy.com/rankings/non_bank_financial_institutions_assets/North-America/)

<sup>16</sup> Source: TheGlobalEconomy.com, The International Monetary Fund, [https://www.theglobaleconomy.com/rankings/non\\_bank\\_financial\\_institutions\\_assets/South-America/](https://www.theglobaleconomy.com/rankings/non_bank_financial_institutions_assets/South-America/)

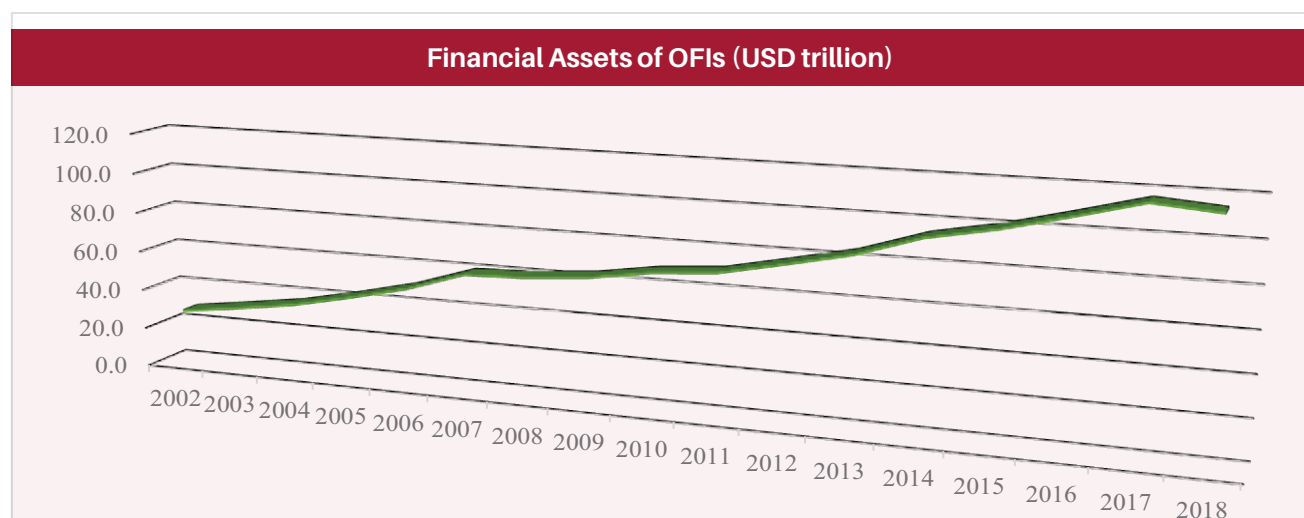


Figure 9: Non-bank Financial Institutions Assets to GDP in Australia (Country Rankings)<sup>17</sup>



Globally, the series of financial assets of Non-Bank financial intermediation is showing an increasing trend. However, there is a slight decline in OFI<sup>18</sup> assets in 2018. The fundamental cause is asset valuation declines in the course of time that negatively impacted investment funds' assets, predominantly equity funds, along with transactions (net outflows) that negatively affected other OFI sub-sectors.

Figure 10: Global Trend in OFI Financial Assets<sup>19</sup>



<sup>17</sup> Source: TheGlobalEconomy.com, The International Monetary Fund, [https://www.theglobaleconomy.com/rankings/non\\_bank\\_financial\\_institutions\\_assets/Australia/](https://www.theglobaleconomy.com/rankings/non_bank_financial_institutions_assets/Australia/)  
<sup>18</sup> OFIs stands for Other Financial Intermediaries that comprised of all financial institutions that are not central banks, banks, public financial institutions, insurance corporations, pension funds, or financial auxiliaries.

<sup>19</sup> Source: Global Monitoring Report on Non-Bank Financial Intermediation 2019, Financial Stability Board.

<sup>20</sup> Source: Global Monitoring Report on Non-Bank Financial Intermediation 2019, Financial Stability Board.

## 2.1 Recent Innovations in NBFIs<sup>20</sup>

The first innovation is Blockchain-based bond issuance: the licensing of a Securities Token Offering (STO). The offering was for the issuance of unsecuritised qualified subordinated token-based bonds with a maximum total nominal amount of €100 million and a term of June 2029.

Secondly, Buy Now Pay Later (BNPL) service providers were reported to have increased. BNPL providers offer financing for the purchase of goods and services from participating retailers, which the borrower pays back over time. These arrangements differ from regular credit provision as customers are not charged interest on their balance, and often do not pay an establishment fee. Instead, providers receive income through late fees charged to borrowers if they fail to meet scheduled repayments, as well as through commissions charged to the seller of the goods and services.

The third innovation is Securitisations collateralised by commercial real estate. Commercial real estate collateralised loan obligations are issued with floating interest rates and final maturities of two to three years. Commercial real estate collateralised loan collateralised mostly by first-lien mortgages on properties that are undergoing renovations or other significant transitions.

## EXCLUSIVE INTERVIEW:



## NBFI &amp; MODARABA ASSOCIATION OF PAKISTAN

## BASHEER A. CHOWDRY

Chairman  
NBFI & Modaraba Association of Pakistan

### 1. Tell us about the journey of Trust Modaraba.

The management of Trust Modaraba was entrusted to Al-Zamin Modaraba Management (Private) Limited by SECP in February, 2009 due to irregularities committed by the previous management. Trust Modaraba at that time was faced with multifarious challenges of operations, profitability, systems and controls to say the least. After take over, we diligently focused on revamping the entire operational and organizational structure with well-defined targets to achieve operational efficiency and growth. The efforts based on carefully developed business plan started showing positive trends of improvements in assets and profitability of the Modaraba from the year 2010 onwards and has now been able to achieve a stable financial standing.

### 2. Modarabas have not been successful in mobilization of savings or deposit either. What are the problems and issues faced by the Modaraba Sector?

For mobilization of deposits, permission from SECP is

mandatory. The eligibility requirements are quite strict and most of the Modarabas do not qualify those requirements.

### 3. How do you see Modarabas contributing to the development of Islamic finance in Pakistan?

Modarabas were the forerunner of Islamic financial system and it is very encouraging to see that Shariah compliant activities in the form of Islamic banking, mutual funds, takaful and other areas have evolved substantially over the last 20 years. Judging from the quantitative yard stick, the growth in Modaraba sector has been rather limited, compared to other forms of Islamic banking. There have been many reasons for this, one of them being lack of full awareness of the potential and universality of Modaraba concept for undertaking multiple activities like financing, manufacturing and trading specially SME sector, some of which cannot be handled by Islamic banks. However, NBFI & Modaraba Association of Pakistan is playing its due role to further enhance the image of the sector to be reckoned as an effective arm to the development of the Islamic Financial Sector.

**4. Most of the Modarabas are doing their business with their Equity only. What measures you have taken for development of new liability product for Modaraba to address the resource mobilization issue?**

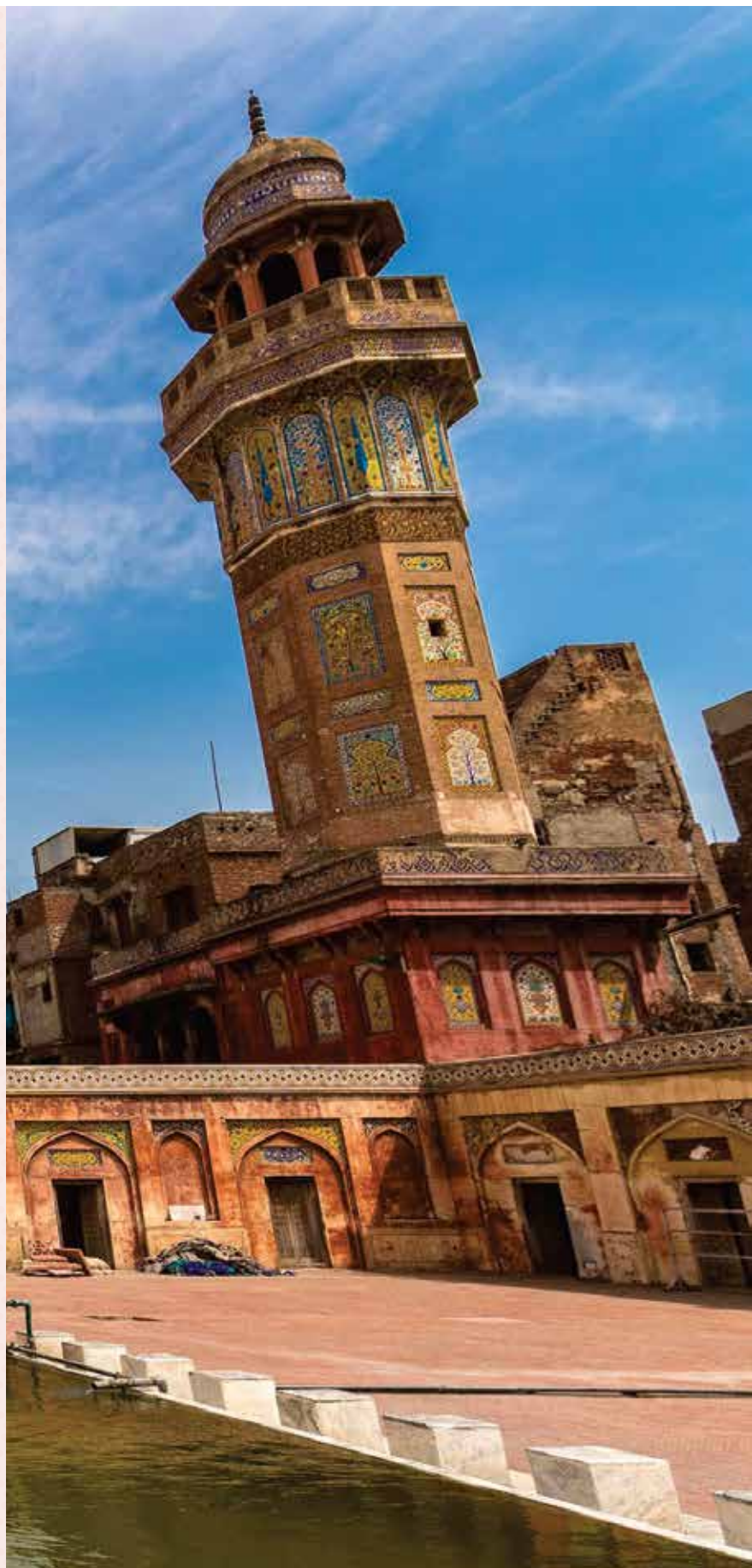
Resource Mobilization is a serious constraint for most of the non-banking financial companies including Modarabas. It is a fact that most of the Modarabas are doing business with their equity only, the reason behind this factor is that Modarabas are not allowed to take deposits from financial institutions and general public. In the past, six Modarabas were allowed to take deposits under Certificate of Musharaka (COM) which due to strict regulations by Securities & Exchange Commission of Pakistan have been reduced to only two Modarabas.

The avenues of resource mobilization are dependent upon acceptable credit ratings, which in case of Trust Modaraba had been withdrawn during the tenure of previous management but reinstated through our concerted efforts at a level of BBB-. We are making all out efforts to meet the criteria of eligibility for resource mobilization by further improvements in our operations.

**5. Your Modaraba had issued TFCs on Musharaka based in the past. How was your experience and why the same has not been further issued. It is said that mobilization of funds is a mammoth job for Modarabas. While you were CEO, Al-Zamin Leasing Modaraba you had issued two tranches of Shariah compliant TFCs. Why others have failed in following your footprints?**

Yes Al-Zamin Leasing Modaraba issued Musharakah based Term Finance Certificates, which were listed and the issue was oversubscribed and also successfully redeemed.

For Public floatation of any instrument, economic factors and market sentiments matter the most. If we look at the past few years, economic crises, political instability, high interest rates have generally lowered the market sentiments for acceptance to subscribe to such instruments and that too by the Modaraba Sector.







# 3 MODARABA & NBFI LANDSCAPE AND TRENDS





# MODARABA & NBFI

## LANDSCAPE AND TRENDS

This chapter focuses on the evolution, structure, and progress of NBFI's and Modaraba Sector. In addition, the chapter outlines Pakistan's Modaraba sector structure highlighting the numbers of Modarabas and NBFI's operating in Pakistan. Financial details of Modaraba Sector and NBFI e.g. assets, equity, and profitability are presented to give a detailed snapshot of the Modaraba Sector and NBFI. Furthermore, the evolution of the Modaraba Sector in Pakistan is presented with a timeline, focusing on the important stages and events in history. Finally, the role of Modaraba Sector and NBFI's in the economic development of Pakistan and the most recent developments and trends are described.

A Non-Banking Financial Institution (NBFI) can embrace a large portion of the financial services, with the exception of commercial banking and insurance. In particular, A NBFI can provide financial services including investment finance, leasing, housing and car finance, venture capital investment, discounting, investment advisory and assets management services depending on the compliance of prescribed criteria. There are eight classifications of NBFI's based on their business activities that are: Development Financial Institutions (DFI's), Investment Finance Services, Leasing companies, Modarabas, Housing finance companies, Mutual funds, Discount houses, and Venture capital companies.<sup>21</sup>



<sup>21</sup> Source: State Bank of Pakistan: <http://www.sbp.org.pk/publications/fsa-2001-2002/Chapter%204.pdf>



The best financial system in the economy has a diversity of financial institutions that offer a variety of financial products and services to the clients. Such an arrangement encourages competition among financial institutions and leads to efficiency and cost minimization of financial services. The availability of such alternate financial institutions is important, in case of a lack of investor confidence in formal financial institutions, to maintain the market inflows. The list of companies operating in Pakistan are:<sup>22</sup>

	MODARABAS	Date of Incorporation	Years in Operations
1	ALLIED RENTAL MODARABA	10-Jan-07	13
2	AWWAL MODARABA	10-Feb-16	4
3	B.F. MODARABA	11-Jun-89	31
4	B.R.R. GUARDIAN MODARABA	Nov-85	35
5	FIRST ELITE CAPITAL MODARABA	26-Sep-91	29
6	FIRST EQUITY MODARABA	Jan-92	28
7	FIRST AL-NOOR MODARABA	2-Nov-92	28
8	FIRST FIDELITY LEASING MODARABA	5-Dec-91	29
9	FIRST HABIB MODARABA	Mar-85	35
10	FIRST IBL MODARABA	19-Oct-89	31
11	FIRST IMROOZ MODARABA	1-Mar-94	26
12	FIRST PAK MODARABA	15-Aug-91	29
13	FIRST PARAMOUNT MODARABA	19-Jan-95	25
14	FIRST PRUDENTIAL MODARABA	4-Dec-89	31
15	FIRST PUNJAB MODARABA	23-Dec-92	28
16	FIRST TREET MANUFACTURING MODARABA	27-Jul-05	15
17	HABIB METRO MODARABA	6-Oct-17	3
18	KASB MODARABA	22-Oct-90	30
19	MODARABA AL-MALI	8-Jul-87	33
20	FIRST NATIONAL BANK MODARABA	3-Dec-03	17
21	ORIENT RENTAL MODARABA	24-Nov-17	3
22	ORIX MODARABA	Aug-87	33
23	POPULAR ISLAMIC MODARABA	6-Aug-13	7
24	SINDH MODARABA	9-Feb-15	5
25	FIRST TRI-STAR MODARABA*	1991	29
26	TRUST MODARABA	12-Nov-91	29
27	FIRST UDL MODARABA	May-91	29
28	UNICAP MODARABA*	1991	29

\*Non-Member of NBFI & Modaraba Association of Pakistan

	INVESTMENT FINANCE SERVICES	Date of Incorporation	Years in Operations
1	ESCORTS INVESTMENT BANK LIMITED	15-May-95	25
2	LSE FINANCIAL SERVICES LIMITED	11-Jan-16	4
3	ORIX LEASING PAKISTAN LIMITED	1-Jan-87	33
4	FINJA LENDING SERVICES LIMITED	21-Feb-20	1

Note: There are 6 more Investment Finance Services but they are not member of NBFI & Modaraba Association of Pakistan.

<sup>22</sup> Source: Securities & Exchange Commission of Pakistan (SECP)

	LEASING COMPANIES	Date of Incorporation	Years in Operations
1	CAPITAL ASSETS LEASING CORPORATION LIMITED	01-Apr-92	28
2	GRAYS LEASING LIMITED	31-Aug-95	25
3	PAK-GULF LEASING COMPANY LIMITED	16-Sep-96	24
4	PRIMUS LEASING LIMITED	Dec-17	3
5	SAUDI PAK LEASING COMPANY LIMITED	Jan-91	29
6	SECURITY LEASING CORPORATION LIMITED	21-May-95	25
7	SINDH LEASING COMPANY LIMITED	27-Mar-14	6
8	SME LEASING LIMITED	28-Jan-03	17

NBFI Sector currently includes Leasing Companies and Investment Finance Services which has been an essential component of the financial industry and a significant arm for the development of the SME Sector. The SMEs are the backbone of the Country's economy which can be services through expertise, commitment and market penetration of NBFI Sector.

The Leasing Companies are experiencing recessionary trend due to (i) Liquidity constraint (ii) reluctance of Commercial Banks to lend to NBFIs (iii) Minimum Equity Requirement (MER) (iv) Capital Adequacy Ratio (CAR) and (v) Lack of innovative products.

NBFI & Modaraba Association of Pakistan had numerous meetings with the Regulator and efforts are being made to resolve the issues so that the sector may grow.

### 3.1 Global Overview

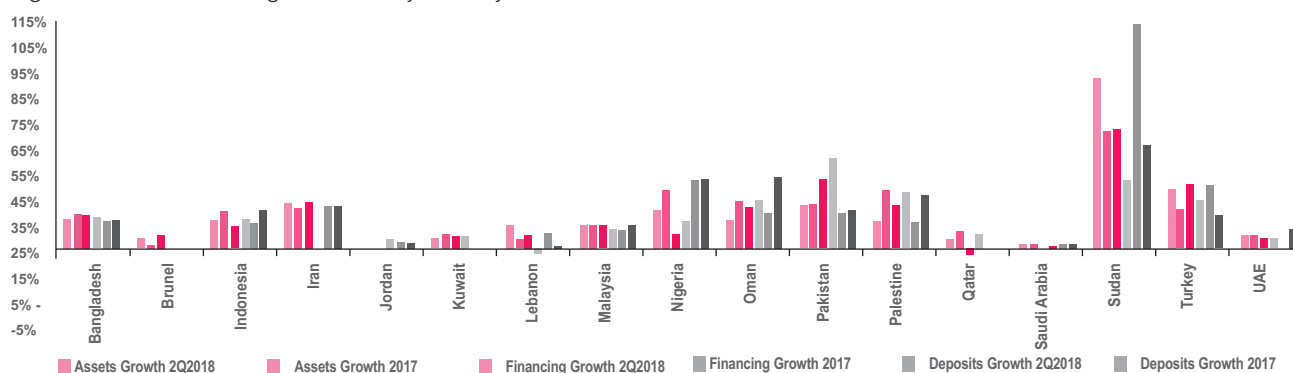
The Islamic financial industry in Pakistan is rapidly gaining stream with strong governance and regulatory framework. Pakistan ranks seventh in terms of Islamic Finance Development and eighth in terms of Global Islamic Economy indicators.<sup>23</sup>

However, Pakistan's Islamic financial institutions are exposed to environmental and social risks. The details are given below:

Topmost Risk Exposures	Topmost Risk Sectors
Emissions to Air & Water	Manufacturing
Energy Consumption	Agriculture
Workplace Health and safety	Utilities

The Islamic banking indicators of several countries are presented in the following diagram where Pakistan's Islamic banking shows a stable growth trajectory with regard to assets, deposits and financing.

Figure 11: Islamic Banking Indicators by Country<sup>24</sup>



<sup>23</sup> Source: Islamic Finance ESG Outlook 2019

<sup>24</sup> Source: Islamic Financial Services Industry Stability Report 2019, page 17

Similarly, Islamic Fund's assets are presented in Figure 12 with a geographical focus in 2018. Pakistan is in the 8th position in terms of volume with 2.22 percent growth of Islamic Funds' assets.

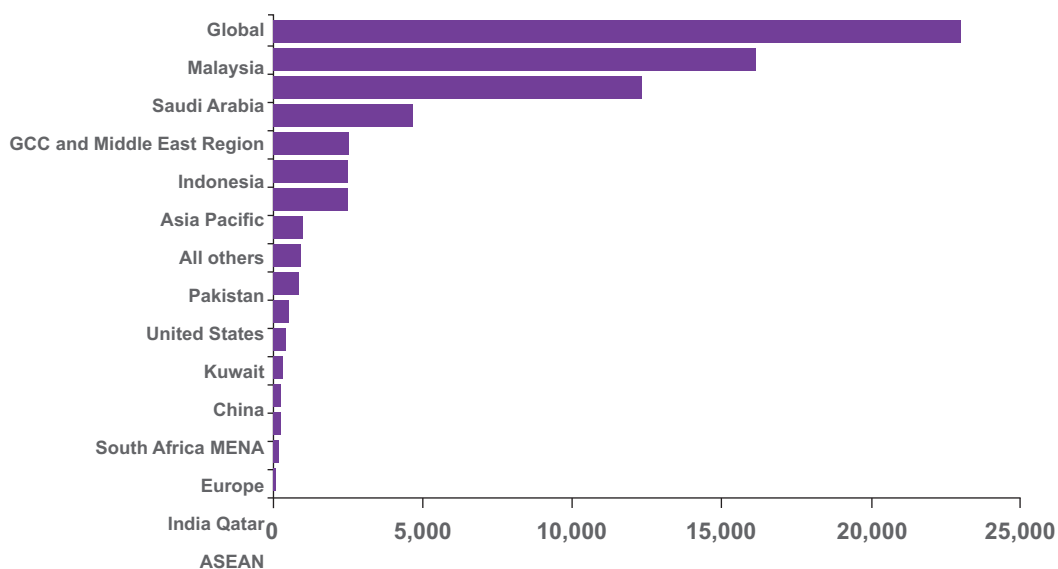
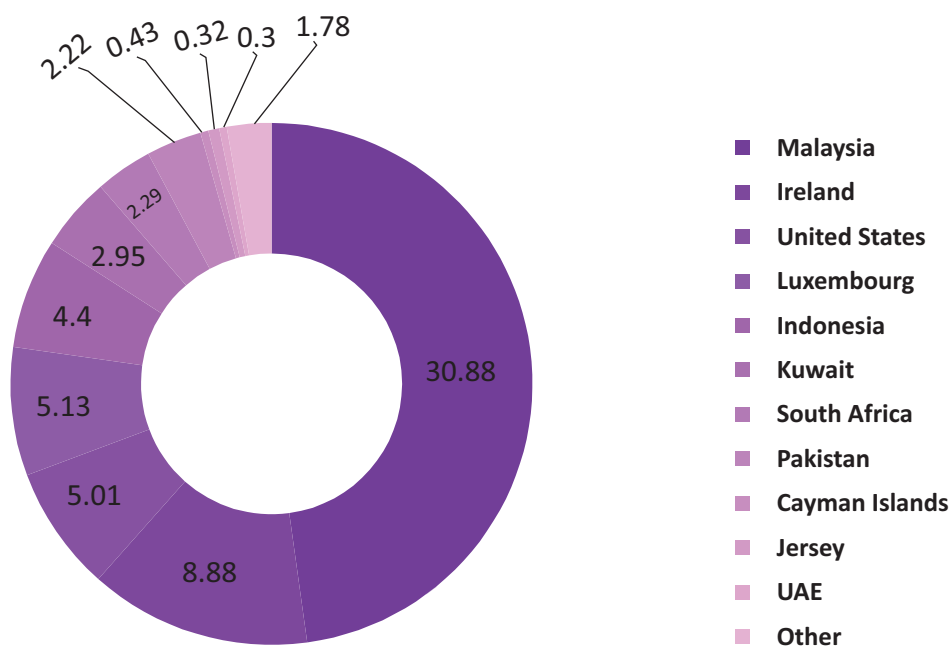


Figure 12: Islamic Funds' Assets by country

Figure 13: Growth of Islamic Funds Assets Country-wise





Currently, the State of Global Islamic Economy is showing a growing trend for ethical products and services from Islamic finance based on ethical, Shariah-based principles, to halal food that enhances trust between producer and consumer. Shariah-compliant companies play a vital role in addressing Muslim consumer needs and increasing economic growth and activity. The GIE Indicator score is based on the evaluation of the leading national ecosystems. Top fifteen countries and their respective scores are presented in the following table:

Table 3: State of Global Islamic Economy (GIE)<sup>25</sup>

Top 15 Countries	GIE Score	Halal Food	Islamic Finance	Halal Travel	Modest Fashion	Halal Media and Recreation	Halal Pharmaceuticals and Cosmetics
Malaysia	127	81	173	92	33	51	96
UAE	89	91	83	97	106	109	104
Bahrain	65	45	86	20	19	44	45
Saudi Arabia	54	48	64	34	16	33	47
Oman	51	62	52	28	25	28	43
Jordan	49	60	49	35	23	25	58
Qatar	49	49	55	27	12	63	35
<b>Pakistan</b>	<b>49</b>	<b>58</b>	<b>53</b>	<b>15</b>	<b>22</b>	<b>9</b>	<b>58</b>
Kuwait	46	42	57	12	12	30	34
Indonesia	45	48	46	65	34	16	44
Brunei	45	58	43	26	12	37	57
Sudan	37	55	34	29	8	11	21
Iran	34	36	37	19	11	22	37
Bangladesh	32	35	33	19	28	7	34
Turkey	31	44	21	71	32	25	41

Pakistan is in 8th position which means that the demand for Shariah-compliant products is high. Thus, there is a great scope for Modarabas operating in Pakistan.



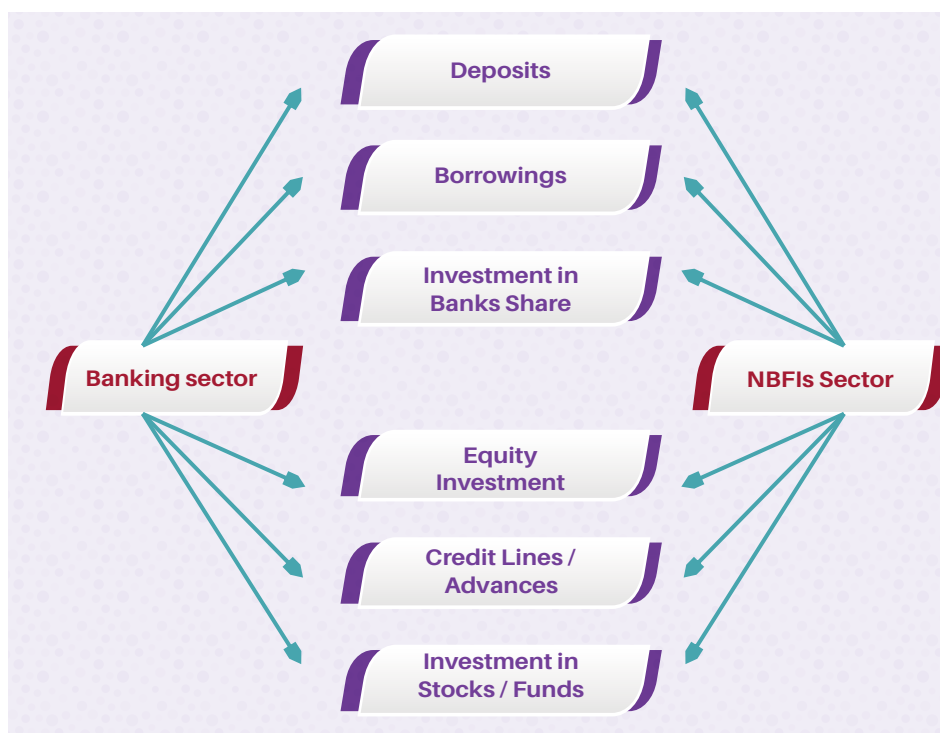
<sup>25</sup> Source: State of the Global Islamic Economy Report 2018/2019

<sup>26</sup> Source: Performance and Risk Analysis of Non-Bank Financial Institutions, page 89, Financial Stability Review 2018, State Bank of Pakistan (SBP)

### 3.2 Pakistan's NBFI & Modaraba Sector Structure

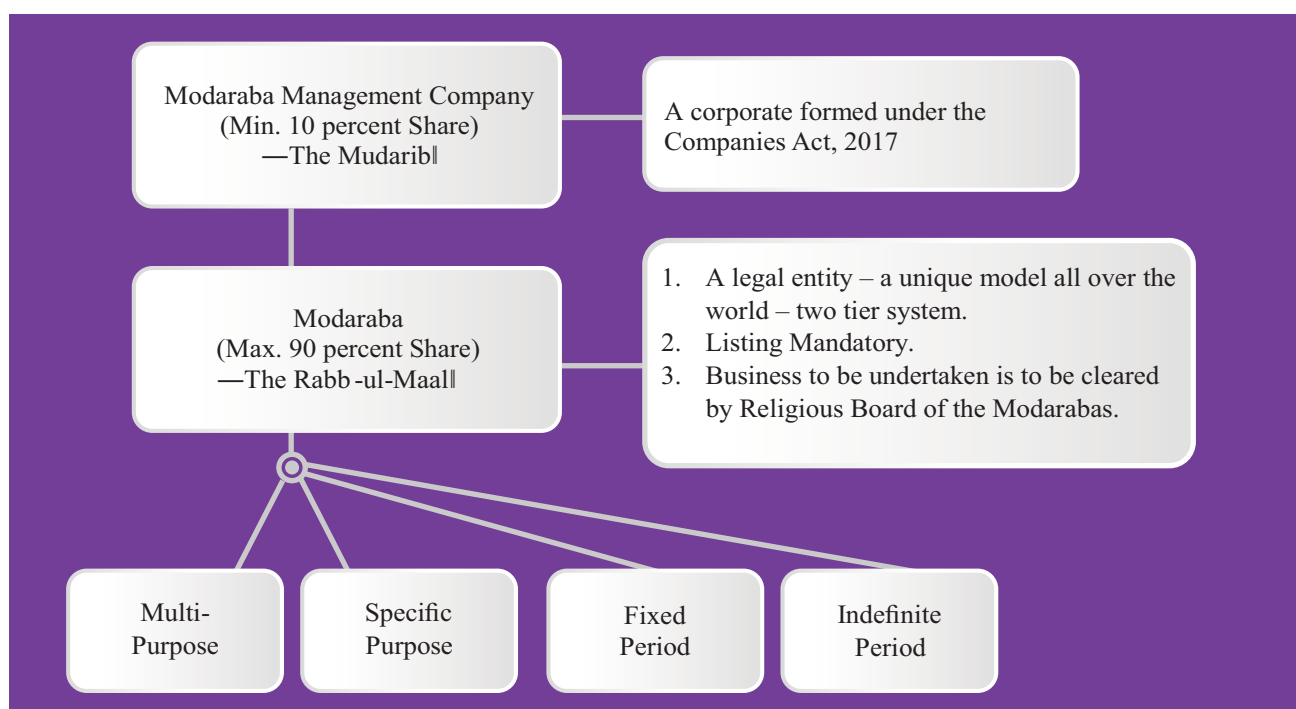
Pakistan's NBFI & Modaraba sector consists of conventional and Shariah-compliant non-bank financial institutions including Modarabas, Shariah-compliant mutual funds, Shariah-compliant pension funds, REITs, leasing companies and investment finance services contributing to the economic development of the country. NBFIs and Modarabas provide Islamic financial products to individuals and small businesses for their financing needs. The banking sector and NBFI sector are interconnected with each other in terms of equity investments, borrowing / lending, investments, and deposits.

Figure 14: Channels of Interconnectedness<sup>26</sup>



The institutional framework has started in Pakistan with the Modaraba Companies and Modaraba (Floatation & Control) Ordinance 1980. At present, 26 Modarabas are operating in Pakistan that are following the basic structure illustrated in Figure 15.

Figure 15: Basic Structure of Modarabas in Pakistan



<sup>27</sup> Section B: Non-Banking Financial Sector, page 94, Financial Stability Review, 2017, State Bank of Pakistan (SBP).

Modarabas are categorized into two practices: multipurpose and specific purpose Modarabas. Multipurpose Modarabas transactions are based on Ijarah, Musharakah, Diminishing Musharakah, Murabaha, Musawama, Salam, and Istisna, whereas, specific purpose Modarabas are designed to handle nominated projects.

The NBFI sector has been spreading the vision of an Islamic financial system, in line with this, more business models, for instance, Mutual/pension funds, and REITs are added in the Shariah-compliant offerings.<sup>27</sup> Total assets of NBFIs are presented in the following table from Fiscal Year 2014 to 2018.

Table 4: Total assets of NBFIs <sup>28</sup>

NBFIs	2014	2015	2016	2017	2018	2019
Asset Management Companies /						
Investment Advisors	30	32	37	41	39	37
Mutual Funds	452	492	546	710	679	578
Pension Funds	8	14	19	26	27	27
Portfolios	72	97	139	141	153	198
Total Assets Under Management	532	603	705	877	859	803
REIT Management Companies	0	2	1	2	5	6
Real Estate Investment Trust (REIT)	-	23	27	41	42	46
Private Equity & Venture Capital Firms	-	-	-	-	0.2	0.2
Private Equity Funds	-	-	-	-	5	7
Modarabas	30	31	37	44	53	54
Leasing Companies	36	40	42	43	10	10
Investment Finance Companies	11	10	10	21	58	63
Non-Banking Microfinance Companies	-	-	-	61	97	117
Total Assets	639	741	859	1130	1169	1140
						(PKR billion)

Figure 16: Modaraba Sector-Timeline of Events

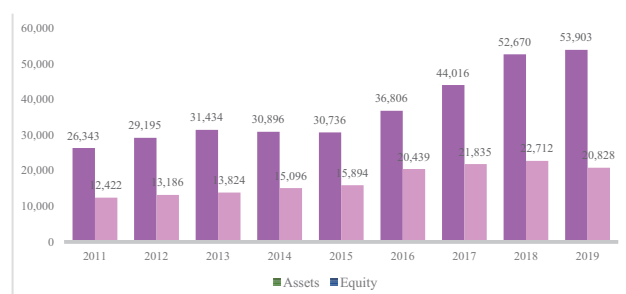


<sup>28</sup> Source: Performance and Risk Analysis of Non-Bank Financial Institutions, page 88, Financial Stability Review 2019, State Bank of Pakistan (SBP)



In 2019, the Modaraba sector is growing with PKR 53,903 million assets. The Modaraba sector growth in terms of Assets and Equity is presented in the following diagram:

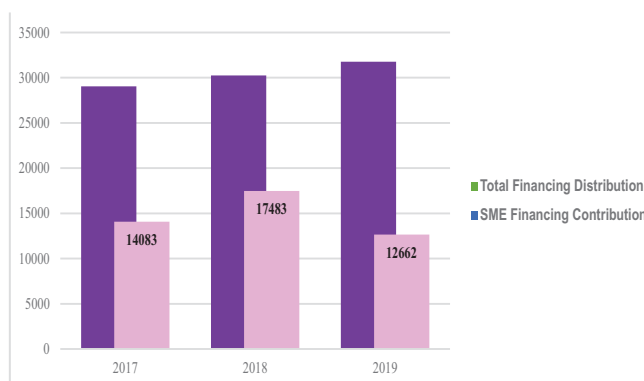
Figure 17: Growth of Modaraba sector in Pakistan in terms of Assets and Equity<sup>29</sup>



### 3.4 Role of NBFI & Modaraba Sector in the Economic Development of Pakistan

NBFI & Modaraba sector is essential for the economic development of Pakistan. Since 95-98 percent of Pakistani are Muslim, therefore, they need Shariah-compliant solutions for medium to long term financing services. Moreover, small and medium enterprises do not have sufficient access to funds from conventional financial institutions. SME finance is among the prime objectives of NBFI & Modaraba sector of Pakistan because SMEs are under-served by banks and other financial institutions. Therefore, 58 percent of funds are being disbursed to small and medium enterprises out of the total financing of NBFI & Modarabas. The following diagram shows SMEs financing contribution of the NBFI & Modaraba sector for the years 2017, 2018 and 2019.

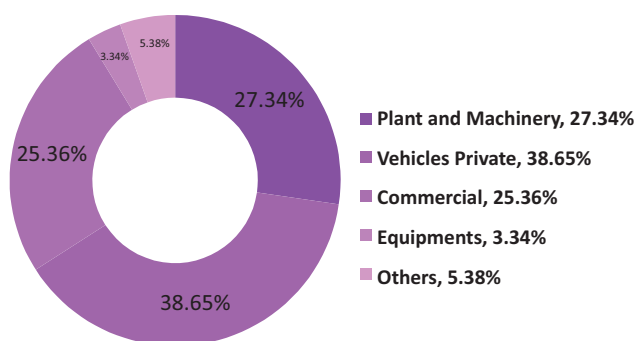
Figure 18: SMEs Financing Contribution of NBFI & Modaraba sector<sup>30</sup>



NBFIs & Modarabas are doing investment in financing in Plant & Machinery, Commercial & Private Vehicles, pieces of Equipment and many other assets. A major share of 29.48 percent out of total modaraba financing going to plant and machinery. By using plant and machinery, more goods and services can be produced with the same quantity of raw materials. As a result, GDP growth will increase with an increase in productivity. So, NBFI & Modaraba sector is playing a vital role in the economic development of Pakistan.

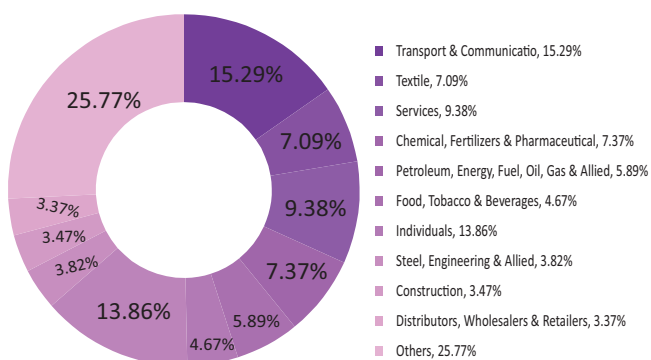


Figure 19: Asset-wise financing of NBFI & Modaraba Sector for the Period 2018-19<sup>31</sup>



Moreover, the NBFI & Modaraba sector has broaden access to finance across various sector including transport and communication, textile, services, chemical, fertilizer, pharmaceutical, petroleum, energy, fuel, oil & gas, food, tobacco, beverages, individuals, steel, engineering, construction, sugar, and many others.

Figure 20: Sector-Wise Financing of NBFI & Modaraba Sector for the Period 2018-19<sup>32</sup>



<sup>29</sup> Source: Islamic Finance growing on sound footings in Pakistan by Muhammad Shoaib Ibrahim

<sup>30</sup> Source: Yearbook 2019, NBFI & Modaraba Association of Pakistan

<sup>31</sup> Source: Yearbook 2019, NBFI & Modaraba Association of Pakistan

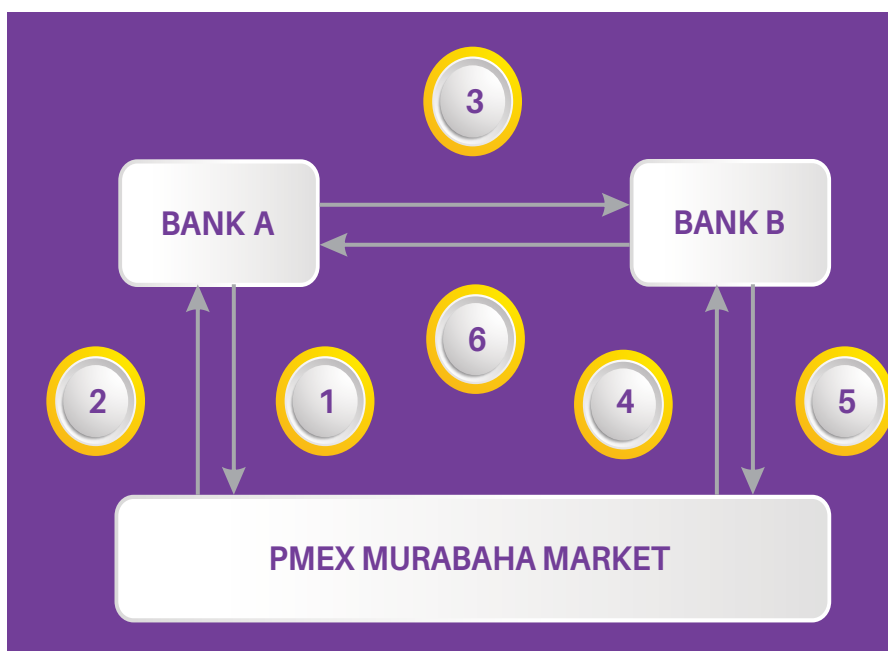
<sup>32</sup> Source: Yearbook 2019, NBFI & Modaraba Association of Pakistan

Though we fail to take full advantage from the potential of NBFI & Modaraba sector in economic development due to trust deficiency and the lack of awareness on the investor side.

### 3.5 Recent Developments and Trends

Recent development is the first electronic Murabaha transaction at the Shariah Compliant Trading Platform (SCTP) in 2018 and that is a breakthrough for Islamic money market. In this way, excess liquidity of Islamic financial institutions including Modarabas can be managed in a completely Shariah-compliant manner and settlement risk can be reduced.<sup>33</sup> The transaction flow of the Murabaha transaction is illustrated in the diagram below (Figure 21).

Figure 21: PMEX Murabaha Trading process Flow



Step 1: Bank A buys oil from PMEX Murabaha Market & gives cash  
 Step 2: Oil is sold to Bank A  
 Step 3: Bank A sells oil to Bank B on deferred payment

Step 4: Bank B sells oil into PMEX Murabaha Market  
 Step 5: PMEX Murabaha Market gives cash to Bank B  
 Step 6: Bank B pays the money back to Bank A as per agreed deferred term

Bank A is the primary bank that may offer this oil externally to another bank (i.e. client Bank B) on Murabaha basis. Subsequently, Bank A has to notify PMEX about the transaction so ownership can be transferred to Bank B. while the physical possession of the oil remains with PMEX. PMEX delivers funds to Bank B in case Bank B trade oil in the PMEX market.

Consolidated trends of aggregate indicators and the trends of key ratios for the years 2017, 2018, and 19 are presented below:<sup>34</sup>

#### CONSOLIDATED TRENDS OF AGGREGATE INDICATORS

	2019	2018	2017
No of Companies	37	37	35
Paid up Capital	23,703	23,198	18,934
Reserves	13,338	14,940	12,670
Total Equity	37,041	38,138	31,604
Financing /Trading/Manufacturing Assets	60,092	59,018	58,468
Investments	8,683	8,688	9,318
Borrowings	30,882	29,155	25,313
Revenues	15,906	15,991	11,843
Operating Expenditure	11,526	9,947	6,338
Financial Charges	3,651	2,585	2,535
Taxation	542	493	437
Net Profit	(236)	2,488	2,450
Cash Dividend & Bonus	1,685	1,945	1,595
Total Assets	95,091	94,585	82,123

<sup>33</sup> Source: PMEX Shariah-Compliant Trading Platform <https://fp.brecorder.com/2018/04/20180428367333/>

<sup>34</sup> Source: Yearbook 2018, NBFI & Modaraba Association of Pakistan

Trends of Key ratios of leasing companies, Investment finance services, and Modarabas are presented below for the same period.

<b>Leasing Companies</b>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Earnings per Share (Rs.)	(0.11)	0.21	0.00
Return on Equity (percent)	(1.46)	3.54	0.05
Return on Assets (percent)	(0.73)	1.54	0.02
Current Ratio (X)	1.44	1.67	1.36
Financing /Trading/Manufacturing Assets	68.85	68.53	62.57
Book value per Share (Rs.)	7.71	7.65	6.26
Time Interest Earned (X)	0.95	1.01	1.16
Total Assets / Net Worth (X)	2.02	1.97	2.95
Financial Charges / Total Expenses (percent)	15.75	22.29	27.70
Dividend & Bonus per share (Rs.)	0.03	0.08	0.04
<b>Investment Finance Services</b>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Earnings per Share (Rs.)	3.33	5.04	3.42
Return on Equity (percent)	10.72	18.24	12.91
Return on Assets (percent)	3.65	5.10	2.55
Current Ratio (X)	1.63	1.46	1.29
Financing /Trading/Manufacturing Assets	72.33	71.35	96.09
Book value per Share (Rs.)	32.28	32.56	27.77
Time Interest Earned (X)	2.01	2.31	1.76
Total Assets / Net Worth (X)	2.79	3.09	4.27
Financial Charges / Total Expenses (percent)	53.01	46.70	53.79
Dividend & Bonus per share (Rs.)	2.15	2.44	1.89
<b>Modarabas</b>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Earning per Certificate (Rs.)	(0.96)	0.59	1.31
Return on Equity (percent)	(5.93)	3.49	7.46
Return on Assets (percent)	(2.42)	1.61	3.90
Current Ratio (X)	0.70	0.77	0.84
Financing /Trading/Manufacturing Assets	56.90	55.84	55.71
Book value per Share (Rs.)	15.43	17.07	18.08
Time Interest Earned (X)	0.34	1.82	3.15
Total Assets / Net Worth (X)	2.59	2.33	2.02
Financial Charges / Total Expenses (percent)	16.40	10.74	13.88
Dividend & Bonus per certificate (Rs.)	0.69	0.85	0.91
<b>Consolidated Trends of Key Ratios</b>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Earnings per Share/Certificate (Rs.)	(0.10)	1.07	1.29
Return on Equity (percent)	(0.63)	7.14	8.03
Return on Assets (percent)	(0.25)	2.82	2.98
Current Ratio (X)	0.96	1.05	1.06
Financing /Trading/Manufacturing Assets	63.19	62.40	71.20
Book value per Share/Certificate (Rs.)	15.63	16.44	16.69
Time Interest Earned (X)	1.10	2.06	2.14
Total Assets / Net Worth (X)	2.57	2.48	2.60
Financial Charges / Total Expenses (percent)	23.40	19.87	28.30
Dividend & Bonus per certificate / share (Rs.)	0.71	0.84	0.84



## EXCLUSIVE INTERVIEW:



## MR. MUHAMMAD SHOAIB IBRAHIM

Chief Executive Officer,  
First Habib Modaraba

**1. Modaraba has established itself as a well understood Shariah compliant instrument of financing in Pakistan. Can you explain briefly about the Modaraba sector?**

Modaraba sector has turned up as a major sector under the category of Non-Banking Financial Institutions (NBFIs). Modarabas are regarded as a feasible and trustworthy source of Shariah-compliant financing for medium to long term. The underlying model is multi-faceted in the context of Shariah compliant business activity. The business prospects of the Modaraba sector are financing, manufacturing, equipment rental, trading, distribution business, and portfolio management. These activities are carried out with the permission of SECP and its religious board. Currently, the Modaraba sector consists of 28 listed entities with approximately 53 billion total assets and 23 billion total equity.

**2. A fundamental requirement of an Islamic Financial Institution is that its whole business practices and operations are based on Shariah Rules and Principles. Can you share about Shariah**

**compliance mechanism of the Modaraba Sector?**

The principal business activity of Modarabas is based on the Shariah-compliant mode of financing. All the Modarabas in Pakistan are operating in compliance with the Modaraba Ordinance, 1980, Modaraba Rules, 1981, Prudential Regulations and Guidelines, and Shariah Compliance & Shariah Audit Mechanism (SCSAM). Moreover, the Religious Board of the SECP approves business practices and operations of Modarabas. After getting the approval of the Religious Board, the Registrar Modaraba at SECP registers, authorizes and monitors the Modarabas. Furthermore, to ensure the quality of existing compliance and to minimize the risk of any inadvertent violation of Shariah Rules and Principles, every Modaraba company appoints Shariah Advisor.

**3. Tell us about the journey of First Habib Modaraba.**

First Habib Modaraba established in 1985 as a first perpetual Modaraba. In all these 34 years of operational processes, First Habib Modaraba has been consistently perceiving for its

reasonable outcomes, good corporate governance, and sound credit rating. The share of First Habib Modaraba in the Modaraba sector in terms of total equity and assets is 15 percent and 20 percent respectively. On the basis of financing assets, it is equal to 28 percent while with regard to net profit, the share of First Habib Modaraba is equal to 37 percent. Moreover, First Habib Modaraba has an unbroken history of payment of excellent dividends every year since inceptions.

**4. SECP has made certain amendments in Modaraba Companies and Modaraba (Floatation & Control) Ordinance, 1980 for the promotion of Modaraba Sector. What are the pros and cons of relevant laws and regulations? And what kind of regulatory support you need?**

SECP is very keen on the progress of the Modaraba Sector. However, some laws/regulations have negative impact and are hurting the growth of Modaraba sector including the condition of listing before commencement of operations, standard agreements, restrictions on fund raising through COM only, restriction on financing to associated undertakings, ceiling of 10% on management fees, tax neutrality of Shariah-compliant products and exclusion of profit distribution through Bonus

certificates for tax exemption purpose.

**5. Why Modarabas and Leasing Companies at PSX low traded despite of high book value and good payment history of dividends?**

There are other factors that can be held responsible for the low trading of listed Modarabas and Leasing Companies at PSX along with the announcement of dividends. The share price is also sensitive to the earnings of the Modarabas and Leasing companies, government policies, and investor's confidence.

**6. What are the missing elements for the growth of the NBFI & Modaraba sector? Describe some incentives and impediments in the growth of the sector.**

The missing element for the growth of the sector is that the NBFIs and Modarabas are not counted in SBP schemes. Over and above that the NBFI & Modaraba sector is dominated by a few large companies while other companies have a lack of human capital to launch differentiated products. As far as incentives are concerned, Modarabas can take a variety of financial activities under a single license. In addition, Modarabas can be engaged in non-financial Shariah compliant businesses. Having said that, resource mobilization is the main impediment to the growth of the sector.









# 4 INTRODUCTION TO NBFI & MODARABA SECTOR



## 4. INTRODUCTION TO NBFI & MODARABA SECTOR

The chapter gives a comprehensive account of the concepts, practices, models, and products of the Modaraba sector. The difference between the role of the Banking and Modaraba sector is highlighted along with the drivers of the NBFI & Modaraba Sector.

### 4.1 Shariah Aspect of Modaraba

The SECP Religious Board duly approves all the agreements of Modarabas. There is an elaborative Shariah Compliance and Shariah Audit Mechanism (SCSAM) in place for the verification of business operations in order to ensure compliance of Shariah principles and to appoint competent Shariah advisors for compliance at every stage. The Registrar Modaraba has implemented it in 2012 in consultation with NBFI & Modaraba Association of Pakistan in order to improve the image of Modaraba and to verify that inflows and the outflows of resources of the Modaraba sector. In essence, to make the system, policies and procedures of the Modaraba sector in line with the principles of Shariah.

### 4.2 Features & Basic Elements of Modaraba

The basic elements and the noticeable features of Modaraba framework are as follows:

- Modaraba model gives an opportunity of Shariah-compliant business / investment to individuals / entrepreneurs.
- The profit of the Modaraba companies is free from tax provided 90 percent of the earnings are disseminated amongst certificate holders.
- An investor can get the maximum dividend under these circumstances.
- A Modaraba can commence any Shariah-compliant business encompassing financial goods & services, local & international trading, manufacturing, distribution and various corporate functions under one authority and one license.

Modaraba is a non-bank financial institution that offers Shariah-compliant products such as, Ijarah, Musharakah,

Diminishing Musharakah, Salam, Istisnah, Murabaha, and Musawwamah. Many Modaraba companies are engaged in equipment rental, trading of products & services, imports and manufacturing business. At present, 23 Modarabas are financial services Modaraba, one manufacturing Modaraba, one trading Modaraba, and one equity Modaraba out of 26 Modaraba companies operating in Pakistan.

### 4.3 Financial Products of Modaraba Companies

Initially, the Modaraba companies were allowed to undertake Islamic financing modes such as Ijarah, Murabaha, and Musharakah. In 2008, the following twelve model Islamic financing agreements<sup>35</sup> were approved by the religious board which comprises of a Chairman and two Shariah Scholars<sup>36</sup>:

Diminishing Musharaka DM-Immovable property financing agreement

- DM-Joint Sharing Agreement
  - DM-Musharakah Agreement
  - DM-Rental Agreement
  - Undertaking to purchase MU upon termination
  - Undertaking to purchase MU during the term of DM
- Ijarah | Short Form Lease Agreement
- Istisna
- Mudarabah
- Musawamah
- Musharaka
- Murabahah
- Salam
- Syndicate Mudarabah
- Syndicate Musharakah
- Investment Agency Agreement
- Islamic CFS Murabahah
- Sukuk

In addition to these products, deposit taking Modarabas<sup>37</sup> are

<sup>35</sup> Source: [http://www.nbfi-modaraba.com.pk/Data/Sites/1/skins/nbfi/sector\\_report.pdf](http://www.nbfi-modaraba.com.pk/Data/Sites/1/skins/nbfi/sector_report.pdf) pp 6-7

<sup>36</sup> Former Justice Syed Zahid Husain Bokhari (Chairman), Mufti Muhammad Saeed Khan (Shariah Scholar), and Dr. Muhammad Tahir Mansoori (Shariah Scholar).

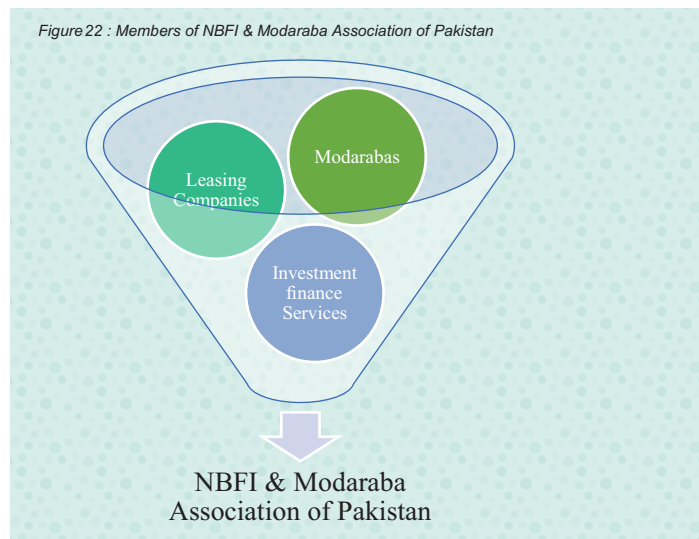
<sup>37</sup> Permission was granted to Six Modarabas that are: First Habib Modaraba, ORIX Modaraba, First Punjab Modaraba, First Paramount Modaraba, First National Bank Modaraba, and KASB Modaraba. Albeit, only three Modarabas are taking Deposits currently through COM due to regulatory restrictions.

permitted to issue Certificate of Musharakah (COM). While, two fund-raising products; Certificate of Investment on Modaraba basis (COIM); and Commodities Finance Certificate are under the review of regulatory authority.

#### 4.4 Main drivers of NBFI & Modaraba Sector

NBFI & Modaraba Association of Pakistan is a representative body of non-bank financial institutions operating in Pakistan including 26 Modarabas, 8 leasing companies, and 4 investment finance services.

Figure 22: Members of NBFI & Modaraba Association of Pakistan



The following tables comprehend a description of the overall size of leasing companies, Investment Finance Services and Modaraba sector in Pakistan and their performance for the period 2018-19. The trends of NBFI & Modaraba sector aggregate indicators for the period 2018-19 are given below:

Table 5: Financial Overview of Modarabas<sup>38</sup>

S.No.	Name of the Company	Total Assets	Total Equity	Profit / (Loss)
1	Allied Rental Modaraba	8,829.04	5,333.54	382.85
2	Awwal Modaraba	1,234.33	1,184.76	111.38
3	B. F. Modaraba	126.32	136.19	1.78
4	B.R.R. Guardian Modaraba	1,838.31	1,373.75	44.84
5	First Al-Noor Modaraba	288.96	252.05	(14.12)
6	First Elite Capital Modaraba	182.27	113.25	(4.37)
7	First Equity Modaraba	636.46	594.31	(3.30)
8	First Fidelity Leasing Modaraba	382.25	341.00	1.15
9	First Habib Modaraba	11,124.02	3,511.72	319.69
10	First IBL Modaraba	229.73	190.97	4.71
11	First Imrooz Modaraba	341.23	139.16	25.31
12	First National Bank Modaraba	303.07	(22.11)	(35.72)
13	First Pak Modaraba	72.64	66.20	0.51
14	First Paramount Modaraba	466.94	215.57	12.09
15	First Prudential Modaraba	493.40	425.97	2.32
16	First Punjab Modaraba	2,129.60	192.61	6.23
17	First Treet Manufacturing Modaraba	13,175.69	2,042.84	(2,391.79)
18	First UDL Modaraba	493.56	464.51	(54.09)
19	Habib Metro Modaraba	319.42	312.11	11.09
20	KASB Modaraba	270.58	240.71	(34.24)
21	Modaraba Al-Mali	261.09	233.30	7.96
22	Oreint Rental Modaraba	1,607.39	872.49	102.73
23	ORIX Modaraba	6,966.01	1,160.48	126.06
24	Popular Islamic Modaraba	120.57	86.06	4.84
25	Sindh Modaraba	1,639.27	1,063.05	81.15
26	Trust Modaraba	371.27	303.87	1.04
TOTAL (A)		53,903.43	20,828.34	(1,289.89)

<sup>38</sup> Source: <http://www.nbfi-modaraba.com.pk/Data/Sites/1/skins/nbfi/docs/yearbook2019.pdf> page 102



Table 6: Financial Overview of Leasing Companies

S.No.	Name of the Company	Total Assets	Total Equity	Profit / (Loss)
1	Capital Assets Leasing Corporation Ltd.	381.43	243.01	20.15
2	Grays Leasing Limited	292.49	67.47	(1.86)
3	Pak-Gulf Leasing Company Limited	2,661.79	758.65	64.38
4	Primus Leasing Limited	1,261.94	1,039.16	46.91
5	Saudi Pak Leasing Company Limited	743.79	(607.03)	27.17
6	Security Leasing Corporation Limited	656.77	117.17	(27.61)
7	Sindh Leasing Company Limited	4,097.79	3,526.85	(185.24)
8	SME Leasing Limited	509.00	111.68	(21.36)
	TOTAL (B)	10,605.01	5,256.95	(77.47)

Table 7: Financial Overview of Investment Finance Services

S.No.	Name of the Company	Total Assets	Total Equity	Profit / (Loss)
1	Escorts Investment Bank Limited	1,435.02	30.76	(50.30)
2	LSE Financial Services Limited	3,156.55	2,911.57	158.74
3	ORIX Leasing Pakistan Limited	25,990.80	8,013.09	1,022.52
	TOTAL (C)	30,582.38	10,955.42	1,130.96
	GRAND TOTAL (A+B+C)	95,090.81	37,040.72	(236.39)



# SHARIAH COMPLIANCE IN MODARABAS



## MR. MUHAMMAD SAMIULLAH

**Secretary General,  
NBFI & Modaraba Association of Pakistan**

The concept of Modaraba as a Shariah compliant mode of financing was evolved and introduced as an institutional framework in Pakistan with proper legislation, regulatory and Monitoring structure and operating guidelines as back as in 1980. This privilege of translating the concept into an institutional and properly regulated structure is unique. In fact, the Modarabas, as Islamic financial institutions are the fore-runners of Islamic banking and mutual funds in Pakistan.

The Modaraba Companies and Modaraba (Floatation & Control) Ordinance, 1980 was promulgated in June, 1980. Initially the Modarabas were regulated by the Central Bank like other financial institutions. Later on, the responsibility was entrusted to the Securities & Exchange Commission of Pakistan. The office of the Registrar Modaraba, being a part of SECP, monitors and controls the sector through Rules, Regulations and Guidelines. The Modarabas are subjected to reporting requirement, prudential disciplines and on site audit like the rest of the financial institutions. A properly constituted Religious Board approves and guide the functional integrity of the Modarabas for shariah compliance. No Modaraba can undertake any modes of business or execute any form of agreements other than those which are specifically approved by the Religious Board of SECP.

The Modaraba Sector being the pioneer in providing Islamic financial services in Pakistan is the most important segment of the financial sector. However, the immense potential of the Modaraba concept has not been fully utilized primarily due to lack of awareness on the part of the investors and lack of enthusiasm by most of the market operators.

Initially the business of the Modaraba sector was restricted to only three products i.e. Ijarah, Musharaka and Murabaha. No efforts were made to innovate and design new products neither by the market operators nor by the regulators. There was a need to design new innovative Islamic business products to capture the market for a consistent growth of the Modaraba sector.

The first Modaraba was floated in July, 1980 and then came a boom and total number of Modarabas at one time went up to as high as 52. These Modarabas were not only trend setters of Islamic modes of financing in a pre-dominant conventional financial system in Pakistan but also built confidence among the general public regarding the practice of Islamic modes of financing.

Though Modarabas have been working since 1980 as Islamic Financial Institution in Pakistan but actual dent to the sector was hit when Islamic banks as well as Islamic windows of the conventional banks were opened in Pakistan. The Modaraba sector lost its reputational attitude as Islamic financial institution to such extent that Al-Meezan Investment Management Limited includes Modarabas in the list of prohibited companies to do business with them or to make any investment in them. Moreover, this was displayed on its website which further deteriorated the reputation of the



Modaraba sector. As a result Islamic banks did not allow Modarabas to avail any facility from Islamic banks. Further Islamic Banks refused to open the accounts of Modarabas with them.

Under the circumstances, Modaraba Association of Pakistan took initiative and adopted various measures to mitigate the reputational risk of the Modaraba sector such as:

Arranged meetings with the management and Shariah Advisor of Al-Meezan Investment Management Limited and persuaded them to remove the name of the Modaraba from the list of prohibited companies displayed on their website.

Revised the existing agreements of Ijarah, Musharaka and Murabaha.

Introduced Nine model agreements including Diminishing Musharaka, Salam, Istisna, Mudaraba, Musawamah, Syndicate Modaraba, Syndicate Musharaka and Islamic CFS Murabaha and submitted to the Registrar Modaraba for the approval of the Religious Board.

On 19th March, 2008, a delegation of the Association made a detailed presentation to the Religious Board chaired by Justice (R) Mian Mehboob Ahmed. After detailed deliberations, nine agreements were approved by the Religious Board, the text of these agreements were issued by the Registrar Modaraba through Circular No.06 dated May 08, 2008. The Religious Board also approved the conceptual framework for issuance of Sukuk by Modarabas.

In spite of all these efforts by the Association, Modarabas could not get the status of a shariah compliant entity and still there were reservations to the Islamic Banks about the integrity of the Modarabas. Islamic Banks were reluctant to extend any facility to the Modarabas on the plea that their day to day transactions are not transparent and according to the







shariah principles.

Again a debate started that Modarabas are shariah compliant or not. In this connection a number of meetings with the Regulators were held and it was decided that a guidelines for Modarabas be issued by the Registrar Modaraba to ensure the compliance of all the regulatory and shariah requirements by the Modaraba Sector. The need for shariah compliance in Modarabas is of paramount importance to get credibility and respectability to the Modaraba sector as an active component of the Islamic financial regime. In order to ensure the inflows and outflows of the resources of Modarabas are free from Riba, Qimar and Gharrar and support from business prohibited by shariah (e.g. drugs, alcohol, tobacco and pork related items etc.), the Registrar Modaraba issued a draft guidelines "Shariah Compliance & Shariah Audit Mechanism (SCSAM) for Modarabas. Prior to finalization of these guidelines, an intense consultative process was undertaken by seeking input of members, holding various discussions and eventually holding a meeting of all stakeholders with the Registrar Modaraba. After carefully considering all aspects of the matter, the guidelines were finalized and issued by the Registrar Modaraba through Circular No.08 of 2012 dated 3rd February, 2012.

These guidelines have improved the quality of existing compliance and eliminated the risk of any inadvertent violation of shariah principles by the Modarabas. It was an important step towards the enhancement of the image of Modarabas as a responsible component of Islamic Financial Industry in Pakistan.





# 5 STRUCTURAL FLEXIBILITY IN THE MODARABA SECTOR





## 5. STRUCTURAL FLEXIBILITY IN THE MODARABA SECTOR

In Pakistan, **Modaraba** is a **unique model** of its kind as no such example exists in rest of the world. The **Modarabas** are allowed to offer any financial product or conduct any business based on Islamic concept provided it is Shariah compliant and approved by the Religious Board.

Currently there are 26 modarabas operating in Pakistan which are of different types and nature as detailed hereunder:

- Financial Modarabas
- Trading Modarabas
- Manufacturing Modarabas
- Rental Modarabas

Most of the Modarabas are financial modarabas which are perpetual, multi-purpose and multi-dimensional and are involved in the Islamic modes of financing such as Ijarah, Musharaka, Diminishing Musharaka, Murabaha and other modes approved by the Religious Board. The income of the financial modarabas is exempted from tax provided they distribute 90% of their profit to their certificate holders.

One of the Modaraba is engaged in the domestic and international trading activities. Some of the financial modarabas are also undertaking trading business but at a limited level as the income of trading activities is taxable.

Another modaraba is engaged in manufacturing and sale of corrugated. Manufacturing modarabas were previously tax exempted but in the last Finance Bill, exception from tax to the manufacturing modarabas was withdrawn due to which a Modaraba of a big manufacturing group, although finalized for IPO, cancelled the floatation of modaraba.

Rental business is flourishing in the country as there is a huge demand of Generators due to shortage of electricity in the country. In the year 2007 a rental modaraba started its operations which is now one of the biggest entity in the modaraba sector. In 2015 another rental modaraba started its business which is performing satisfactorily. Another rental modaraba is in the pipeline and expected to be completed its regulatory formalities soon.

### Unlisted Modaraba

In accordance with the Authorization Certificate (Section 11 of Modaraba Ordinance, 1980) every modaraba is required to be listed for trading in Stock Exchange. Since listing formalities are cumbersome and involve significant expenses,

the investors and Entrepreneurs are reluctant to establish and float a modaraba as such the growth in the modaraba sector is very slow.

In order to provide an opportunity to the Investors and Entrepreneurs to enter in the sector, the Association approached the Regulator and requested to allow unlisted modarabas to operate in the sector.

The Regulator has considered the request of the Association and certain amendments have been recommended in the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 which are pending at the Commission for their approval.

### Specific Purpose Modarabas:

In addition to the above, there are modarabas established for a specific purpose and for a fix period which have completed their task in time and subsequently wound up. The example of such modarabas are as under:-

#### 1. Twin Tower Modaraba

Immediately after the promulgation of Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 a Modaraba was floated in the same year in the name of "Twin Tower Modaraba, which was a specific purpose modaraba. The Modaraba was established by Bankers Equity Limited with a Paid up Capital of Rs.15 million which was provided by some of the Banks for the construction of a multi-storeyed building at Karachi. After completion of the project the Modaraba was wound up in 1983.

#### 2. Fayzan Manufacturing Modaraba

Fayzan Manufacturing Modaraba was formed under the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 and the Modaraba Rules, 1981 framed thereunder and was managed by Faysal Management Services (Pvt) Limited, which was incorporated pursuant to a Joint Venture Agreement between Faysal Bank Limited, Meezan Bank Limited and Pakistan Kuwait Investment Company (Pvt) Limited. The modaraba was for a period of five and a half years, commencing March 22, 2001. It was listed on the Karachi Stock Exchange (Now Pakistan Stock Exchange Limited). The Paid up Capital of the Modaraba was Rs.900 million.

The Modaraba was a specific purpose formed to construct, operate, manage and own a Polyester Staple Fibre (PSF)

Spinning and Processing Plant at the premises of ICI Pakistan Limited (ICI) under the License Agreement with ICI.

The modaraba was manufacturing PSF and its variants for ICI, under a Toll Manufacturing Agreement signed on March 28, 2001 between the Modaraba and ICI, for a period of four and a half years from the commencement of commercial production. The agreement with ICI can be renewed with the mutual consent of both the parties.

#### **The Plant:**

The production facility has been setup at a capital cost of 1,356 million and carried a name plate capacity of 44 ktpa. The project was carried out on a fast track basis and as a result the project came on line in 12 months of establishing of letter of credit with the main contractor. The events following September 11, 2001, has the potential of delaying the project schedule. However, immediate remedial actions by project management ensured that all such risks were mitigated to deliver the project on schedule. During the construction phase 1.1924 million accident free man-hours were clocked. Performance to high standard of engineering and planning during construction and commissioning phases of this project

resulted in achievement of name plate specifications within 4 days of the trial runs.

The plant, as planned, commenced commercial production on 1st April 2002 and has operated smoothly since then. During 2003 41,136 tons of polyester staple fibre were produced which is 93.50% of installed capacity.

#### **Winding Up of the Modaraba:**

The fixed term of Fayzan Manufacturing Modaraba expired on September 27, 2006 and the process for voluntary winding up was completed in accordance with Section 22 of the Modaraba Companies and Modaraba (Liquidation and Control) Ordinance, 1980 as per agreement between ICI Pakistan Limited (ICI) and modaraba, ICI purchased the manufacturing facility along with related equipment on September 27, 2006 for a consideration of Rs.1,295 million (including receivables), which reflects the fair market value of the manufacturing facility as established under the independent valuation report. The Liquidator finalized winding up proceedings and payment of certificate along with retained earnings to the certificate holders was made upon completion of legal and procedural formalities.



## EXCLUSIVE INTERVIEW:



## MUFTI IRSHAD AHMED AIJAZ

Chairman  
Shariah Advisory Board  
Bank Islami Pakistan Limited

**1. Modaraba has established itself as a well understood Shariah-compliant instrument of financing in Pakistan. What is your view about NBFIs and Modarabas operating in Pakistan?**

In the context of Modaraba as a Shariah-compliant instrument, my view hinges upon two things. First, I agree with the fact that Modaraba is a powerful instrument. Second, the institutionalization of Modaraba in Pakistan is very useful. I believe it is a great idea from an instrument to an institution. Pakistan is among the very few countries that are practicing Modaraba as an institution. But the point is that the Modarabas couldn't perform well despite being in operation from the last 37 years. Modaraba company, as a non-bank financial institution, has immense potential in the economy of Pakistan. Modarabas should have been utilized in its true sense to promote Islamic finance in the country. Still, I hope for the success of Modarabas and the progress of Islamic finance in Pakistan.

**2. A fundamental requirement of an Islamic Financial Institution is that its whole business practices and operations are based on Shariah Rules and Principles. Can you share about Shariah compliance mechanism of the Modaraba sector?**

Shariah compliance mechanism of

the Modaraba sector consists of two parts: current and past. There is an appropriate procedure to ensure Shariah compliance since inception. Modarabas have always been working under the supervision of the religious board at SECP. With the passage of time, the Shariah compliance mechanism of the Modaraba sector has improved. One of the main reason behind is the development of Islamic financial institutions and fund management companies in the last 10 to 15 years. As a result, the compliance and audit mechanism for the Modaraba sector has improved as well. Now every Modaraba has to appoint Shariah advisor for the compliance of its day to day operations. Moreover, Shariah compliance and audit mechanism is obligatory for every Modaraba and that they have to mention it in their annual report. So, it's not that once the Modaraba sector established and now there is no mechanism to verify its business practices and operations.

**3. In your opinion, what are the Shariah and legal issues that NBFIs and Modarabas are facing?**

In my point of view, one of the biggest legal issues is taxes that the NBFI & Modaraba sector is facing. NBFIs and Modarabas that are practicing Islamic instruments are Islamic intermediaries. In practice, they use different words like Trade Finance, Musharakah, Modaraba, etc. to connect with the real sector. So, the taxes are being imposed on these



Islamic intermediaries. Apart from that, there are no reforms in law for legal cases. This issue is not only related to Modaraba companies but of all Islamic financial institutions. At present, decisions are made through Banking Recovery Ordinance in case of a legal issue. Some Shariah issues of Modarabas are related to the industry including liquidity management and fund raising. Therefore, a conducive business environment is essential for the growth of NBFIs and Modarabas.

#### **4. Has the government done enough for the promotion of the Modaraba sector and Islamic Finance?**

To be honest, we cannot say that the government has done enough. No doubt, the government is committed to provide sound infrastructure for the promotion of the NBFi & Modaraba sector. The growth of the sector would not have been possible without the efforts and determination of the government of Pakistan, the State Bank of Pakistan, and the Securities & Exchange Commission of Pakistan. But it is also expected that the government will support more through favorable policies such as trade policies, Islamic banking & finance policies and tax neutrality, etc. In addition, the government should ensure the implementation of these policies. For instance, the commission of Islamization was formed but the government didn't pay much attention

to it. Anyhow, the role of the government can be improved. The government should learn from the example of Malaysia, Turkey, and UAE etc. They have developed dedicated departments considering the importance of Islamic finance. So in my opinion, the government should establish a proper ministry and certain departments to strengthen the Islamic financial institutions.

#### **5. What are the missing elements for the growth of the NBFi & Modaraba sector? Describe some incentives and impediments in the growth of the sector.**

Well, we have an adequate framework for the Modaraba sector. The government has to perform some duties while others are the responsibility of the sector itself. There are some missing elements within the sector. Modaraba sector cannot grow in the absence of experienced professionals. We need enthusiastic people that can expand the sector by establishing various different Modarabas such as trade Modaraba and manufacturing Modaraba. Usually, we observe shortages and price hikes of staple food in the country even though it is an agricultural country. The NBFi & Modaraba sector, in contrast with the Islamic banking sector, has the potential to tackle this issue by generating funds from the public. There is a possibility to improve

business and product development. As a matter of fact, product development is the major impediment to the growth of the sector.

#### **6. What is the way forward for the success of this sector?**

Islamic banks need a Shariah compliant non-bank financial institution for instance, if an Islamic bank would like to do Musharakah but due to capital adequacy ratio and other issues it can't do that on its balance sheet. The following courses of action should be taken for the success of this sector. First, there should be integration among Modaraba companies and Islamic banks. And they should work side by side to cater to the financial needs of the real sector. Moreover, there is a need to look upon the Modarabas that are not performing well. At present, the NBFi & Modaraba sector is regarded as a neglected sector due to the heavy tax burden. Therefore, taxes, in particular, the provincial tax should not be imposed unaccountably. Furthermore, the role of the NBFi Modaraba Association of Pakistan is also important for the growth of the NBFi & Modaraba sector. They should make every effort to improve the impression of the sector.





# 6 MODARABA INFRASTRUCTURE





## 6. MODARABA INFRASTRUCTURE

This chapter presents an overview of the infrastructure and Shariah environment of the Modaraba sector in Pakistan. The role of the Securities and Exchange Commission of Pakistan (SECP) in facilitating is highlighted. Developments that aim to strengthen the regulatory, supervisory and Shariah compliance environment of the industry are mentioned in detail.

### 6.1 Infrastructure Overview

The governing laws were introduced in 1980 for Modaraba entities. The Modaraba Companies and Modarabas are operating under the regulatory framework provided in following laws, rules and regulations:

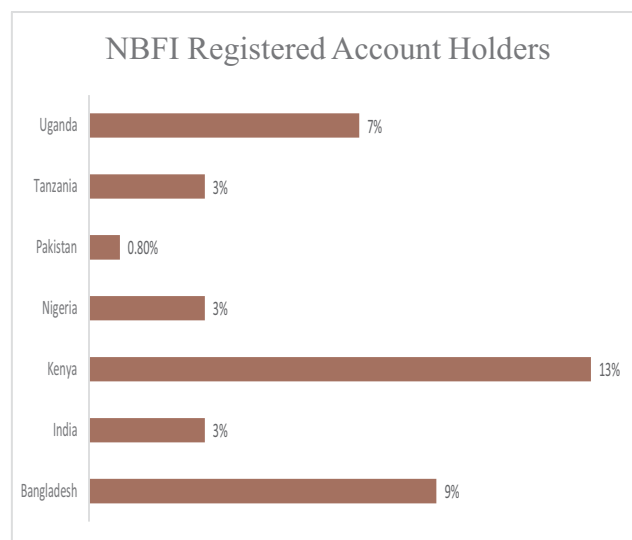
- Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980
- Modaraba Companies and Modaraba Rules, 1981
- Companies Act, 2017 (Repeated Companies Ordinance, 1984)
- Income Tax Ordinance, 2001
- Prudential Regulations for Modarabas, 2004
- Shariah Compliance and Shariah Audit Mechanism (SCSAM)
- Shariah Governance Regulations, 2018
- Shariah Advisers Regulations, 2019
- Code of Corporate Governance Regulations, 2019<sup>39</sup>

### 6.2 Pakistan's NBFI & Modaraba Sectors Global Position Snapshot

Globally, Modaraba is not being practiced in the form of a corporate entity. Modaraba, as a mode of Islamic finance, is only used as an Islamic financial product. Therefore, the infrastructure of NBFI & Modaraba

sector cannot be analyzed globally.

The following charts illustrate the regional position of Pakistan in terms of the use of Non-bank financial institutions.<sup>40</sup> However, it is not an accurate representation as data consists of less than 50



observations for the case of Pakistan.

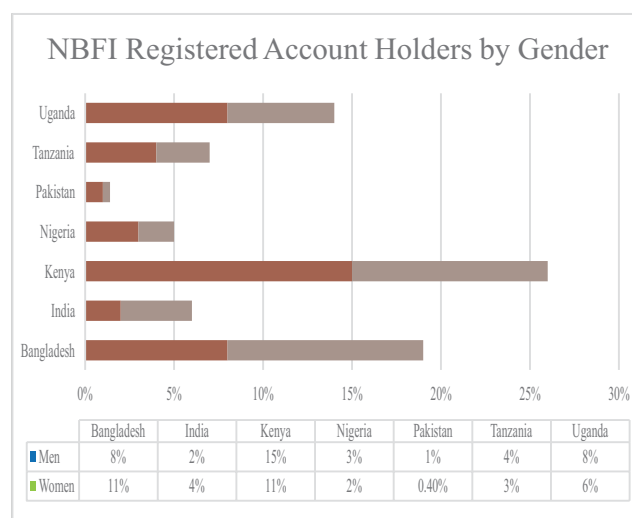
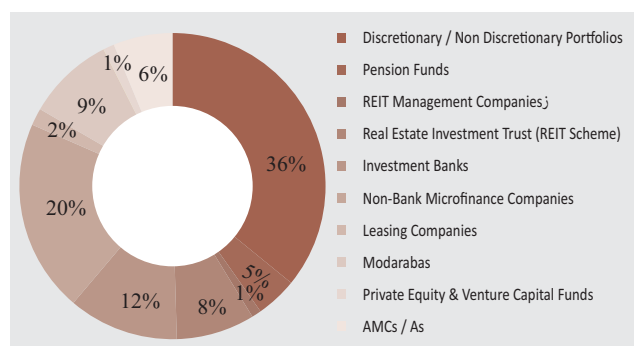


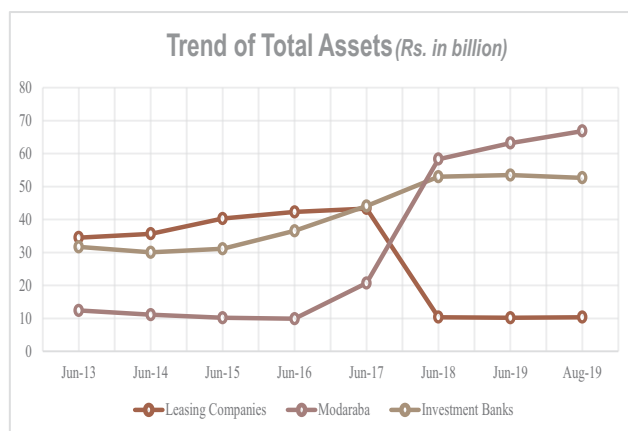
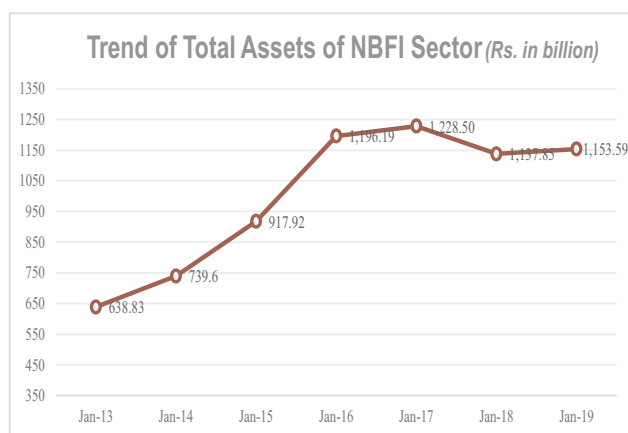
Figure 23 is demonstrating the details of NBFI sector within Pakistan as of August 31st, 2019. The data for this diagram is taken from the Securities and Exchange Commission of Pakistan (SECP).

<sup>39</sup> Source: The Listed Companies (Code of Corporate Governance) Regulations, 2019 [https://www.pwc.com.pk/en/assets/document/AFF%27s%20document%20on%20the%20Listed%20Companies%20\(Code%20of%20Corporate%20Governance\)%20Regulations,%202019.pdf](https://www.pwc.com.pk/en/assets/document/AFF%27s%20document%20on%20the%20Listed%20Companies%20(Code%20of%20Corporate%20Governance)%20Regulations,%202019.pdf)

<sup>40</sup> Source: Use of NonBank Financial Institutions: <http://finclusion.org/topic/nbfi.html#dataAtAGlance>

Figure 23: Glimpse of NBFI Sector<sup>41</sup>

Following two diagrams are showing trend of total Assets of NBFI sector, in particular, for Leasing Companies, Modarabas and Investment Financial Services. The dip in the total assets of leasing companies in 2018 is due to the conversion of a leasing company into investment finance services in terms of license status.



### 6.3 Regulatory, Supervisory and Shariah Compliance Development

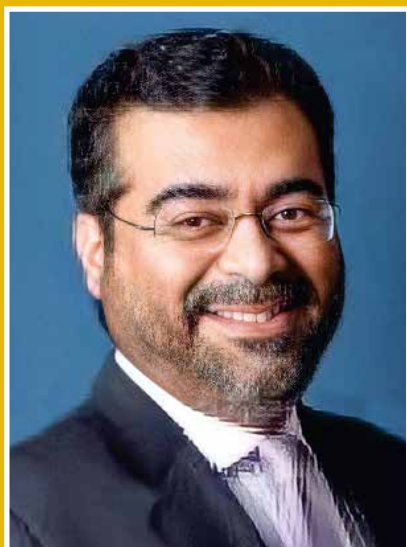
Securities & Exchange Commission of Pakistan (SECP)

proposed certain amendments and new concepts in Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 named 'Modaraba Act 2017'. The NBFI & Modaraba Association of Pakistan submitted its recommendations on Modaraba Act 2017 for their consideration. Subsequently, SECP send the proposed amendments after the approval of the commission to the national Assembly for its approval. These amendments were put forward to strengthen the Shariah compliance and ultimately promote the Islamic financial services in Pakistan. Some of the key amendments in the proposed Modaraba law are as follows:

- Restrict the misuse of the word 'Modaraba' by prohibiting any entity or person who is not authorized to collect deposits or raise funds from the public from using 'Modaraba' and/or 'Musharakah'.
- Permission to establish unlisted Modarabas with the mandatory condition of listing in 3 years and no tax exemption during this period.
- Performance-based remuneration to the Modaraba management company that increases with the return on Equity.
- Introduction of the concept of AGM (annual general meeting) in place of ARM (annual review meeting)
- Reduction of time from six months to four months for the circulation of annual financial statements and reports.
- Selection of a statutory external auditor by certificate holders.
- Powers given to certificate holders to apply for the change of the Modaraba management company.
- Modarabas may issue Shariah-compliant Term Equity Certificates (TEC) to mobilize further resources
- Change of Chief Executive Officer/directors by the SECP in special circumstances.
- Alteration in the winding-up mechanism for the Modaraba management company and Modarabas.

<sup>41</sup> Source: SECP Monthly Sector Summary of NBFCs August, 2019. <https://www.secp.gov.pk/document/monthly-sector-summary-august-2019/?wpdmdl=36248>

## EXCLUSIVE INTERVIEW:



## MR. RAHEEL Q. AHMAD

Chief Executive Officer,  
ORIX Modaraba

### 1. Tell us something about ORIX Modaraba?

ORIX Modaraba (ORIXM) was incorporated in May 1987 as First Grindlays Modaraba and started operation in August 1987. In 2000, Standard Chartered Bank acquired the ANZ Grindlays so name of Modaraba was changed to Standard Chartered Modaraba (SCM). In 2016, ORIX Leasing acquired SCM consequently name was changed to ORIX Modaraba. ORIXM is one of the pioneering Islamic Financial Institution of the country with the largest portfolio of Certificate of Musharika of PKR 2.9 billion in entire Modaraba sector.

### 2. What types of Products your Modaraba is offering?

ORIXM offers both consumer and wholesale Shariah compliant products including Ijarah, Diminishing Musharika (DM), House Finance under DM structure, Sukuk, Murabaha, Salam to Corporates, SME, High network individuals and employees of selected Corporate Clients under Assurance Model. The funds to finance the assets comes from a mix of Certificate of Musharakah, bank financing, equity and operational inflows.

### 3. It is said that NBFI & Modarabas have strong potential for expanding financial inclusion. What do you see as the main forces

### contributing to the slow penetration of NBFI & Modaraba Sector in Pakistan?

Flawed initial or hasty licensing contributed, at the start to many unprofessional and inexperienced people setting up Modarabas which liquidated. A large number also had no risk management of fiduciary capacity. Moreover, listing requirements also created onerous responsibilities to deter new entrants.

### 4. What is your strategy to overcome liquidity and risk management issues?

We have a proper Asset Liability Committee (ALCO) structure that resembles a global bank's ALCO and a risk management structure. It reviews monthly and quarterly cash flow projections with respect to disbursements in pipeline, COM portfolio proceeding towards maturity considering respective reinvestment probabilities, bank financings repayments, available drawing limits of banking lines, status of processing of new banking lines and other major operational cash flows falling due. In addition, ALCO sets guidelines for Maximum Cumulative Outflows (MCO), and Medium Term Funding Ratio (MTFR). The same is monitored regularly. ORIXM carries out extensive Credit & Due Diligence (decision making related) reviews both at the time of booking a new client and at every annual review of all relationships.



**5. What is the market share composition? Is the industry dominated by few big Modarabas?**

The industry is dominated by a few large Modarabas. ORIXM accounts for 13% of the sectors total assets, 5% of the sectors equity and 15% of sectors profit. Moreover, ORIXM has been able to distribute an average dividend payout of 24.06% with the minimum of 16% and maximum of 40% in 32 years. We would like to think that ORIX Modaraba is the clear thought leader.

**6. Modarabas have not been able to diversify their products or differentiate from other market players. Can you please mention the product innovation opportunities available to the Modaraba industry?**

The better Modarabas have gone into innovation, however, the large number of the smaller entities have serious lack of human capital including that in their management to create differentiated product. There are tremendous opportunities for large and successful group to use the Modaraba structure in project financing. Public private infrastructure projects can also be done using the Modaraba model. The National Saving Centre can also be transformed. In fact, the flexibility of the model allows for usage in privatization as well.







# 7 LEGAL FRAMEWORK/ REGULATORY LANDSCAPE





## 7. LEGAL FRAMEWORK/ REGULATORY LANDSCAPE

The chapter presents an analysis of the provisions of law and the relevant directives of the Regulator. Both pros and cons; incentives and impediments of these laws and regulations are discussed. The regulatory landscape has been fluctuating in terms of change in regulators and the status of Modarabas. In the initial phase, Modarabas were regulated by the Corporate Law Authority as Modarabas. Thereafter, the State Bank of Pakistan became the regulatory authority for Modarabas being financial institutions. In succession, SECP is regulating Modarabas as NBFIs.

### 7.1 Laws Related to Modarabas

The SECP regulates several key elements of Islamic Financial Services sector including Islamic mutual and pension funds, NBFIs & Modarabas, Takaful operators, Shariah-compliant companies, Sharia-compliant securities, real estate investment trusts, and indices. Therefore, SECP used to propose amendments in laws and regulations after having discussed with key stakeholders and Shariah Board of the SECP.

Figure 24: Key elements of Islamic Financial Services Sector Regulated by SECP



The regulatory framework for the NBFIs and Modarabas is presented in Figure 25. It has been categorized into two clusters. Cluster one is for Non-Banking Financial Services while the second cluster is for Fund Management Services.

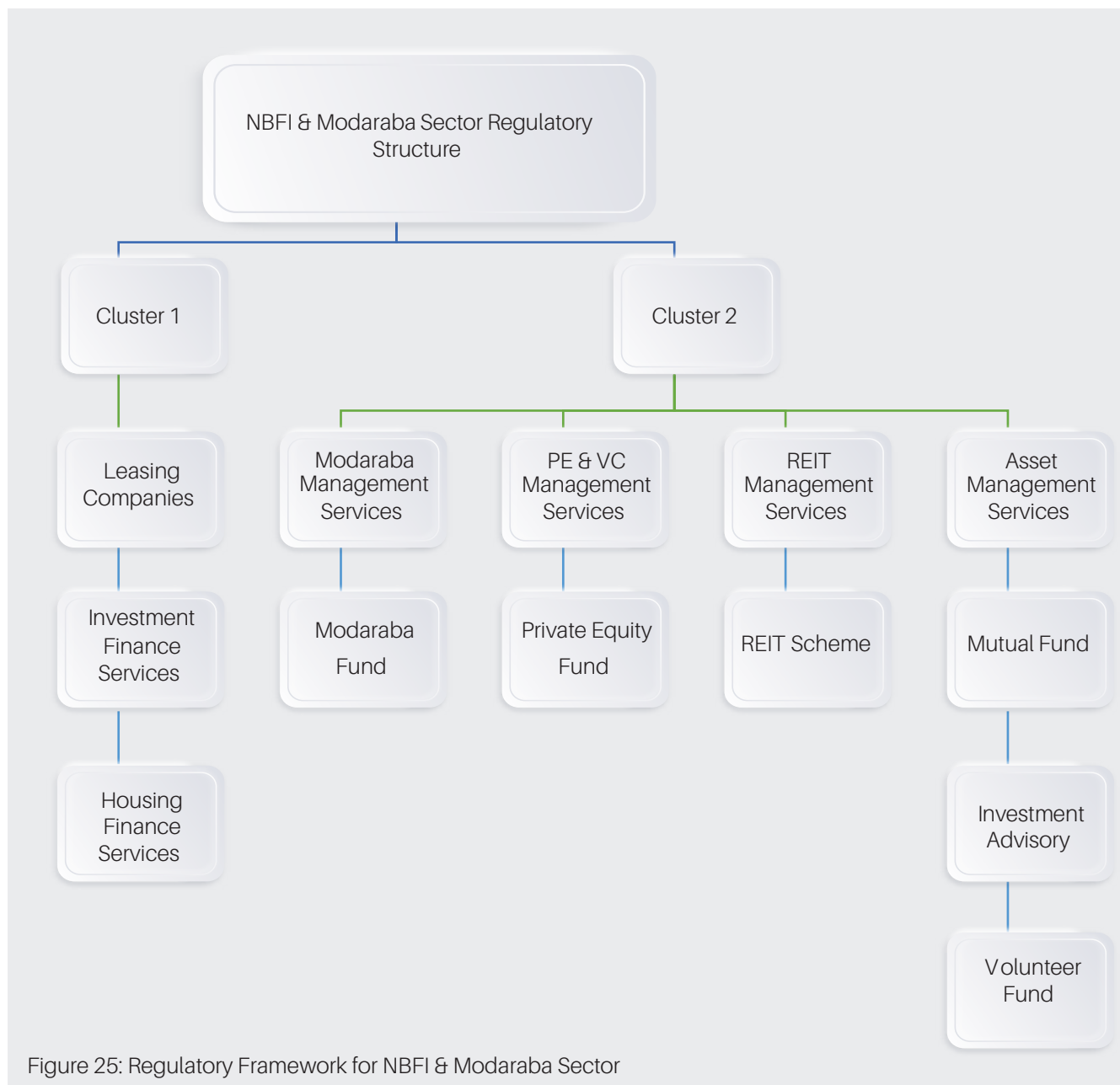


Figure 25: Regulatory Framework for NBFI & Modaraba Sector

Modarabas are observing all the laws and regulations promulgated in the following:

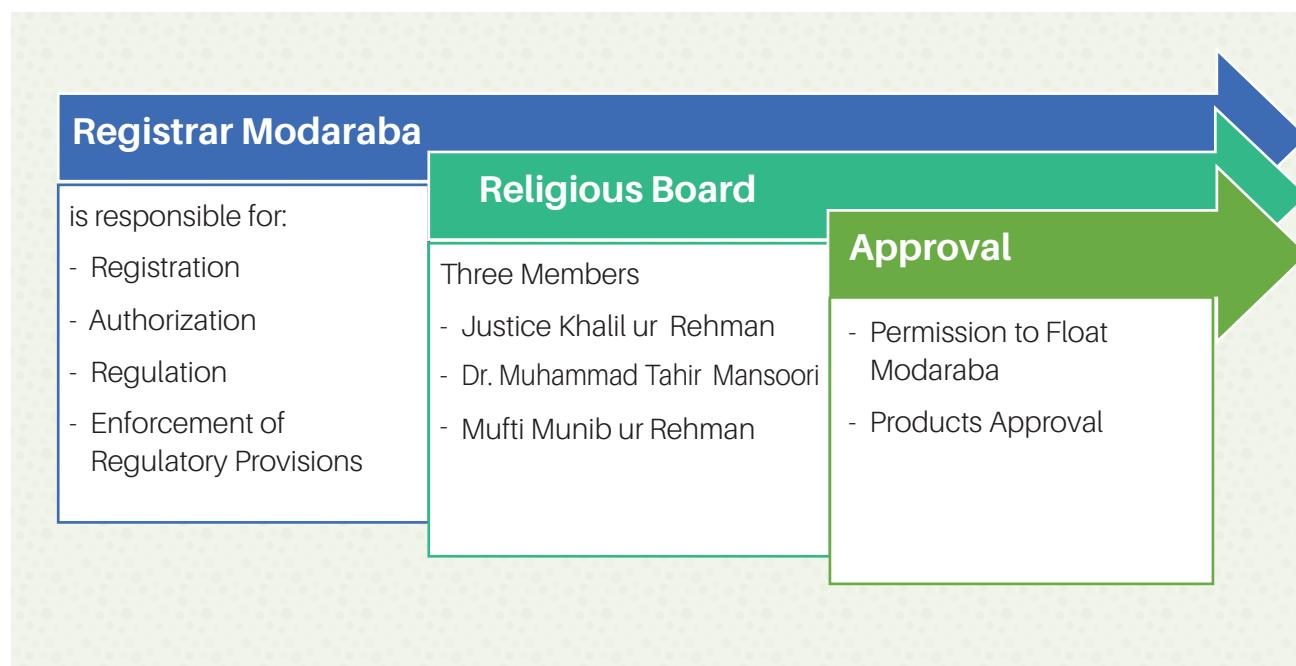
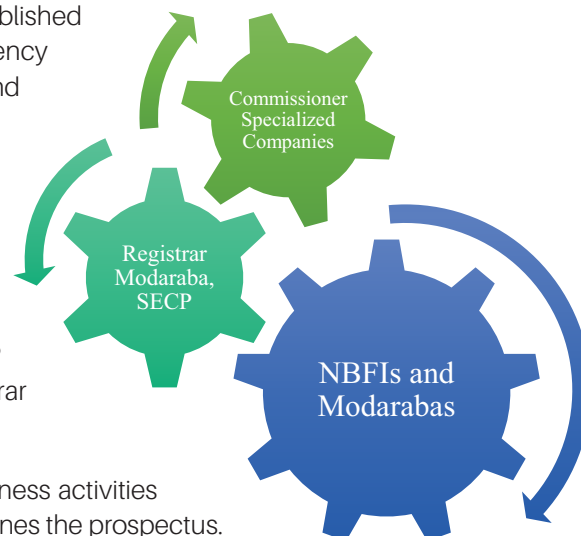
- Modaraba Ordinance, 1980 (updated 2012)
- Modaraba companies and Modaraba Rules, 1981
- Prudential Regulations Modaraba (updated 2008)
- Shariah Compliance and Shariah Audit Mechanism (SCSAM)

Furthermore, in the case of Money Laundering, Anti Money Laundering (AML) regime was in place since 2007 with the promulgation of AML Ordinance 2007, AML Ordinance 2009, AML Act 2010 and the subsequent establishment of Financial Monitoring Unit (FMU). FMU is established to receive Suspicious Transaction Reports (STRs) and Currency Transaction Reports (CTRs) and to provide timely and substantive analysis of STRs and CTRs. To further strengthen the AML regime, SECP has issued amended AML - CFT<sup>42</sup> regulations 2018 that are mandatory for all companies in the NBFIs & Modaraba sector.

## 7.2 Analysis of Relevant Laws and Regulations

NBFI & Modaraba sector is under the purview of SECP through Commissioner Specialized companies and Registrar Modaraba.<sup>43</sup>

SECP's Religious Board approves the prospectuses and business activities of Modarabas. At the first stage, the Registrar Modaraba examines the prospectus. It is then submitted to Religious Board for the clearance of the proposal. Religious Board consists of three members; a chairman and two Shariah scholars. Subsequently, Registrar Modaraba issues certificate.



## Impact

Impact is positive from the governance perspective. However, the requirement for listing in the stock exchange is quite high which has some negative consequences. Moreover, there are no specific laws and regulations for the business model of rental Modaraba, hinders operations thus restrict expansion.

<sup>42</sup> Anti-Money Laundering and Countering Financing of Terrorism

<sup>43</sup> See for example, Pakistan: Modarabas need enabling environment by Shabbir Kazmi <https://shkazmipk.com/islamic-finance-in-pakistan-5/>



Introduction of enforcement measures in the form of rewards and punishments on compliance and non-compliance could augment the impact in favor of the Modaraba sector.

### Pros and Cons

Changes in tax laws, pertaining to direct taxes as well as indirect taxes are restricting the growth of the Modaraba Sector.

1. Recent change in tax on dividend for tax-exempt entities, which are meant to encourage plough back of profits for entities operating in tax-free zones have affected Modaraba certificate holders who were encouraged to invest in Shariah-compliant mode of business by allowing Modarabas to enjoy tax exemption upon 90 percent profit distribution.
2. Provincial tax at a reduced rate on Rental Modaraba's business has rendered rental services expensive for the clients, especially at a time when the economy is going through a correction phase.

One of the benefits is that the relevant laws and regulations enhance governance. On the other hand, the reporting process is not streamlined and over regulations of the Modaraba sector resulting in unnecessary regulatory costs.

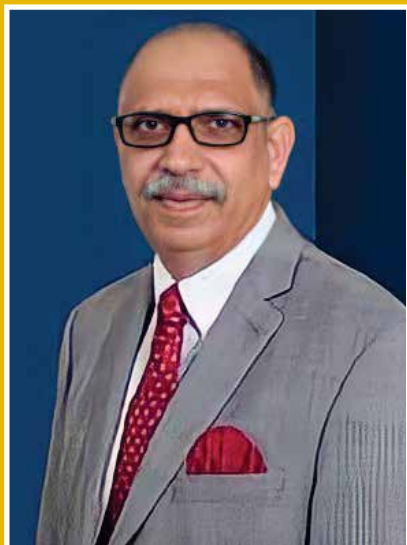
### 7.3 Incentives and Impediments

There are several incentives for the relevant laws and regulations including, tax incentive to manufacturing Modaraba<sup>44</sup>, and SBP Schemes for the promotion of the Modaraba sector. Whereas, provincial taxation issue and ominous regulatory regime belong to impediment in the growth of NBFIs & Modaraba sector.

<sup>44</sup> This incentive has been withdrawn.



## EXCLUSIVE INTERVIEW:



## MR. SHAHEEN AMIN

Chief Executive Officer,  
ORIX Leasing Pakistan Limited

**1. Take us through the recent trends in the leasing industry. Have the dynamics and structure of leasing industry changed of late?**

Trends of leasing in Pakistan changes with the passage of time. At the moment, there are 8 leasing companies operating in Pakistan. The total assets of the sector amount to Rs. 10,605 million, total equity amounts to Rs. 5,257 million in 2019. In Pakistan the first leasing company was established in 1985. In Pakistan from 1985 to 1997, 32 leasing companies were established with the minimum capital of Rs. 100 million. When the minimum Capital requirement was increased to Rs 200 million than this act leads to merger of small companies and only 27 companies left in Pakistani market. The major growth in the leasing sector was done during the period of 1992 to 1995, only in this short span of time 20 leasing companies were established in Pakistan. In October 1995 the leasing companies paid up capital reaches to Rs.7.572 billion, with market capitalization of Rs.6.0 billion as on 30-06-2002. ORIX corporation, one of the largest diversified financial services companies in Japan with global operations across 37 countries is present in Pakistan too. ORIX Leasing Pakistan focuses on creative and flexible financial services for a diverse market.

**2. Is the leasing business in Pakistan is still viable option**

**for assets financing?**

Yes, leasing business has been providing an alternate source of financing over the years and is still a viable option because it is different from other financial institutions that lend money on a collateral base. Leasing business does not provide working capital or stock finance but leases out assets. Therefore, the leasing companies have a very vast scope of operations and can cater to the needs of the clients faster and more effectively. Leasing has attracted borrowers away from traditional bank loans due to the potential advantages that it offers, like simple security arrangements, availability, convenience, lower transaction costs, little cash requirements, flexibility, and tax incentives.

**3. Commercial Banks are the real competitors of the Leasing industry. How your company is competing with banks and progressing well?**

We cannot compete with commercial banks as we have to take funds from them. Despite their encouraging growth and potential, the Leasing companies and Modarabas are basically secondary lenders, as these do not have adequate leverage and earning potential of banks. Besides, there is the non-availability of the level playing field. The competition is particularly severe in respect of mark-up rates vis-a-vis their cost of



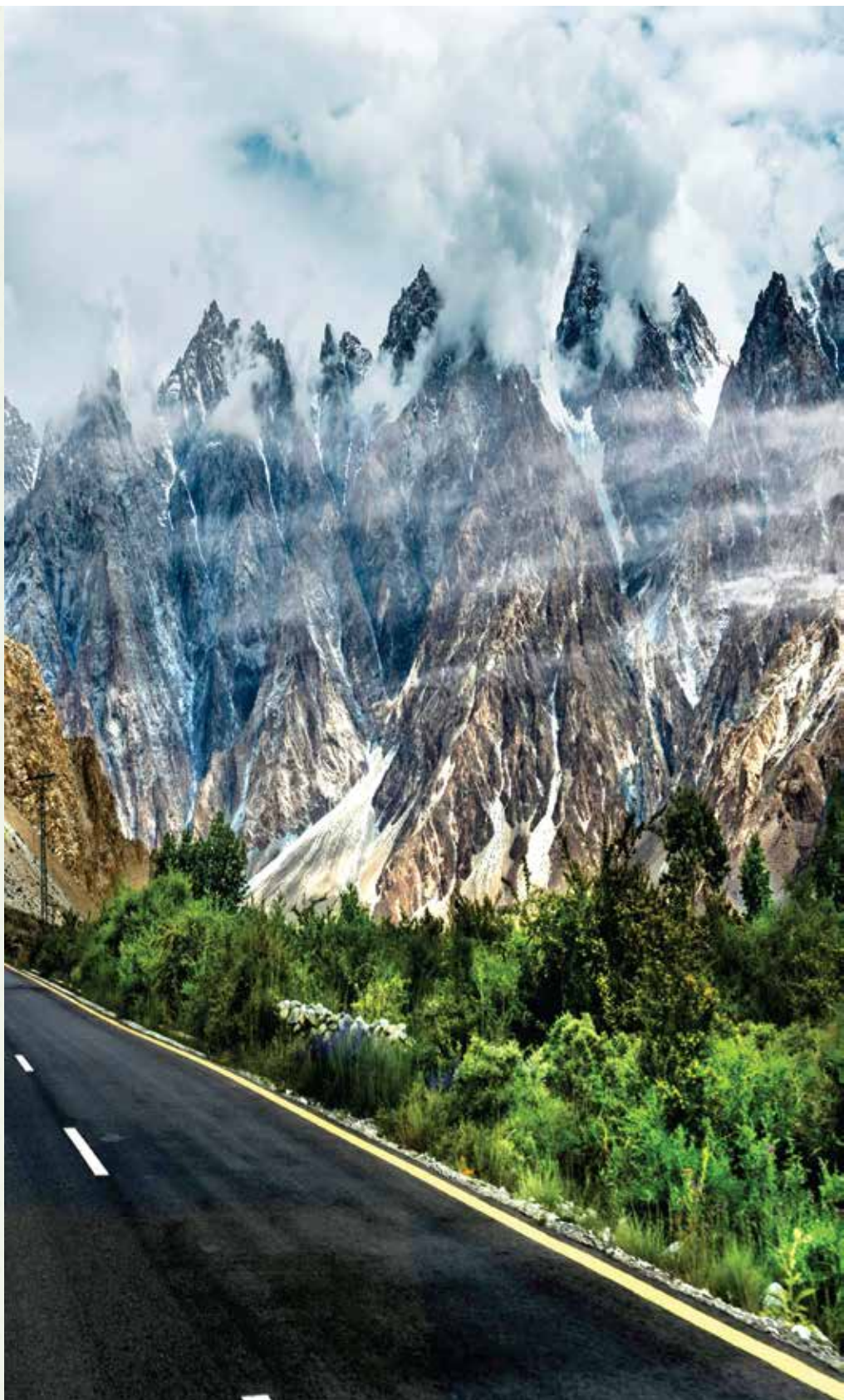
funds, which are much lower than rates offered by leasing companies because of their in-built margins.

**4. SMEs are potential segment within Pakistan and so far financial institutions have not fully explored said sector. What is the experience of ORIX in SME segment of Pakistan?**

ORIX Leasing Pakistan is a catalyst in propelling the growth of SMEs. It caters mainly to smaller cities and Small and Medium Enterprises (SMEs). Seventy percent of clients of ORIX Leasing are SMEs with 50 percent business from smaller cities /towns. ORIX leasing believes in start small and builds big. Moreover, The State Bank of Pakistan is taking interest to promote SME Financing through facilitative mechanism.

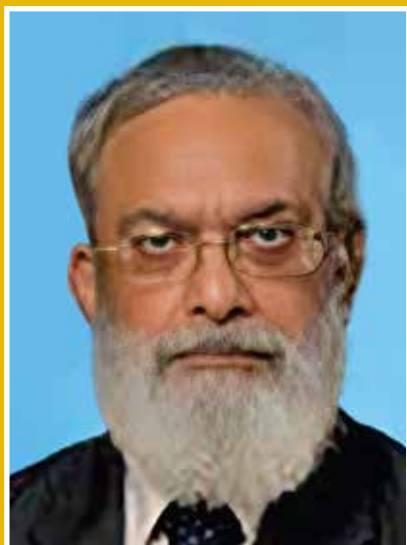
**5. What is the future of Leasing Industry in Pakistan?**

The leasing industry is providing value-added financial services. So it has the potential to grow in the future. However, leasing companies are facing some constraints such as liquidity constraints, unfavorable investment climate, competition, lack of innovative products, etc. Even in these adverse circumstances, some of the leasing companies have performed well and have regularly been giving handsome dividends. However, their performances have not been reflected in the market value of their shares, most of which are much below their par and even break-up value. This is not only due to reflection of the overall economic scenario but also due to a general perception of the leasing and Modaraba sector as a whole. The slowdown in the economy has affected the demand for leasing. Nevertheless, in case of an expected economic revival, the overall Leasing Sector is likely to regain its initial momentum.





# WHAT WENT WRONG WITH THE LEASING COMPANIES IN PAKISTAN?



## MR. KHALIL A. HASSAN

(The writer, has over 55 years of experience in Investment, Merchant & Commercial Banking, both in Pakistan & abroad. He is presently working as an Adviser to Pak-Gulf Leasing Company Limited, Karachi).

### Historical Backdrop:

#### 1. The Pioneers:

- a. Leasing in Pakistan was introduced with the incorporation of National Development Leasing Corporation Limited (NDLC), in 1984, as a Joint Venture between Asian Development Bank (ADB), International Finance Corporation (IFC) and other local sponsors, with a paid up capital of Rs.20 million. NDLC operated under the regulatory umbrella of the State Bank of Pakistan (SBP) and was granted the status of a DFI. In 2003, NDLC merged with the Bangladesh-based IFIC Bank, which later became the forerunner for NIB Bank Limited. In 2017 NIB Bank was merged with MCB Bank Limited.
- b. Orix Leasing Pakistan (Orix) was incorporated in 1986, as Orient Leasing (Pakistan) Limited. It was sponsored by the Orix Corporation (formerly Orient Leasing - the largest leasing company of Japan). It was converted into a Public Limited Company in December, 1987. Orix now operates as an IFS.

#### 2. Growth:

During 1985-1991, only six (06) leasing companies were

established, whereas during 1992-97, as many as 27 leasing companies entered the market. Initially, leasing companies could start business with a capital of Rs 50 million. This limit was raised to Rs 100 million in 1992. For Deposit Taking Leasing Companies, the required Paid-up Capital, at present, stands at Rs.1,000 million. At its prime, there were 35 Leasing Companies operating in Pakistan.

#### 3. Changes in Regulatory Control of Leasing Companies:

- a. Until the promulgation of the Securities & Exchange Commission of Pakistan Act, 1997, the relative responsibilities were carried out by the Corporate Law Authority (CLA), which functioned as a Department of the Finance Division of the Ministry of Finance of the Government of Pakistan.
- b. As a result of amendments in the Banking Companies Ordinance, 1962, affected in 1997, regulation of leasing companies was assigned to Corporate Law Authority.
- c. The CLA, following the issuance of Leasing Companies (Establishment and Regulation)

Rules, 1996, framed under Section 506 of the Companies Ordinance, 1984, along with NBFIs Prudential Regulations issued by the State Bank of Pakistan, took over the function relating to regulation of Leasing Companies from the State Bank of Pakistan in 1996, under the powers granted to CLA through Finance Division Notification No. SRO 698(I)/86, dated July 2, 1986.

- d. This function is being carried out by the SECP since 1st January, 1999, when it became fully operational, in place of CLA.
- e. The aforesaid Rules were repealed in 2000, by SECP, upon issuance of the Leasing Companies (Establishment and Regulation) Rules, 2000, (SRO. 70(9)/2000 dated 17.2.2000).
- f. Until such time that Part VIII-A was inserted in the Companies Ordinance, 1984 for establishment and regulation of NBFCs (promulgated in November 2000), the position of NBFCs was neither defined under the Law, nor had SECP any control over the various activities intended to be pursued by such entities.
- g. Salient Features of Part VIII-A of the Companies Ordinance, 1984 were as under:
  - i. Only a NBFC duly licensed by the Commission to undertake specified activities;
  - ii. Power to make rules for establishment and regulation of NBFCs;
  - iii. Power to issue directions;

- iv. Power to remove any director/chief executive/chairman or any other officer and to appoint another person in his place;
- v. Power to supersede Board of directors of a NBFC; and
- vi. Special/Inquiry audit could be ordered for detailed scrutiny of the affairs of a NBFC.
- h. On January 11, 2002, the SBP and the Commission jointly announced the transfer of supervisory functions of certain Non-bank Financial Institutions (NBFI) from the SBP to the Commission effective July 1, 2002, which included all Leasing Companies.
- i. The first formal NBFC Rules were issued in April 2003, to be followed by the NBFCs & Notified Entities Regulations of 2008.

#### 4. Decline & Fall of Leasing Companies in Pakistan:

The fortunes of the Leasing Companies started to dwindle following the decision on January 11, 2002 of the State Bank of Pakistan for transferring the supervisory functions thereof to the SECP. The reasons could be defined as follows:

- a. Leasing Companies are quasi-banking institutions, in as much as they are required to channelize their Financial Resources (Equity + Cols + Bank Borrowings) into Lending Operations by way of Assets-backed credit operations in the form of Medium Term commitments. Consequently, their core assets comprise of term financing, subject to prudential

credit risk management. Funding for this operation is arranged by leveraging their Equity by creating a liabilities portfolio comprising of funds borrowed from the Public and/or other Financial Institutions, in the shape of Certificates of Investments (Cols).

- b. Backing of SBP is also important to provide security and psychological comfort to investors and lenders of a Leasing Company. The presence of a Lender of Last Resort (LLR), the availability of the SBP's Discount Window and, if provided, the fall back on a Depositors Insurance Fund, all taken together, ensure liquidity to and competent risk management by the Leasing Companies. Hence, despite their limited scope of activities, Leasing Companies are able to enjoy a respectable place among Financial Intermediaries, including Commercial Banks.
- c. The comfort derived by the aforesaid Central Bank support, enables them, as a result, to also act as an active participant of the Inter-bank Money Market.
- d. When the Regulatory Control of Leasing Companies was transferred to SECP, it was perhaps inadvertently overlooked that SECP would have no fiduciary powers, as opposed to SBP. Moreover, an administrative control alone, by the SECP, would not, like the SBP, have the capacity to devise policies based on fiscal management comprising of money supply, credit expansion, interest rates and sectoral distribution of a Leasing Company's credit portfolio.

e. The NBF Sector Reform Committee of SECP did acknowledge (and indeed recommended) for SBP to reassume its fiduciary disciplining powers over all NBFCs, with only the administrative control remaining with SECP. However, this proposition failed to make a comeback when the Amended Non-Banking Entities Regulations 2008 were later notified.

f. The impact of the Withdrawal of SBP from regulating the Leasing Companies resulted in the following reduction in numbers of operating Leasing Companies:

i. No. of Operational Leasing Companies between 1984-1989: 9

ii. No. of Companies incorporated during 1990-1999: 26

iii. Total No. of Operational Leasing Companies as at end of 2002: 35

iv. Only a single Leasing Company was incorporated in 2003, following withdrawal of the SBP Regulatory Umbrella.

v. By 2009, only eleven (11) Operational Leasing Companies were left in the Market.

vi. It was not until December, 2017, that Pak-Brunei (a DFI), launched its wholly owned subsidiary in the name of Primus Leasing Limited.

vii. As of now, strictly speaking, only two (03) hard core Leasing Companies (ignoring the fact that Orix is now an IFS) namely, Orix Leasing, Primus Leasing and Pak-Gulf Leasing Company Limited continue to survive as profitably operating Leasing Companies in Pakistan.

g. The route adopted by the Leasing Companies to exit from the fold, was through mergers and acquisitions and, in some cases, by switching over to activities other than Leasing.

5. Other Reasons for Diminishing Interest in Setting Up Hard Core Leasing Companies:

Besides the withdrawal of the regulatory umbrella of SBP, and the increased MER (Minimum Equity Requirement), there are other constraints too, in the way of any entrepreneur planning to sponsor a Leasing Company in Pakistan. Some of those impediments are as follows:

a. Competition with Commercial Banks & FI-Sponsored Companies & Modarabas:

Commercial Banks had always had the option to offer Leasing Finance, as one of their many products for the benefit of their customers. Initially, they were reluctant to get into the field as they did not possess the professionally competent Human Resource to manage Leasing transactions. They had been eyeing the feasibility of undertaking Leasing business in the backdrop of the astounding growth of the Leasing Sector from 1985 to 2002, but were shy of taking a plunge in the field.

With SBP gone as the Regulator of Leasing Companies at the end of 2002, and the decline witnessed in the growth and profitability of Leasing Companies, thereafter, adequate Human Resource was willing to go overboard and join a Leasing Company/Division of a Commercial Bank.

Banks already had sufficient supply of low cost liquidity available for diversification into high yielding Leasing transactions. With the former leasing company employees' availability guaranteed, they availed of the opportunity by sponsoring their own subsidiary leasing companies and Modarabas, besides creating leasing divisions within the banks.

Devoid of Bank Borrowings at reasonable terms and unable to compete with Banks on cost of funds, besides the additional facilities and services offered by the banks to a lessee, Leasing Companies began to lose both their qualified and experienced HR, as well as established clients.

b. Taxation:

It has been said that Leasing is all about efficient tax management on the parts, both of the Lessor and the Lessee. The Lease versus Buy and Lease versus Loan Models were always used in earlier years by the Leasing Companies to convince their prospective customers to make use of leasing finance.

The Small & Medium Enterprises (SMEs) were particularly the more sought after clients for the Leasing Companies, as commercial banks considered SME financing to cost higher, in terms of administration expense, than the big ticket lending. The latter, based on the economies of scale and the collateral business opportunities offered by high end borrowers seemed more lucrative business options for the Banks.

SMEs consequently found



Leasing Companies to be more sympathetic towards fulfilling their Sector's borrowing demands, albeit at Interest Costs which were a tad higher than those offered by commercial banks, not to mention the absence of demand for a collateral security by a Leasing Company, which relied only on the Cash Flow of the Borrower and the Asset being leased.

Alternate Corporate Tax has been applied with retrospective effect on Accounting Profit of a Leasing Company. Provincial Sales Tax and Duties have been going up and certain cases, Federal Excise Duties have been introduced in addition to the Provincial Government's taxes.

On the other hand, Modarabas continue to enjoy a more conducive tax environment, but are entitled to carry out leasing transactions in the garb of Sharia-compliant Ijarahs and other similar products, thereby offering tough competition to conventional leasing companies.

c. Other Administrative & Regulatory Constraints:

The Revised Regulations notified recently by the SECP for NBFCs, with respect to Leasing Companies, have made it even harder for the Privately Sponsored Leasing Companies to profitably operate in a highly competitive market. Some of the newly restrictive conditions introduce relate to:

i. Per party and per Group exposure has been reduced;

- ii. MER has been increased, although a grace period has been provided;
- iii. Provisioning for Non-Performing Loans (NPLs) has been tightened;
- iv. Leveraging limits and conditions for mobilizing funds through Cols have been reduced; and
- v. Compliance Requirements have been made tougher, in addition to full adherence with the Code of Corporate Governance.

## 6. Conclusion:

The only recipe, for getting the Leasing Company's out of their continuing predicament, is for the SBP to re-assume its Regulatory and LLR role for the entire NBFCs Sector, including Leasing Companies. While doing so, SBP must undertake an intensive exercise to independently assess the underlying difficulties faced by the Sector, with regard to protecting the interest of all the concerned stakeholders. SECP may continue with the Corporate Affairs and Administrative Compliance issues relating to NBFCs. Once this Sector regains its protective umbrella from the SBP, all issues relating to Liquidity and Credit Risk Management would automatically be resolved and the Sector would be in a position to contribute to the growth and wellbeing of the SMEs, which by some estimates represent an Asset Base of over US\$ 70 billion and has immense capacity of creating job opportunities for millions of unemployed Pakistanis, besides

adding to Tax Revenue for the National Exchequer.

## 7. Other Recommendations:

- a. Asset-backed financing, which Leasing essentially represents, is a high risk orientated transaction. Leased Assets legally continue to remain under the ownership of the leasing company and it is only the usufruct of the leased assets which is assigned to the Lessee. Hence, the standard legislation available for recovery of secured bank lending are not effective and expeditious enough for a leasing company to either re-possess its leased assets from its defaulting customers and to auction the same for recovery. There are other legal impediments too in the way towards recovery from delinquent accounts. Government must review and introduce independent legislation to cover Leasing Companies against defaults.
- b. Under the existing regulations, only moveable assets can be leased. Leasing of Immoveable Assets must also be allowed for increasing business opportunities for the leasing companies.
- c. The Insurance Sector should introduce Credit Risk Insurance for Leasing Finance.
- d. The Governments, both Provincial as well as Federal, must look into the Tax Structure for Leasing transactions, both for the Lessor and the Lessee and make it more feasible for leasing business to prosper.





# 8 LEASING SECTOR





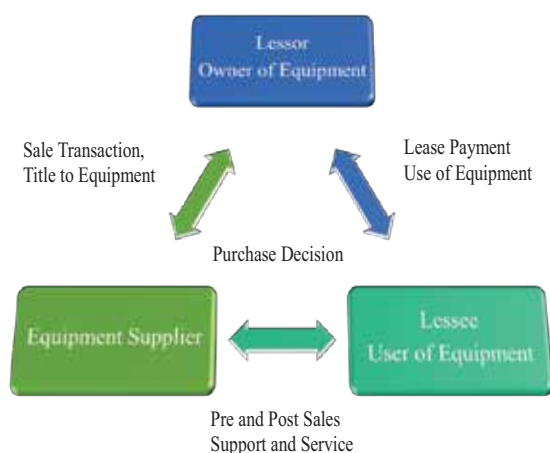
## 8. LEASING SECTOR

The leasing sector is an indispensable cogwheel of any developing economy as it serves to drive macroeconomic growth by means of fueling the factors of production through financing. For that reason, the role of the leasing sector in the progress and development of the industrial sector remains very prominent. This chapter gives a snapshot of the leasing sector in Pakistan, its evolution, structure, and progress. It also highlights the potential of the leasing sector and the main challenges experienced by the leasing sector in Pakistan.

### 8.1 Leasing Sector Overview

Leasing is an alternative source of financing for medium-term and long-term. It is viewed as the quickest way to get equipment finance; without extensive and tedious methods. It permits the protection of working capital that can be used for other productive business purposes. The underlying model of financing is Shariah-compliant given certain adjustments in the procedure and rental installment which might be levied as a tax-deductible payment to the borrower's balance sheet. The basic Leasing structure is provided below:

Figure 26: Basic leasing Structure<sup>45</sup>



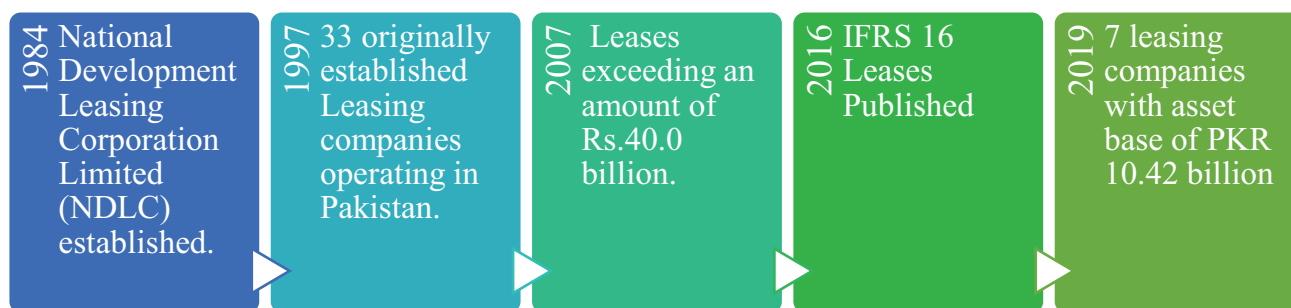
It has started in Pakistan in the mid-eighties with the setting up of the first leasing company in 1984 named the National Development Leasing Corporation Limited (NDLC). NDLC was developed as a joint venture between the Asian Development Bank (ADB), International Finance Corporation (IFC), National Development Finance Corporation (NDFC) and local sponsors under the supervision of the State Bank of Pakistan (SBP). Financial lease and operating lease are two main types of lease practiced in Pakistan. In addition, Ijarah, an Islamic form of lease, is also being performed by NBFIs in Pakistan. The differences among them are elaborated in the table given below:

Table 8: Differentiating Finance lease, Operating lease and Ijarah

Criteria	Finance Lease	Operating Lease	Ijarah
Legal ownership of equipment	Lessor	Lessor	Lessor
Securing the transaction	Asset ownership	Asset ownership	Asset ownership
Equity / Security Deposit	Medium	Low	Low
Responsibility for maintenance and insurance	Usually Lessee	Usually Lessor	Lessor
Risks (damage, residual value risk etc.)	Usually Lessee	Usually Lessor	Lessor
Cancellation option	Usually not available	Usually available	Usually available

<sup>45</sup> Source: [http://www.microfinancegateway.org/sites/default/files/mfg-en-paper-leasing-a-potential-solution-for-sme-expansion-and-rural-financial-sector-deepening-a-study-of-russia-2006\\_0.pdf](http://www.microfinancegateway.org/sites/default/files/mfg-en-paper-leasing-a-potential-solution-for-sme-expansion-and-rural-financial-sector-deepening-a-study-of-russia-2006_0.pdf)

Figure 27: Historical perspective of Leasing Sector



From that point forward the leasing sector has witnessed constant growth. The leasing sector is contributing to the development of the industrial sector through capital assets financing. At present, 8 leasing companies are operating in Pakistan. The size of assets of the leasing sector was PKR 10.42 billion as of March 31, 2019.<sup>46</sup> Correspondingly, the size of equity of the leasing sector was PKR 5,257 million in 2019.

Figure 28: Growth of Leasing sector in Pakistan in terms of Assets and Equity

Figure 28: Growth of Leasing sector in Pakistan in terms of Assets and Equity



The dip in the assets is due to the exclusion of ORIX Leasing from the leasing sector. It has a large market share with PKR 33.4 billion assets<sup>47</sup>. Recently it has leaped to become a full-fledged Investment Finance Services company. Leasing companies in Pakistan are offering a variety of products such as corporate lease, consumer auto lease, operating lease for various equipment, commercial vehicle lease, and leasing to SME sector.<sup>48</sup>

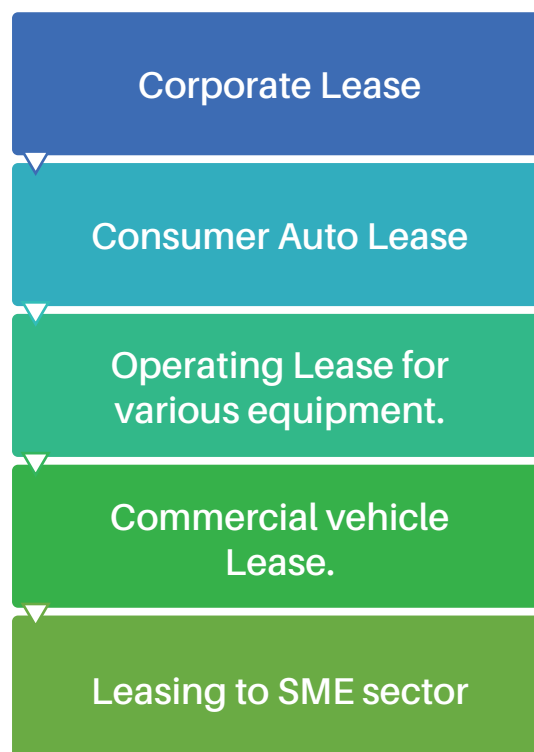


Figure 29: Products of Leasing Companies

## 8.2 Constraints on operations of Leasing Sector

Leasing sector is not performing well due to the following reasons:<sup>49</sup>

- Leasing sector is under the regulatory regime of Securities & Exchange Commission of Pakistan (SECP) contrary to the State Bank of Pakistan (SBP). Though its

<sup>46</sup> Chapter 6: Capital Markets and Corporate Sector, Pakistan's Economic Survey 2018-19, pp 95  
<sup>47</sup> Source: <https://karandaaz.com.pk/wp-content/uploads/2019/06/KARANDAAS-PAKISTAN-RFP-61-V4.pdf>  
<sup>48</sup> <https://fb.brecorder.com/2015/08/201508271221070/>  
<sup>49</sup> See for example: "Constraints on Profitable Operation of Leasing Companies in Pakistan" by Khalil Anwar Hassan. This article was published in Yearbook 2013, NBFi & Modaraba Association of Pakistan.

operations require funds in the form of Certificates of Investments/Deposits (Cols/CoDs) or from the Islamic banking industry. Hence, the leasing companies do not have the fiduciary support of SBP in the form of “Lender of Last Resort”, SBP Discount Window, or any other funding facilities for financing their liquidity requirements.

- Removal of credit lines by the banks
- Investors are concerned about the security of their invested capital as the Leasing Companies are repudiated the umbrella of the Deposit Insurance Scheme.
- The minimum equity requirement is very high that is PKR 1000 million.<sup>50</sup> There is a lack of ability of some leasing companies to meet the minimum equity requirement.
- Leasing sector is going through tough competition with the banking industry in terms of access to cheaper funds and larger risk-carrying ability. Leasing sector have the non-availability of long-term resources at low costs. Funding sources of leasing companies are limited to; Shareholder's equity, Certificate of Investment, and borrowing from banks in the form of Running or Term Finance Facilities
- High non-performing loans in the leasing sector's cumulative portfolio.
- Slowdown in economic activities and investment opportunities.
- Leasing companies are not permitted to levy initial depreciation on previously used machinery and equipment.
- The loan losses are also not treated as “Tax-admissible Expense”.
- A Federal Excise Duty has been imposed on the leasing companies in addition to provincial sales tax.

- Leasing companies hesitate to finance high-value passenger vehicles due to the upper limit of claiming tax depreciation that is PKR 2.5 million.

In order to obtain revival of the leasing companies in Pakistan, the issues and challenges of leasing companies need to be investigated and mitigated.

### 8.3 Regulatory Landscape of Leasing Sector

In Pakistan, there is a distinct regulatory landscape for Leasing companies from Modaraba companies. However, there exists some commonality in rules and regulations for Leasing companies and Modarabas. Laws dealing with leasing companies are:<sup>51</sup>

- Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (Amended SRO – 1002 of 2015)
- Non-Banking Finance Companies and Notified Entities Regulations, 2008 (Updated December 28, 2016)
- Companies Act, 2017)
- Income Tax Ordinance, 2001

Some of the major regulations that apply to the leasing companies are enumerated as follows:

A leasing company shall register and get a license in order to be registered as a public limited company for the period of 3 years.

- A leasing company shall maintain accounts in accordance with the accounting policies and disclosures related to leases, both for lessees and lessors.
- Maximum coverage of a leasing company to its directors, affiliated companies and companies in which any of the directors or his family members hold controlling interest shall not be more than 10 percent of the overall leasing portfolio.

<sup>50</sup> Source: NBFC Regulation (updated December 28, 2016)

<sup>51</sup> Source: <https://jamapunji.pk/knowledge-center/faqs-related-leasing-companies>

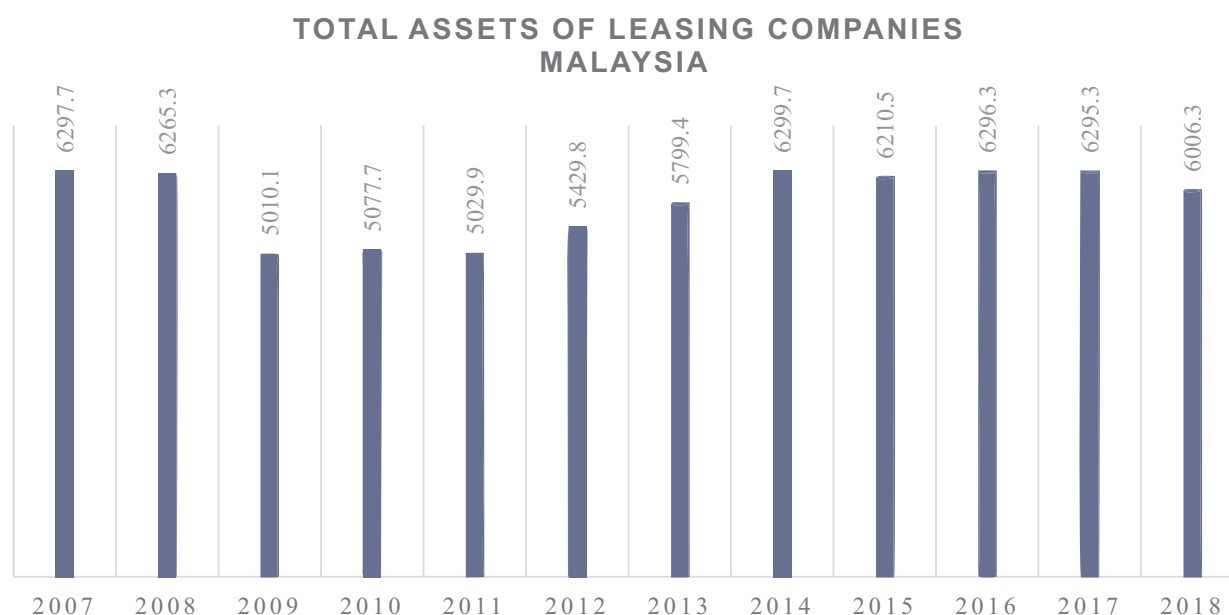


- A leasing company be going to invest 70 percent of its funds in the leasing business.
- SECP shall endorse the appointments of CEO's and Executive Directors of leasing companies.
- A leasing company is permitted to do business activities such as leasing of machinery, equipment, and vehicles to construction companies. Likewise, leasing of land and buildings is also not permitted.
- Capital base requirement for leasing companies is equal to PKR 1000 million for deposit taking entities.

Moreover, the International Financial Reporting Standard applicable to leases is IFRS 16 effective from January 1, 2019. IFRS 16 replaced the previous standards such as IAS 17 (Leases), IFRIC 4 (Determining whether an Arrangement contains a Lease), SIC-15 (Operating Leases – Incentives), and SIC 27 (Evaluating the Substance of Transactions Involving the Legal Form of a Lease).<sup>52</sup> The concept of operating lease has been eliminated concerning lessee accounting. It means that each lease will be reflected as a financial lease irrespective of the characteristics.

#### 8.4 Leasing Sector in Malaysia

As of 03 Jun 2019, 324<sup>53</sup> pure leasing companies had registered with Bank Negara Malaysia (BNM). BNM is the regulatory authority for leasing companies operating in Malaysia. The assets of Malaysian leasing companies for the period 2007-18 are presented below. The total assets of the Malaysian leasing companies amounted to RM 6.01 billion in 2018.<sup>54</sup>



<sup>52</sup> Source: IFRS—Leases, Standards, Deloitte: <https://www.iasplus.com/en/standards/ifrs/ifrs-16>

<sup>53</sup> Source: List of Leasing Companies, International Business and Financial Centre, Malaysia: <https://www.labuanibfc.com/areas-of-business/financial-services/leasing/list-of-leasing-companies>

<sup>54</sup> Source: Monthly Highlights and Statistics in September 2019, Bank Negara Malaysia. [http://www.bnm.gov.my/index.php?ch=en\\_publication&pg=en\\_msb&ac=274&en&uc=2](http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_msb&ac=274&en&uc=2)

<sup>55</sup> Pure leasing companies are those companies whose primary activities are in leasing.

Table 9: Assets and Liabilities of Malaysian Leasing Companies<sup>55</sup>

Year	Cash and bank balances	Investments	Leasing	Others	Other assets	Total assets/liabilities	Capital, reserves and retained earnings	Borrowings from financial institutions	Inter-company borrowings	Other liabilities
2003	161.1	352.3	1,706.1	653.5	3,136.5	6,009.5	861.1	1,738.2	1,165.6	2,244.6
2004	157.4	326.6	1,588.0	592.0	2,868.5	5,532.6	1,016.8	1,816.1	604.8	2,094.9
2005	105.7	309.4	1,632.3	1,228.0	2,867.2	6,142.5	1,018.0	1,984.6	1,001.3	2,138.7
2006	148.5	273.5	1,626.8	1,455.7	2,901.7	6,406.1	1,030.7	2,266.2	1,235.3	1,873.9
2007	177.6	262.2	1,585.6	1,421.3	2,850.9	6,297.7	1,024.7	2,493.8	879.1	1,900.0
2008	325.4	189.3	1,501.8	1,329.1	2,919.7	6,265.3	981.0	2,685.0	743.4	1,855.8
2009	295.3	195.1	1,198.2	978.2	2,343.3	5,010.1	861.7	1,837.5	457.4	1,853.6
2010	313.0	185.9	1,024.0	1,100.4	2,454.4	5,077.7	925.5	1,898.7	429.5	1,824.1
2011	234.6	242.7	982.7	1,156.0	2,413.9	5,029.9	735.6	1,881.9	794.1	1,618.4
2012	150.8	244.9	963.9	1,108.5	2,961.8	5,429.8	724.4	2,332.5	791.6	1,581.3
2013	143.4	207.7	358.3	1,889.8	3,200.4	5,799.4	1,092.6	2,986.8	1,011.9	708.0
2014	52.6	201.1	1,114.7	1,245.7	3,685.6	6,299.7	1,149.1	3,557.1	771.2	822.4
2015	64.3	204.1	665.0	1,101.2	4,175.9	6,210.5	1,402.6	3,651.0	393.9	763.1
2016	55.8	214.5	662.3	1,119.3	4,244.4	6,296.3	1,810.1	3,231.1	550.9	704.2
2017	68.6	211.5	700.8	1,211.7	4,102.6	6,295.3	1,777.1	3,712.5	200.8	604.9
2018	231.5	117.9	334.8	1,721.5	3,600.6	6,006.3	2,486.8	2,838.6	324.1	356.7



## EXCLUSIVE INTERVIEW:



## MR. MUHAMMAD SAMIULLAH

Secretary General,  
NBF & Modaraba Association of Pakistan

### 1. How did the Modaraba sector emerge in Pakistan's financial system?

As a policy move for Islamization of the economy, the Government of Pakistan introduced important amendments in the Banking Companies Ordinance in the year 1980 and Modaraba Ordinance, 1980 was promulgated to provide a legal framework for Islamic financial system in the country. This was an historic move through which the concept of "Modaraba Financing" was transformed into a corporate structure of the Islamic financial institution to operate under a defined legal framework and full regulatory regime. Pakistan has the unique privilege of taking this initiative for promotion of Islamic financial system as nowhere else Modaraba has been given a statutory and legal status though it is a popular business model in global Islamic financial practices.

The Modaraba Sector being a pioneer and the first vehicle in promoting Islamic financial services in Pakistan, is an important segment of the financial sector. The first Modaraba was floated in July, 1980 just after the issuance of Modaraba Ordinance. It was followed by a large number of Modarabas which once reached up to as high as 52. The Modarabas have been the trend setters of Islamic modes of financing in a predominant conventional financial system in Pakistan.

Currently, there are 26 Modarabas operating in Pakistan most of which

provide financial services like Islamic banks. The diversity of concept has brought in Modarabas engaged in trading, manufacturing, rental of assets or equipment.

### 2. What is the role of NBF & Modaraba Association of Pakistan?

NBF & Modaraba Association of Pakistan is an authorized representative body of all Modarabas, Leasing Companies and a few Investment Finance Services licensed by the Securities & Exchange Commission of Pakistan, operating in the country. The Association handles all sectoral issues and matters including micro and macro strategies for operational issues and deals with the Regulators, government functionaries, industry bodies, federations and other relevant entities. It provides an active and participative platform to the members for growth and improvement of the sector besides dealing with their individual issues.

One of its key function is to provide public awareness of potential and performance of its members for the national economy and facilitates their constant alignment with the changing market environment and challenges. The Association creates awareness through (i) holding workshops/seminars to enhance professional and operational capabilities of its members, (ii) Publication of Year Book which is a regular feature of the Association



since its inception, (iii) Publication of Monthly/Quarterly Newsletter to disseminate instant information and (iv) Participation in the workshops/seminars at the national as well as international level by the CEOs and senior members of the sector.

The Association is also enhancing its relationship with the academia to arrange awareness programs for introducing NBFI & Modaraba models. In this connection meetings are in the process with Institute of Cost & Management Accountant of Pakistan (ICMAP) and Institute of Business Management (IoBM) and modalities are being processed.

### **3. What steps have been taken by the regulator for the development of NBFI & Modaraba Sector?**

Modarabas have a well-established regulatory regime maintained by SECP under a full Modaraba Wing while a separate wing is regulating Non-Banking Finance Companies, both under the control of a Commissioner. All Modarabas and NBFCs are licensed by SECP and all the Modarabas are listed with Pakistan Stock Exchange while leasing companies are necessarily required to be listed.

Modarabas fulfill all financial and corporate disciplines and in addition, operates under a well-defined Shariah Compliance Framework. It is mandatory for every Modarabas to have a qualified Shariah Advisor whose certificate of compliance is published as an integral part of the financial statements.

SECP operates closely with the NBFI & Modaraba Association of Pakistan which is a representative body of the sector. Based on evolving needs and circumstances, SECP revises, updates and introduces necessary changes in Rules and Regulations. This maintains effectiveness of the regulatory regime and alignment with the international

practices.

Due to the potential of the Leasing and Modaraba Sector and the supportive regulatory environment of the SECP, significant business and Industrial Groups have started coming into the sector over the recent past. Three Modarabas and two leasing companies have been established during the last two/three years whereas a few NBFCs and Modarabas are in the pipeline.

SECP has also launched a public awareness campaign in collaboration with the Association for the growth of the sector. This first session was held at Islamabad Chamber of Commerce & Industry and efforts are being made to arrange awareness programs in collaboration with FPCCI, KCCI and KATI, for which meetings with these entities are in the process.

Recently SECP has proposed certain amendments in the NBFC Regulations, 2008 and Modaraba Regulations, 2019 wherein some of the recommendations of the NBFI & Modaraba sector have been approved and the Association has submitted its recommendations/suggestions, after the concurrence of the members, to SECP for their consideration. This would also help the NBFI & Modaraba sector for the growth in their business.

### **4. Tell us about the Shariah Compliance in Modaraba sector?**

Modaraba being an Islamic financial institution requires compliance of the Modaraba Ordinance, 1980, Modaraba Rules, 1981, Prudential Regulations, 2004 and Shariah Guidelines prescribed by Shariah for Modarabas for its execution. To achieve this objective of the Securities & Exchange Commission of Pakistan (SECP) has a Religious Board which approves the prospectus and business of the Modarabas and provides directions to achieve Maqasid al Shariah under the control of the Registrar Modaraba.

Registrar Modaraba is responsible to ensure the compliance of all the regulatory and Shariah requirements by the Modaraba sector.

Towards quality improvement of Shariah Compliance of Modarabas, the Registrar Modaraba has launched the Shariah Compliance & Shariah Audit Mechanism for Modarabas whereby Modarabas are required to appoint a Shariah Advisor who will look after their Shariah issues and provide them guidance on an ongoing basis. The mechanism also requires setting up of Shariah Compliance structure by Modaraba which can ensure compliance at every stage on a continuous basis.

NBFI & Modaraba Association of Pakistan in consultation with Mufti Irshad Ahmed Aijaz has prepared a Shariah Compliance Guide to help Modarabas in setting up their Shariah compliance Mechanism. This guide explains the requirements of Shariah compliance and provide assistance in developing methodology for implementation of its various aspects.

### **5. What is the future of NBFI & Modaraba Sector?**

Non-banking Financial Institutions and Modarabas have co-existed along with the conventional and Islamic Banks by serving SME sector, undertaking special activities like equipment rentals and meeting requirements of the micro borrowers which find it difficult to access the banking facilities.

Islamic banking in Pakistan has witnessed significant growth during the last decade and now constitutes around 15 percent of the banking system with an asset base. Modarabas are an important segment of the Islamic financial industry. Currently 26 Modarabas, 8 Leasing Companies and 4 Investment Finance Companies are the members of the NBFI & Modaraba Association. During the last five years, some new groups entered in the sector and established Modarabas



and Leasing Companies which has strengthened the NBFI & Modaraba Sector. There is a great potential in the Modarabas and Leasing Companies and with the recent amendments in Modaraba Regulations and NBFC Regulations and other regulatory framework would facilitate the sponsors/investors to undertake this business.

Securities & Exchange Commission of Pakistan in collaboration with the Association is arranging awareness campaign to give awareness about the Modaraba and Leasing models among the business community. For the purpose, Association is enhancing its contacts with Federations and Chambers in the country to arrange awareness sessions throughout the country.

Presently all the Modarabas operating in the country are listed with the Pakistan Stock Exchange, which is a mandatory regulatory requirement. In order to attract the new entrants, the Regulator is going to introduce Unlisted Modaraba which would help to enhance the numbers of players in the financial market.

#### **6. In the present scenario other than Pakistan which countries allow to operate Modarabas?**

Modaraba business model remains extremely versatile, dynamic and diversified. Under the concept any business venture complying with the Islamic Shariah Principles can be floated, which could be for a specific purpose or multi-purpose. The Modaraba concept is derived from the Islamic traditions of trade and finance.

Most probably Pakistan is the first amongst the Muslim countries that converted the concept of Modaraba as a mode of financing into a corporate entity which is fully Shariah compliant. In the countries where Islamic modes









# 9 NBFI & MODARABA ASSOCIATION OF PAKISTAN



## 9. NBFI & MODARABA ASSOCIATION OF PAKISTAN

The NBFI and Modaraba Association plays a very active part in the promotion of this sector by maintaining an active coordination between the regulatory authorities and its members. The NBFI & Modaraba association aims to manage the activities of members (that are Modarabas, Leasing Companies, and Investment Finance Services) and provide a platform for corporate development through innovative Shariah-compliant solutions. Moreover, the NBFI & Modaraba Association also addresses members' issues through interaction with SECP, implementation of an integrated approach and development of a supportive environment to solve common challenges by sharing ideas.

### 9.1 Association History

The NBFI and Modaraba Association of Pakistan was established in 2010 through an amalgamation of Modaraba Association of Pakistan (MAP) and Leasing Association of Pakistan (LAP).

The following table shows the total number of companies from 2011 to 2019 which are the member of NBFI & Modaraba Association of Pakistan.



Table 10: Number of member business entities of NBFI & Modaraba Association of Pakistan

	Year								
	2011	2012	2013	2014	2015	2016	2017	2018	2019
Modarabas	26	24	24	25	25	25	25	26	26
Leasing Companies	10	9	9	10	10	10	9	8	8
Investment Finance Services	3	3	3	3	3	0	0	3	3
Total	39	36	36	38	38	35	34	37	37

Source: Year books of NBFI & Modaraba Association of Pakistan.

Figure 30: Number of Modarabas, Leasing Companies, and Investment Finance Services (Year-wise)

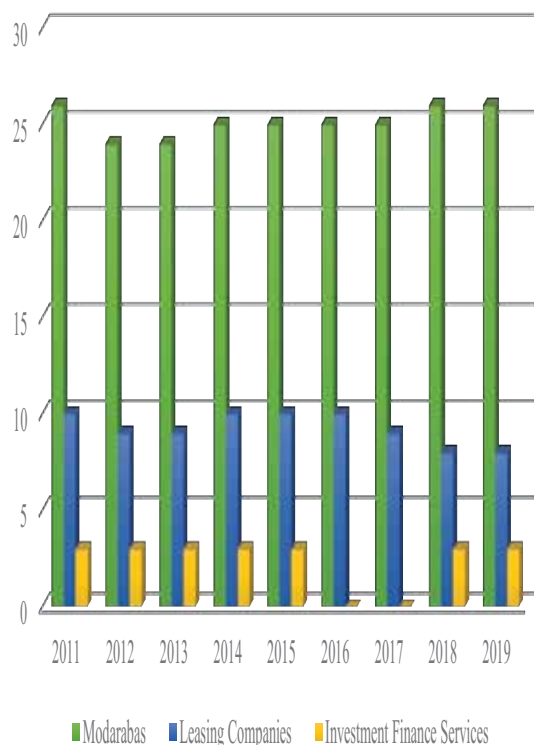


Table 11: List of Chairman of NBFI & Modaraba Association of Pakistan

Year	Name of the Chairman
2011	Mr. Basheer A. Chowdry
2012	Mr. Raheel Q. Ahmad
2013	Mr. Murtaza Ahmed Ali
2014	Mr. Muhammad Shoaib Ibrahim
2015	Mr. Mahfuz-ur-Rehman Pasha
2016	Mr. Ayaz Dawood
2017	Mr. Basheer A. Chowdry
2018	Mr. Raheel Q. Ahmad
2019	Mr. Muhammad Shoaib Ibrahim
2020	Mr. Basheer A. Chowdry





## EXECUTIVE COMMITTEE - 2020-2021



**Basheer Ahmed Chowdry**

**Chairman**



**M. Naimuddin Farooqui**

**Senior Vice Chairman**



**Irfan Ahmed**

**Vice Chairman**



**Shiraz Butt**

**Member**



**Mohammed Sadiq Sheikh**

**Member**



**Zainuddin Aziz**

**Member**



**Qazi Obaid Ullah**

**Member**



**Shabbier Ahmed Jamsa**

**Member**



**Muhammad Shahzad**

**Member**



**Zunaira Dar**

**Member**

### 9.2 Role of NBFI & Modaraba Association of Pakistan

The NBFI & Modaraba Association of Pakistan is coordinating with the regulatory authorities, the Registrar Modaraba, and its members for affirmation of regulatory and Shariah compliance in a uniform and persistent manner.

In particular, the NBFI & Modaraba Association is focusing on the following areas:

#### I. Image Building of the NBFI & Modaraba Sector:

The NBFI & Modaraba Association determined to implement Shariah Compliance Mechanism for the image building of the Modaraba sector in the general public and to maintain the trust of the stakeholders.

#### II. Co-ordination among the Shariah Advisors:

The Association engages the Shariah advisors for the affirmation of Shariah Compliance Mechanism and to design controlling strategies for adequate and easy observance of Shariah requirements.

### III. Periodic Review of the Modaraba Sector:

The Association audits the evolution of the Shariah Compliance Mechanism established on the observations and recommendations of Shariah Advisors and the feedback received from the Modaraba sector.

### IV. Arrangement of skill development programs:

The Association conducts workshops, pieces of training and interactive sessions for staff and management of Modarabas since there is a lack of trained professionals in this sector.

### V. Dispute Resolution:

The association helps in dispute resolution in case of a dispute occurrence among the administration and the Shariah Advisors.

### VI. Publications

- The Association is publishing the Year Book since its inception. The book has been a source of information and vital statistics for the Stakeholders, Research Analysts and the Investors.
- The association has published Shariah compliance guide, and Model Financing Agreements for Modarabas.

Moreover, there are 6 sub-committees in the NBFI & Modaraba Association of Pakistan in order to make recommendations to the management committee for decision. The details are given below:

#### Rules and Regulations Committee

- Rules and Regulation committee reviews existing rules and regulations for NBFI & Modaraba sector and provides recommendations to SECP on the challenges of NBFIs and Modarabas.

#### Audit and Taxation Committee

- Audit and Taxation committee deals with the Audit, Accounts, and Taxation matters of NBFI & Modaraba Association and its members.

#### Training + Outreach Committee

- This committee arranges workshops and seminars for the executives of NBFI & Modaraba Sector.

#### Publication Committee

- Publication committee is responsible for the quality of published work within the Association.

#### Best Performance Award Review Committee

- This committee evaluates and rank the nominees in order to recognize exemplary performance of the members.

#### Revenue Committee

- Revenue Committee is accountable for budget mechanism in accordance with revenue and expenditure targets.



### 9.3 Milestones

In 2012, Allied Rental Modaraba has been included in the KSE 100 Index.

The NBFIs & Modaraba sector has accomplished the accompanying with regard to the Shariah Compliance and Shariah Audit Mechanism (SCSAM):

- The same standard of disclosure and transparency has been observed in everyday transactions of the Modarabas.
- Uniform agreements about different sorts of Islamic modes of financing are being utilized by Modarabas.
- Elimination of the components of Riba, Qimar, Gharrar from the transactions of Modarabas, all things considered.
- The business of Modarabas is being moved to the Islamic Banks from conventional banks. Now they are acknowledging Modarabas as a Shariah-compliant company and establishing business relationships.

The NBFIs and Modaraba Association of Pakistan has conducted various workshops, seminars, and interactive sessions including workshop on AAOIFI Shariah Standards, Law seminar on "Corporate Governance, Compliance & Litigation in Pakistan", workshop on Anti-Money Laundering (AML) & Countering Financing of Terrorism (CFT), workshop on IFRS-9 & SECP Supervision Mechanism, Talk on Evolution of Islamic Financial System in Pakistan, and Interactive session on Applicability of IFRS-9 in order to enhance the professional capacity of members.









## EXCLUSIVE INTERVIEW:



## MR. MURTAZA AHMED ALI

Chief Executive Officer,  
Allied Rental Modaraba

### 1. What types of products your Modaraba is offering?

Allied Rental Modaraba (ARM) is unique in nature. Its philosophy is to work on the modern concept of OUSTSOURCING, offering innovative and dynamic Rental solution to its customers, through Islamic Ijarah contracts, this modern business concept also truly reflects the ISLAMIC IJARAH concept, which is the main theme of the contract which Allied Rental Modaraba offers to its customers. The top of the brand name of CATERPILLAR creates a perfect blend of Best Brand under the modern business concept with Islamic Ijarah Contract. The primary business of Allied Rental Modaraba is the rental business of specialized equipment such as:

- Power Generation equipment,
- Earthmoving & Construction Machines
- Mobile Lighting Towers
- Material Handling Equipment
- Cranes Services,
- Road Logistics Solutions.
- CATERPILLAR powerhouse Operation and Maintenance (O&M) Management

### 2. Tell us about the journey of Allied Rental Modaraba.

ARM took over the Rental business from Allied Rental Services (Private) Limited. It was the first Modaraba which got permission from the newly constituted Religious Board in 2006 and was immediately floated as soon as the required formalities were completed. It mainly deals in Caterpillar Brand of Products, which is also mentioned in its Prospectus and is the source of strength to the Modaraba. The main sponsors of the Modaraba, Allied Engineering and Services Limited possess vast experience of Sales and Service of the Caterpillar Equipment and have established its brand image and necessary infrastructure to support its products. This established network immensely benefits the Modaraba in terms of brand recognition, after sales services support and secondary market for the sale of Used Equipment. Allied Rental Modaraba is also following the policy of rollover of its rental fleet to keep its Rental Fleet young, so as to offer new environmentally friendly technologies with better fuel consumption. This also translates into efficient marketing with better and premium pricing. Initially what started as only a "Generator Rental venture" has now expanded into a portfolio of diverse Equipment Rental solutions with approximately 1,500

Rental equipment currently on ground. Since its inception, Modaraba's Total Asset base has grown many folds, from PKR. 706 Million to PKR. 8,829 Million in a span of 13 years.

**3. The general perception is that Modaraba Companies pay attractive dividend, but investors refrain from investing in these certificates. How do you explain the phenomenon?**

This is generally due to perception issues of the Modaraba sector, mainly due to a) past failures of the Modarabas and b) present dismal performance of some of the Modarabas. The sector needs consolidation so that viable and performance oriented entities are left in the business; to not only perform and deliver results but also create positive image of the sector.

**4. Would you like to term distribution of 90 percent of annual profit an incentive or deterrent?**

It's both. It creates interest of the investor who looks for dividend payments to gauge the performance and viability of the business and looks for return on his investments in the shape of dividends and Bonus shares. On the other hand, 90% dividend payment (after 20% statutory retention) erodes capacity of the Modaraba on profit retention and reinvestment of profits to create sustainable long term business model. In addition, due to devaluation of the rupee vs US \$ and other currencies, the profit retention and reinvestment in the business is important to not only increase Capital base of the Modaraba to at least maintain business volume but also to increase business opportunities and

create capacity for any contingencies and shock absorption capacity for troubled times.

However, since 2007, Modarabas are allowed to maximum retain 50% of the profits as statutory reserves, which has resultantly increased profit retention capacity of the Modaraba. This profit retention tool was excellently used by ALLIED RENTAL MODARABA in building its Capital base, retain profits and have reinvested in building its Ijarah / Rental Assets based. From Power Generation Assets to now Logistics and Infrastructure Equipment and Earth Moving Machines is the result of prudent profit retention policies of the Modaraba to create one of the largest RENTAL COMPANY with > 1,500 assets base in Pakistan.

**5. What are the major impediments that Modaraba sector faces in terms of taxation policies?**

Ominous Taxation regime and complex taxation laws have been a major impediment for the smooth functioning of the business. Further, Modaraba is continuously facing hardship and delays in getting Tax Exemption Certificates from tax authorities for deduction of tax on both Sales and Import stage, despite the fact that Modaraba is exempt from income tax by virtue of Clause 100 of Second Schedule of the Income Tax Ordinance, 2001. This resulted in unnecessary deduction of Income Tax by our customers and payment of Income Tax on import of new equipment, creating unnecessary cash flow pressures on funds management.

**6. Your Modaraba was the pioneer in rental business thereafter one more Modaraba**

**came into existence. How do you see the future of rental business in Pakistan?**

Rental is much more than a financial product. It is a highly competitive business model strongly linked to induction of new Equipment, sales and services support, financing services, work tools and finally sale of Used Equipment at the right time to generate maximum revenue stream. Strong branding creates the perfect marketing mix and sales tool for continued deployment with minimum idle time and premium pricing. These business concepts are the hallmark of Allied Rental Modaraba's formation, its growth and success.

Some prominent growth factors for rental business are:

- Shift from "ownership" to "asset management"
- Trend of outsourcing
- Development of the Rental concept
- Shortage of financial resources with certain key industry segments.

Despite the challenges facing the country currently, with over 200 Million population, we see our country as big market for all sorts of investment, whether industrial investment for rising Power Generation demand or investment in the logistics sector by partnering with leading FMCG brands or movement of cargo on CPEC front. We feel positive of the rental industry potential, CPEC development and tremendous opportunities it has generated so far and in the future.







# 10 POTENTIAL OF NBFI'S AND MODARABA SECTOR



# 10. POTENTIAL OF NBFI'S AND MODARABA SECTOR

The chapter focuses on the potential of Modaraba Sector & NBFI's. It highlights the impact on economic development, employment generation, growth of SMEs, and financial inclusion through the development of this sector. The level of penetration of NBFC's & Modaraba companies and the untapped potential is discussed. Furthermore, the chapter mentions the product innovation opportunities available to the industry. A survey of NBFI's & Modaraba company's executives also highlights the supply and demand of professionals, knowledge requirements for entering the industry, training and development measures used and the level of public awareness about the concepts, practices, and products.

## 10.1 Potential of NBFI's & Modaraba Sector

The large Muslim population and low market penetration indicating sufficient room for expansion in the NBFIs and Modaraba sector. NBFIs and Modarabas have untapped potential in the development of sectors like transport and infrastructure, substantial employment generation, wealth creation, broad-based economic development and to finance economically weaker sections.

### 10.1.1 Financing Small and Medium Enterprises (SMEs)

The SME sector in Pakistan is the neglected sector in terms of financing. SMEs do not have adequate access to financing from the formal financial institutions, therefore, they are primarily relying on the financing facilities from the informal channels at a cost even higher than the cost paid to formal financial institutions like banks. Though SMEs have the potential to contribute to growth and development of the country, employment generation, poverty alleviation, so on and so forth.

At present, only 180,704 SMEs are getting financing from banks and Development Financial Institutions (DFIs) out of approximately 4.5 million SMEs operating in Pakistan.<sup>56</sup> In view of that, the State Bank of Pakistan (SBP) has taken various initiatives to enhance SME financing in Pakistan including improved regulatory framework, SME supportive subsidized refinance schemes, risk coverage scheme, and Islamic SME financing. The headline target set by the Government of Pakistan is to increase the SME sector credit to 17 percent of the private sector credit through financing 700,000 SMEs by 2023.<sup>57</sup>

Therefore, there is immense potential for the NBFIs and Modarabas in SME financing since the NBFI & Modaraba sector complements the banking sector by serving the underserved sectors, for instance, SMEs. NBFIs & Modarabas have the potential to achieve the objective of macroeconomic policies of generating more jobs in the country by financing SMEs. The NBFI's and Modarabas are fully aware of the fact and are active financier of SMEs operating in Pakistan. It can be observed from the following table that SMEs have the dominant share out of total financing disbursement of NBFI's and Modarabas.

<sup>56</sup> Source: <https://www.brecorder.com/2019/10/20/532803/session-on-sme-financing-held-at-iba/>

<sup>57</sup> Source: Government's 100-Days Agenda <http://www.finance.gov.pk/NFIS.pdf>



Table 12: Financing Disbursement of Modarabas to SMEs

Name of Company	2019	2018	2017
	Rs. in Million	Rs. in Million	Rs. in Million
Allied Rental Modaraba	-	-	8
Awwal Modaraba	35	100	-
B. F. Modaraba	-	-	-
B.R.R. Guardian Modaraba	5	8	5
Crescent Standard Modaraba	-	-	19
First Al-Noor Modaraba	-	-	69
First Elite Capital Modaraba	52	124	-
First Equity Modaraba	-	-	-
First Fidelity Leasing Modaraba	35	35	-
First Habib Modaraba	1,124	953	366
First IBL Modaraba	108	13	114
First Imrooz Modaraba	-	-	-
First National Bank Modaraba	-	-	-
First Pak Modaraba	12	11	6
First Paramount Modaraba	117	107	-
First Prudential Modaraba	40	100	115
First Punjab Modaraba	608	103	737
First Treet Manufacturing Modaraba	-	-	-
First UDL Modaraba	39	98	53
Habib Metro Modaraba	22	-	-
KASB Modaraba	6	33	90
Modaraba Al-Mali	-	-	-
ORIX Modaraba	639	1,269	367
Orient Rental Modaraba	-	-	-
Popular Islamic Modaraba	84	82	88
Sindh Modaraba	18	161	40
Trust Modaraba	87	91	45
TOTAL (A)	3,031	2,931	2,120

Table 13: Financing Disbursement of Leasing Companies to SMEs

Name of Company	2019	2018	2017
	Rs. in Million	Rs. in Million	Rs. in Million
Capital Assets Leasing Corporation Ltd.	-	-	-
Grays Leasing Limited	30	30	-
Pak-Gulf Leasing Company Limited	196	109	198
Primus Leasing Limited	512	458	-
Saudi Pak Leasing Company Limited	1,608	-	1,436
Security Leasing Corporation Limited	473	519	580
Sindh Leasing Company Limited	10	52	63
SME Leasing Limited	116	901	80
TOTAL (B)	2,945	2,068	2,358

Table 14: Financing Disbursement of Investment Finance Services to SMEs

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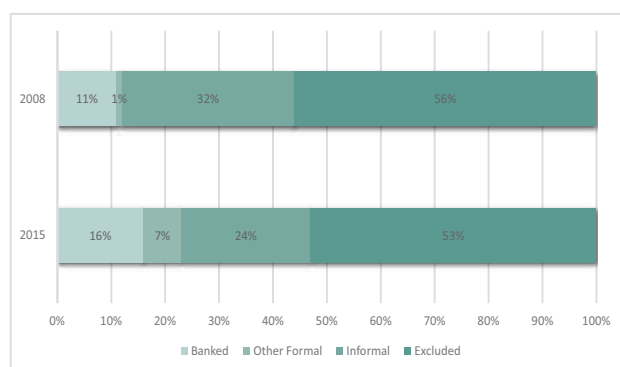
Name of Company	2019	2018	2017
	Rs. in Million	Rs. in Million	Rs. in Million
Escorts Investment Bank Limited	-	-	-
LSE Financial Services Limited	-	-	-
ORIX Leasing Pakistan Limited	6,576	8,637	9,605
TOTAL (c)	6,576	8,637	9,605
GRAND TOTAL (A+B+C)	12,552	13,636	14,083

It is suggested in National SME policy 2019 that NBFIs and Modarabas should be included for the credit guarantee scheme for the promotion of SMEs.<sup>58</sup> Moreover, the State Bank of Pakistan is starting a Modaraba-based Islamic Refinance Scheme for working capital financing of SMEs.<sup>59</sup>

### 10.1.2 Financial Inclusion

Economic policymakers in Pakistan are focusing on expanding financial inclusion since the levels of financial inclusion are quite low in Pakistan. Because borrowing from friends and family and the use of committee savings are the most prevalent methods for financing needs. Secondly, people do not have enough information about the products and conditions offered by NBFIs and Modarbas. Lack of trust is another hurdle in getting funds and placement of funds by the formal financial institutions. Both access to finance surveys (2008 and 2015) highlight the current demand for financial services. Only, 23 percent of the adult population had the access to finance from formal financial institutions in 2015. Hence, there is a high level of untapped potential for Modarabas in Pakistan.

Figure 31: Status of Financial inclusion in Pakistan<sup>60</sup>



Pakistan's financial landscape is diverse regarding the size and type of institutions. It has recently turned out to be more diverse with the up-rise of mobile-phone-enabled solutions, electronic money models and digital payment platforms and growth in the Islamic finance industry. A financial institution clearly has an important role in the strategy to expand financial inclusion in the country. Therefore, NBFIs & Modaraba sector has the niche market in broadening access to Shariah-compliant financial services to individuals and SMEs that are currently out of the financial system. As a matter of fact, it has the potential to not only promote savings by providing different asset classes to the investors but also offer alternative fund raising opportunities to the participants of the financial system.

Hence, NBFIs and Modaraba sector has a great deal of continuing value to add by concentrating on its own distinguished capabilities and achieve the national goals of expanding financial inclusion by partnering with Islamic financial institutions that bring complementary capabilities to bear on the problem.

### 10.2 NBFIs & Modaraba Executive Survey Analysis

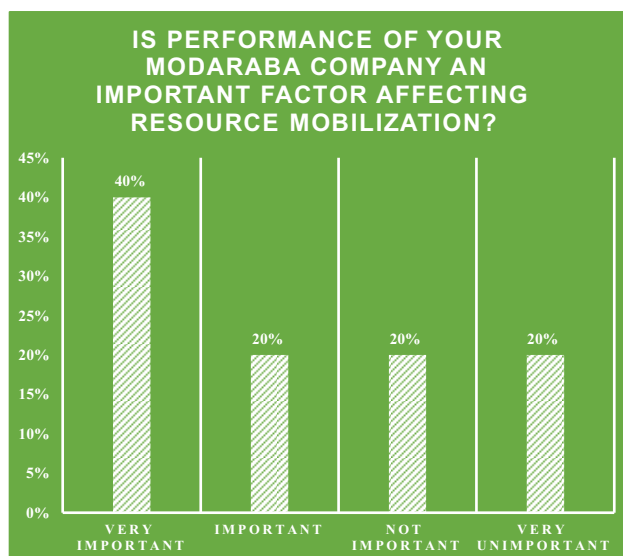
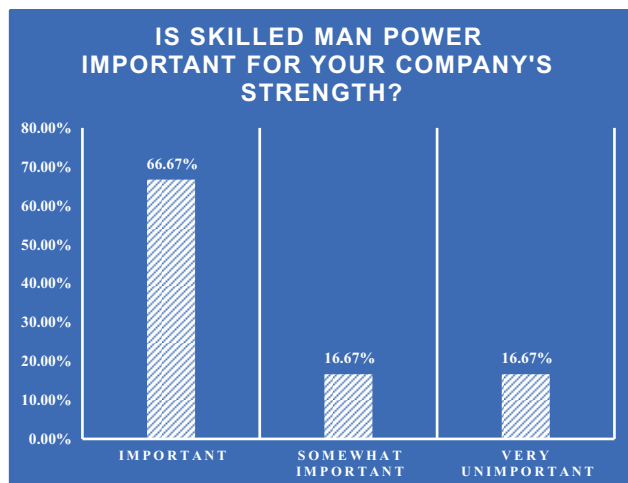
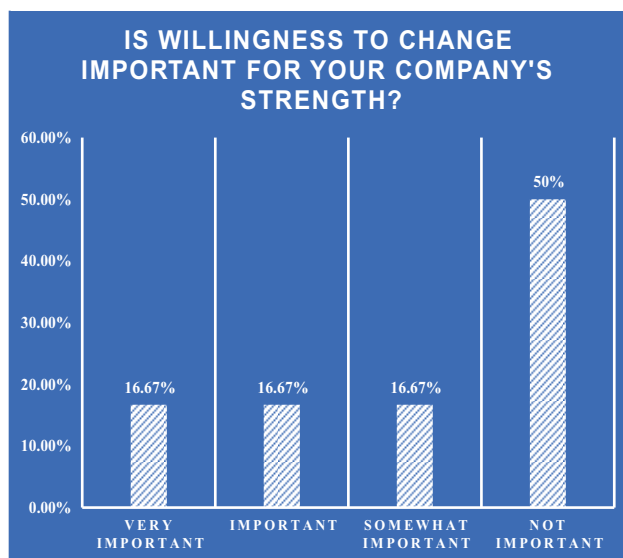
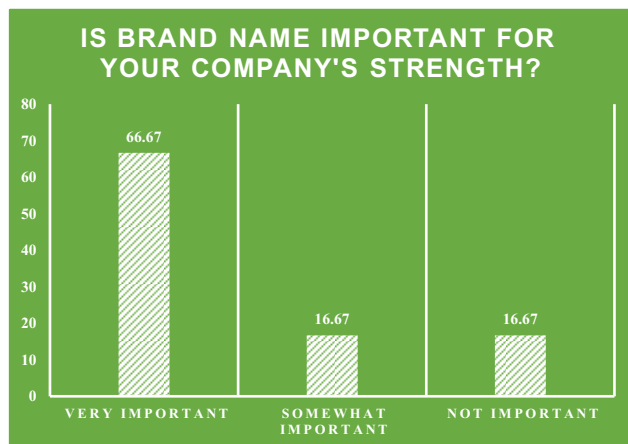
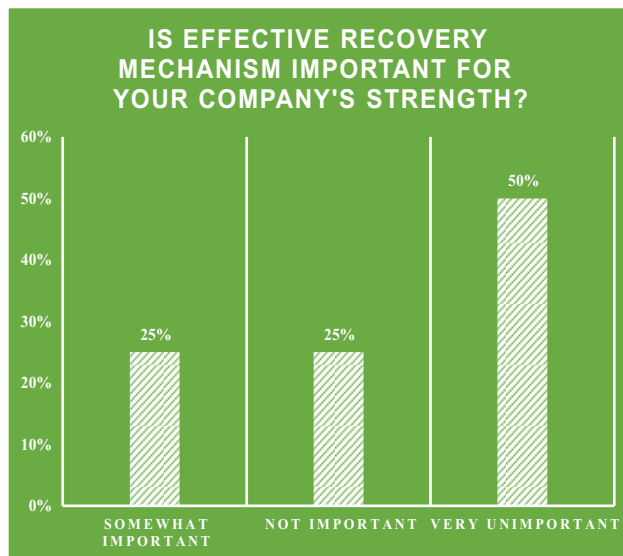
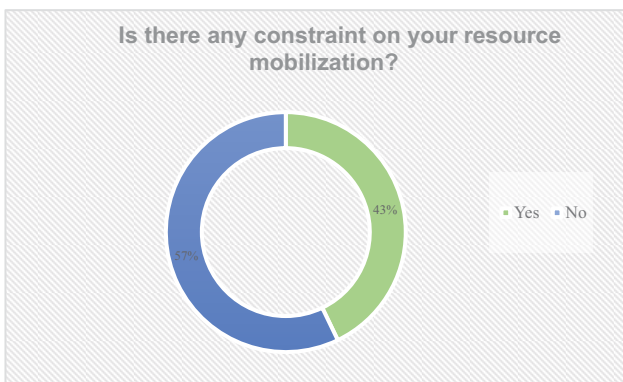
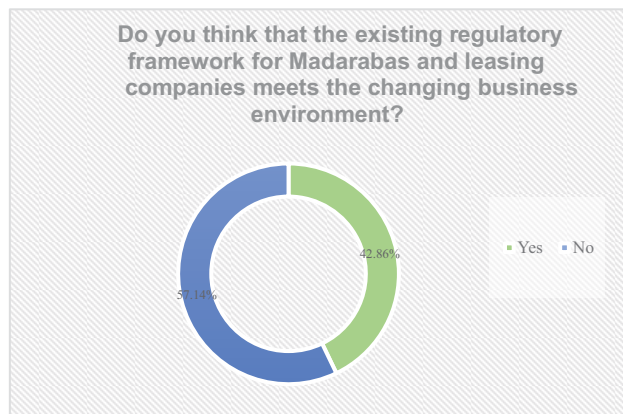
This section explains data collection and generation process with a focus on survey methodology, the structure of questionnaires, sample selection, and composition. The sample was selected from 26 Modarabas, 8 leasing companies, and 3 Investment Finance Services.

This survey of the NBFIs & Modaraba sector captures the financial performance of companies. The data used to compile this survey is extracted from SECP, publicly available yearbooks of NBFIs & Modaraba Association of Pakistan, and annual reports of entities.

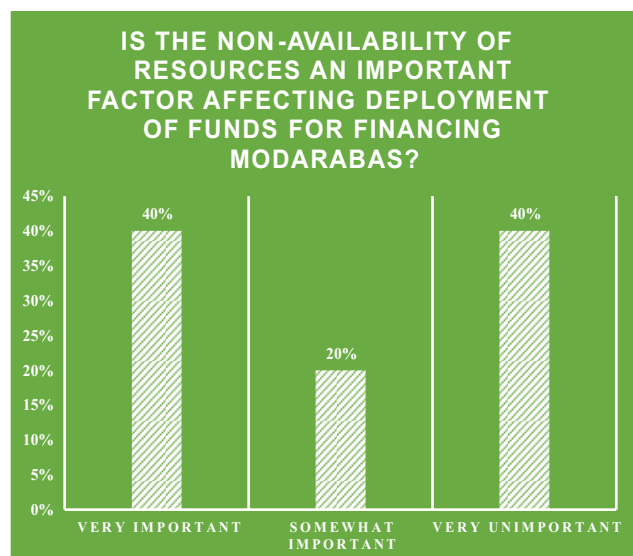
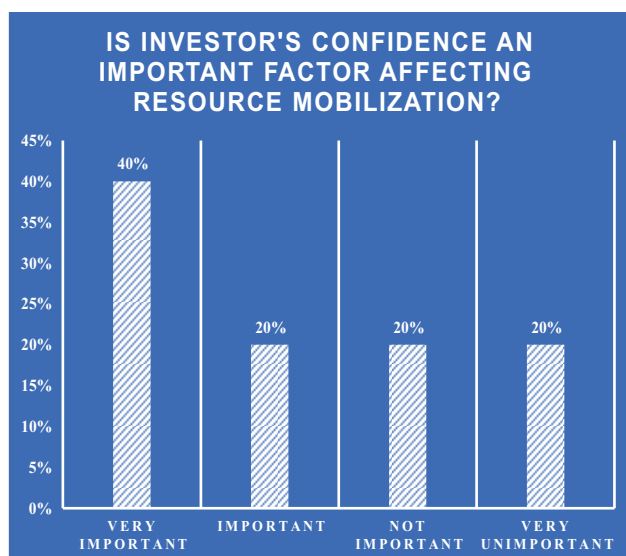
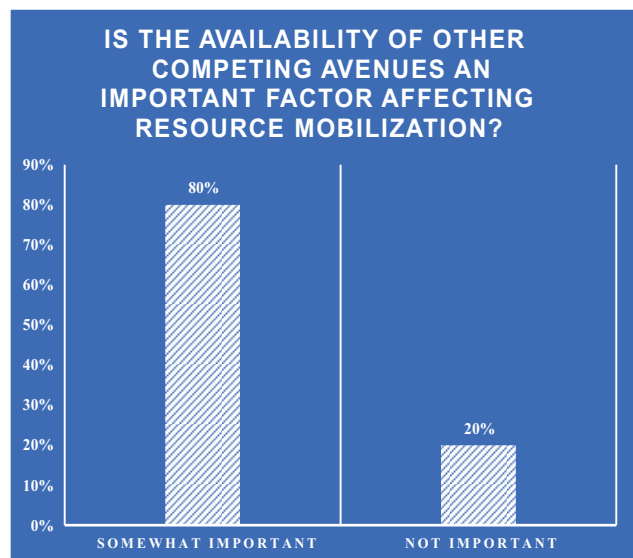
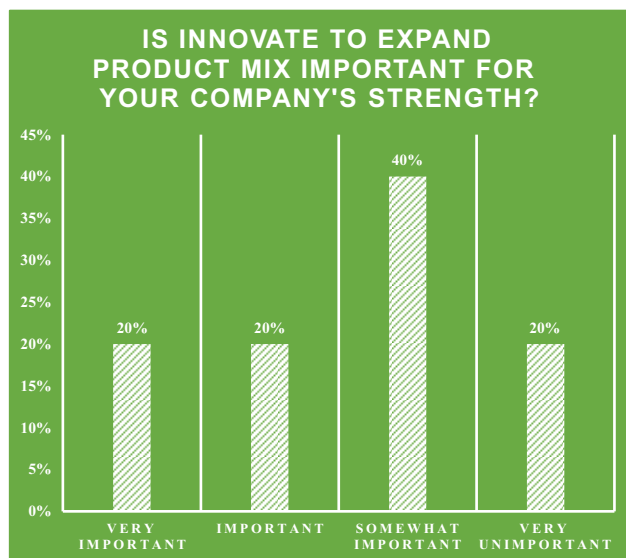
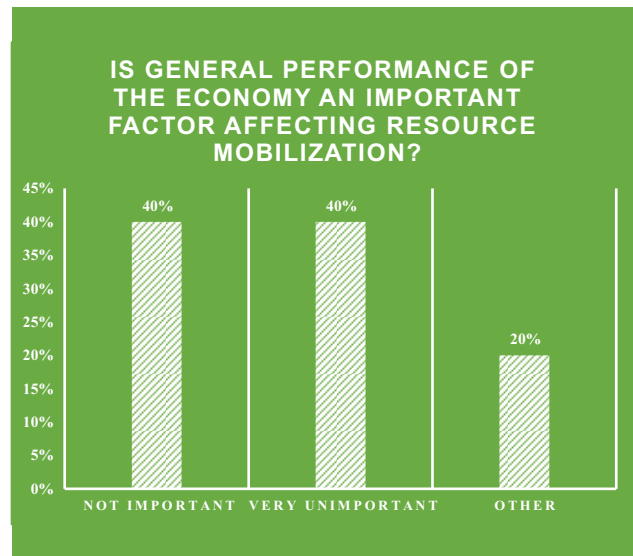
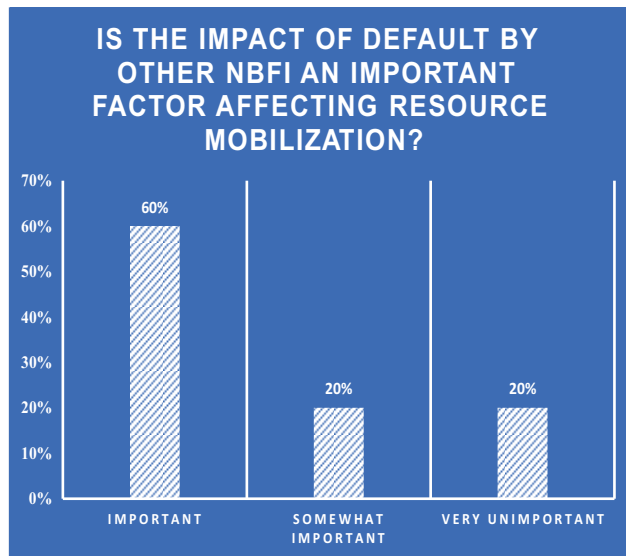
<sup>58</sup> Source: <https://fp.brecorder.com/2019/08/20190810505818/>

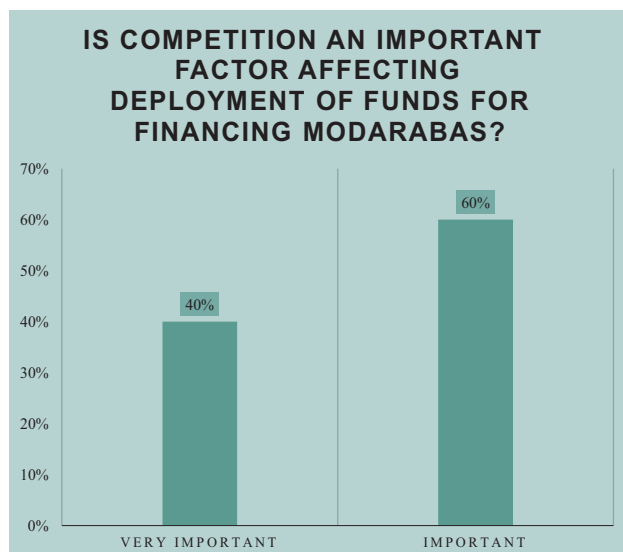
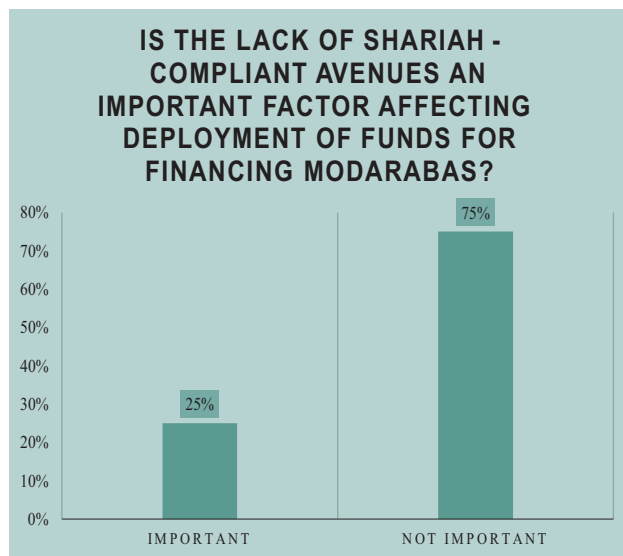
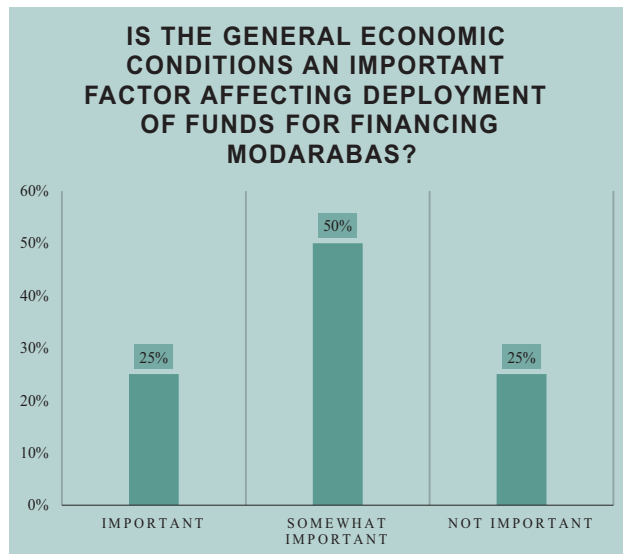
<sup>59</sup> Source: <https://www.dawn.com/news/1498724>

<sup>60</sup> Source: <https://karandaaz.com.pk/blog/takeaways-from-pakistans-access-to-finance-survey-2015/>















# 11 CHALLENGES AND ISSUES FACED BY NBFI & MODARABA SECTOR



# 11. CHALLENGES AND ISSUES FACED BY NBFI & MODARABA SECTOR

This chapter highlights the challenges and issues that are being faced by the sector which are causing a hindrance in its potential development. The different issues experienced by Modaraba companies; Leasing companies, & Investment Finance Services are distinguished. The actions and efforts being undertaken by the NBFIs and Modarabas to overcome those challenges are also highlighted.

## 11.1 Challenges and Issues

The Modaraba sector is working far below its potential. NBFI & Modaraba sector is one of the key sectors which has huge potential to bring economic growth and prosperity in the developing countries like Pakistan but unfortunately this sector is neglected by the government authorities in terms of utilization of its potential. For instance, NBFI and Modaraba sector is currently facing the issue of Sindh Sales tax on gross rentals of Ijarah transactions. Sindh Revenue Board (SRB) has issued notices to Modaraba companies and levied sales tax on Ijarah transactions considering it as services rendered. Limited mobilization sources, lack of empowerment to the certificate holders in the policy decision making of Modaraba, non-capital losses, lack of quality management systems, insufficient risk management policies, and inadequate internal controls are some of the major challenges and issues that the NBFI & Modaraba sector is facing.

### Challenges in Development and Growth

One of the key challenge in the development and growth of the Modaraba sector in Pakistan is the mobilization of funds. NBFI & Modaraba sector is facing the problem of undercapitalization and insignificant amounts of cost-effective funds. Only 6 Modarabas were permitted to raise funds from the general public through the scheme of Certificate of Musharakah as per the criteria set by the SECP. And the rest Modarabas are completely reliant on their equity to expand their business. Previously, 1







Modaraba company has used Musharakah-based term finance certificates for the mobilization of resources.

Moreover, all the Modaraba companies are situated in two main cities (Karachi and Lahore). For the development and growth of the Modaraba sector, it is essential to increase the branch network and establish Modarabas in different areas of the country.

Furthermore, there is a lack of investor education about Modaraba financing. Also, there is a lack of awareness about the Modaraba sector and its financial activities. No efforts were made by the registered Modaraba companies regulated by SECP in order to recover their image after a group of Shariah scholars misused the word Modaraba. Though the reputation of the Modaraba sector was severely damaged by the Modaraba scandal and the confidence of investors was shattered. And from the general public point of view, it is a major hindrance in the growth of the Modaraba sector.

On top of that, the tax on certificate holders has been raised. This leads to certificate replacement with the more viable option for instance, Islamic banks are considering Government SUKUK instead of investing in Modaraba Sector.

### 11.2 Efforts to Overcome Issues

NBFI & Modaraba Association of Pakistan took opinion from a Tax consultant and then 9 Modaraba companies filed a petition in the Sindh High Court. But the decision is still pending in Sindh High Court.

SECP has allowed Modarabas to issue Shariah-compliant Term Equity Certificates (TEC) for the mobilization of resources in addition to Modaraba Certificates.





# 12

## RECOMMENDATIONS



## 12. RECOMMENDATIONS

The proposed suggestions to take this industry forward including those given by the interviewed dignitaries are included in this chapter. An analysis of the NBFIs & Modaraba Sector and the executive survey gives intensive insights into the industry and the recommended action plan will help in the further development of the industry. The solutions that can be employed by regulators and Modaraba companies to fill gaps identified are also highlighted.

### 12.1 Suggestions and Solutions

The market share of the Modaraba sector is very low despite a well-developed operational and legal framework. Therefore, it is suggested that the Modaraba sector should design new innovative Islamic business products in order to raise its market share and for consistent growth. Likewise, the NBFIs & Modaraba sector should focus on better governance, adherence to Shariah standards, and better risk management practices.

Moreover, steps should be taken to encourage the establishment of Modarabas in different cities of Pakistan since it has a limited branch network. In particular, establish an extensive distribution network in smaller towns.

In addition, there should be a governing body which can perform the last-resort lending function for NBFIs and Modarabas in periods of financial turmoil to ensure the stability of the sector.

Besides, the NBFIs & Modaraba Association of Pakistan should conduct workshops and seminars in collaboration with the SECP and other stakeholders aims at organizing workshops and seminars all over the country to educate investors and create awareness among the majority.

Furthermore, there should be some relaxation in the existing regulatory regime for the NBFIs and Modaraba sector.

### 12.2 Recommended Action Plan

Action plan is essential for NBFIs & Modaraba sector to

foster a deeper linkage and connectivity with the real economy. In this regard, NBFIs and Modaraba sector has to set the following targets:

#### Enhance access to low-cost funding sources

SBP and SECP should collaborate in order to develop new mobilization sources.

#### Explore the new markets

For instance, develop easy & affordable access to finance to farmers

#### Introduce new innovative products and services

For instance, products and services that can facilitate low-cost housing finance.

#### Promote Shariah-compliant financing solutions

It is highly recommended that the Modaraba sector and Islamic banks should work jointly.

#### Expand access points or branch network

It is recommended that the Securities and Exchange Commission of Pakistan should impose a target for branches at the time of giving a license.

#### Develop a mechanism of accountability of the Modarib

The participation of the certificate holders in the formulation of policy is desirable.

#### Enhance capacity/capability of Modarib

It is recommended that there should be a mandatory provision of training of the senior Executives by SECP.

#### Prevent confusions in general public caused by Modaraba scandal

Name and addresses of all the legal entities should preferably be displayed on the website of SECP to restore the confidence on the Modaraba sector.



## CONCLUSION

NBFIs and Modarabas are an integral part of the financial system in Pakistan. They have been facilitating the underserved and unbanked areas. Modaraba sector is emerging as an alternative to conventional banking. However, despite 40 years of its operations, the NBFI & Modaraba sector is a long way from realizing the true potential of its business model which incorporates diversity in operations and maximum profit payouts to its investors. Therefore, it is concluded that NBFI & Modarabas need to audit its current plan of action, adjust to the changing industry needs and capture the opportunities for sustainable growth.



## ACRONYMS

Annual General Meeting	AGM
Annual Review Meeting	ARM
Anti-Money Laundering	AML
Centre of Excellence in Islamic Finance	CEIF
Certificate of Investment/Deposits	COI/COD
Certificate of Musharakah	COM
Development Financial Institutions	DFI
Diminishing Musharakah	DM
Gross Domestic Product	GDP
Institute of Business Administration	IBA
International Monetary Fund	IMF
Ministry of Finance	MoF
Non-bank Financial Institutions	NBFI
Non-bank Financial Companies	NBFC
Pakistan Merchantile Exchange	PMEX
Purchasing Power Parity	PPP
Real Estate Investment Trust	REIT
Small and Medium Enterprises	SMEs
Securities & Exchange Commission of Pakistan	SECP
Shariah Compliant Trading Platform	SCTP
Shariah Compliance and Shariah Audit Mechanism	SCSAM
State Bank of Pakistan	SBP
Term Equity Certificate	TEC

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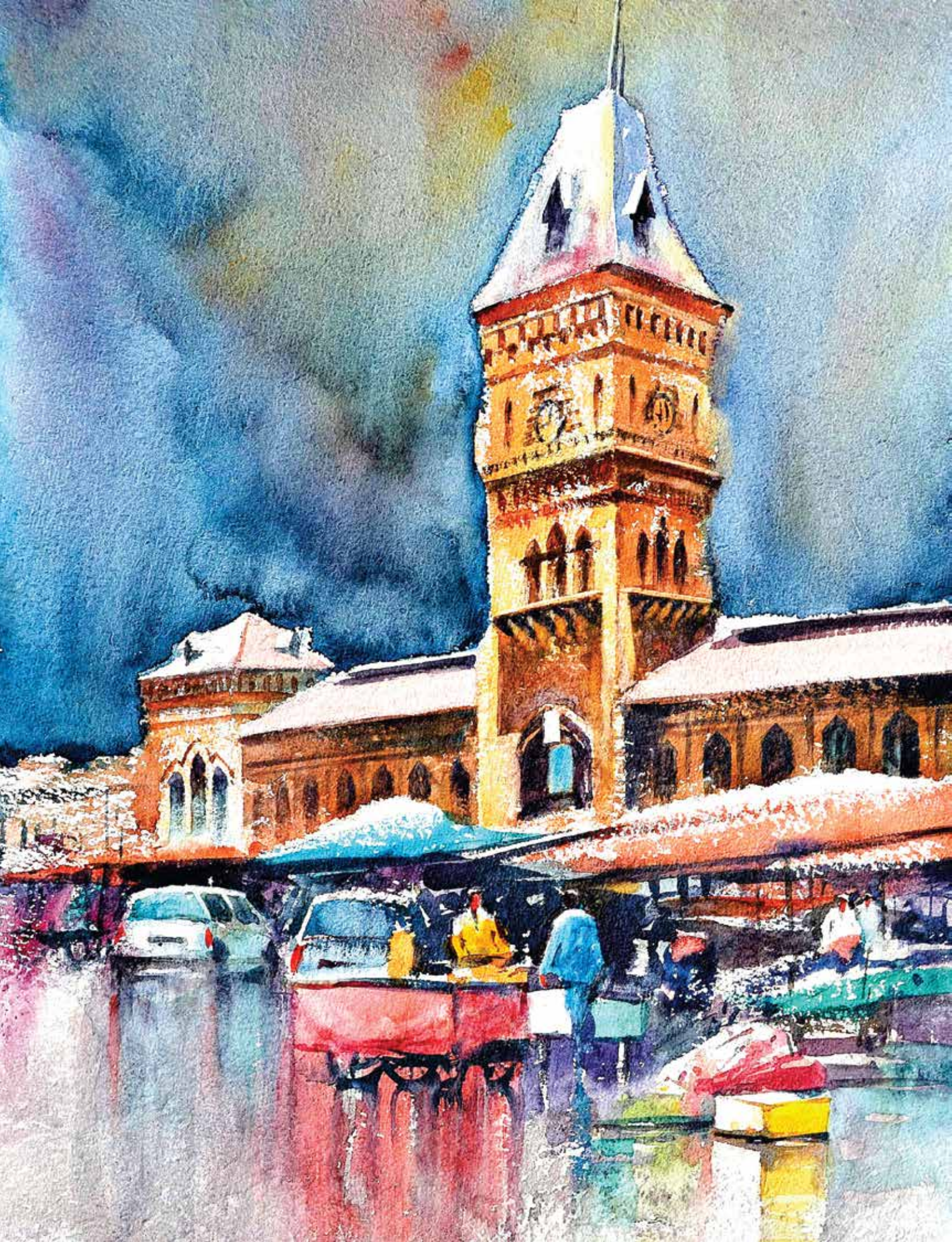
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