3.1 Performance and Risk Analysis of The Banking Sector

The banking sector's resilience has remained satisfactory. Capital adequacy has stayed strong with CAR at 15.8 percent and liquidity conditions at comfortable levels. A sharp pick up in financing has facilitated healthy growth in assets base, while asset quality has improved with NPL ratios declining to a decade low. On the funding side, slowdown in deposits have led to increase in the inter-bank borrowings to match the asset growth. Earnings have remained under pressure due to low interest rates and falling non-interest income, in addition to one-off settlement payment. Banks need to enhance their resource mobilization efforts, keep a close watch on the credit quality of fast growing lending portfolio and plan for ensuring compliance with gradually increasing capital requirements.

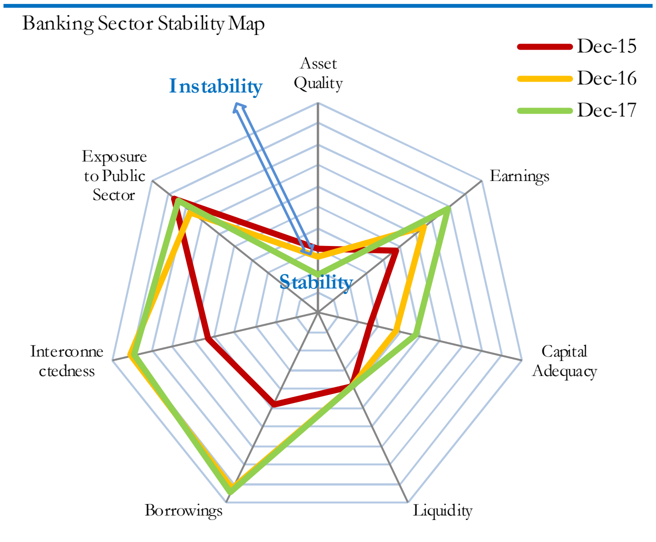
The performance and risk profile of the banking sector reflects challenging environment…

In terms of performance, the banking sector has responded to challenging financial conditions in a mixed way. On the one hand, low interest rates, moderate and below target inflation, pickup in economic activity, improved security situation, and better availability of energy supply to industry have strengthened the financing flows to private sector during CY17. On the other hand, profitability of the banking sector has declined due to sustained low interest rate environment. Moreover, idiosyncratic factors such as one-off settlement payment by a large bank also pulled back the profitability of the banking sector. On the funding side, deposit growth has decelerated triggering higher borrowing to support the asset growth.

In terms of risks, some dimensions have recorded improvements while others have depicted deterioration, as reflected in the Banking Sector Stability Map (BSSM) (**Figure 3.1).**[115] Particularly, asset quality has improved as the infection ratio has reached to a decade low level; capital adequacy remains well above the minimum regulatory benchmark and ample fund-based liquidity ensures banks' ability to meet unforeseen contingencies and obligations. Nevertheless, earnings have declined and moderation in deposit growth has led to rise in borrowings.

Figure 3.1.1

Banking sector perfoms better in some risk dimensions during CY17



Source: SBP

These developments, so far, do not raise any systemic concerns as earnings from core sources (interest earned on advances) are rising while borrowings from financial institutions (excluding

[115] The Banking Stability Map represents a comprehensive picture of stability in seven different dimensions. Risks in each dimension are measured by a weighted combination of key indicators. The percentile rank of each indicator gives the degree of stability relative to its history (since 1996). For details, please see Technical Appendix in FSR 2015. For methodology, please see Dattels, P., McCaughrin, R., Miyajima, K., & Puig, J. (2010). "Can you map global financial stability?" *IMF Working Papers*, 1-42.

SBP) have a small contribution in overall asset funding.

Below various dimensions of BSSM are discussed in detail.

3.1.1 Asset quality

Financing growth leads to reduction in infection ratio…

The quality of assets of the banking sector mainly emerges from advances as major chunk of investments is parked in credit risk-free government securities.

CY17 is marked with a sharp pick up in gross advances with YoY growth of 16.90 percent compared to 12.81 percent in CY16 [5-year (CY13-17) average: 10.92 percent]. Encouragingly, the key thrust has come from financing to private sector (domestic) which has surged by 16.40 percent in CY17 against 12.69 percent in CY16 (5-year average: 10.12 percent). Improvement in macroeconomic landscape with a positive growth outlook, lagged impact of monetary easing,[116] better energy supply and improved security conditions etc. have all played a role in accelerating the flow of advances.

The advances growth has remained broad based: textile (Y-o-Y growth: 16.23 percent), sugar (31.16 percent), cement (58.14 percent), agribusiness (10.17 percent). Segment-wise, the corporate sector has remained the key borrower with a growth of 17.60 percent in CY17 (13.02 percent in CY16). The SMEs' financing has also registered a decent growth of 12.10 percent in CY17 (29.22 percent in CY16). Noticeably, fixed investment advances (i.e. term finance) has seen a visible rise since last few years (5-year average: 13.96 percent). Moreover, the consumer finance has also surged by 20.82 percent in CY17 **(see Box 3.1.1 on consumer finance).**

Due to impressive advances growth, Non-Performing Loans (NPLs) to Gross Loans (infection) ratio has declined consistently to reach the level of 8.4 percent in CY17 (10.1 percent in CY16), lowest since 2008. Similarly, provision coverage ratio (Provisions to NPLs) has also improved to 87.2 percent (85.0 percent in CY16), while net-NPLs to net-loans ratio has declined to 1.2 percent in CY17 (1.6 percent in CY16). More importantly, the improvement in asset quality has been broad based across most of the banking groups **(Table 3.1.1)**.

Table 3.1.1
Asset Quality by Bank Category

Bank Category	CY14		CY15		CY16		CY17	
	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio
	Percent							
PSCBs	17.82	71.20	18.28	79.05	15.90	81.43	13.40	87.03
LPBs	10.40	85.20	9.34	89.78	8.14	90.11	6.77	90.99
FBs	7.61	102.00	7.78	100.35	8.33	100.25	6.65	103.14
CBs	**11.94**	**80.90**	**11.13**	**86.29**	**9.72**	**87.28**	**8.09**	**89.75**
SBs	23.27	61.10	18.92	59.27	21.82	50.09	22.00	50.66
All banks	**12.27**	**79.80**	**11.36**	**84.95**	**10.06**	**85.05**	**8.43**	**87.24**

Source: SBP

NPLs in absolute terms have only declined marginally in CY17. Over the last few years, NPLs are hovering around PKR 600 billion with around 85 percent falling in the loss category. Though such past due loans are mostly provided-for (i.e. already expensed out) limiting the probability of further equity erosion, the provision expenses are, nevertheless, borne by banks. As such, efforts to recover the bad loans or settle through liquidating the pledged collaterals have largely been unfruitful. The recent initiatives at regulatory and legal fronts to resolve this issue create optimism for the future **(See Box 2 on regulatory developments)**.

The recent surge in advances does not raise any stability concerns…

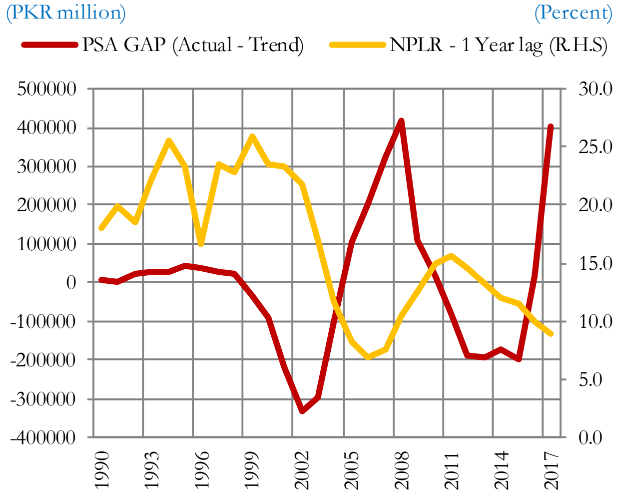
[116] WALR has reduced by 385 bps since November 2014 to 7.46 percent as of end December 2017.

Though the recent improvement in NPLR is a welcome sign, the question is whether this fall is permanent or not. Generally, during easy financial conditions, both borrowers and lenders optimistic behavior leads to excessive risk taking. But as soon as the conditions tighten borrowers repayment capacity shrinks and lenders become risk averse. This dual behavioral change leads to higher infection ratio. The long-term growth pattern of private sector advances gap and infection ratio reveals inverse relationship on few occasions **(Figure 3.1.2).**

Figure 3.1.2

Advances growth over its trend and Non-Performing Loans to Gross Loan (NPLR) ratio show contrasting pattern in different time slots

Private Sector Advances (PSA) growth over its trend and NPLR



Source: Monetary Survey, SBP

On other occasions, however, the trajectory of advances growth is not necessarily harmful as it may be the result of improving economic fundamentals resulting in better investing opportunities. Such financing upticks, generally, lead to permanent financial deepening.

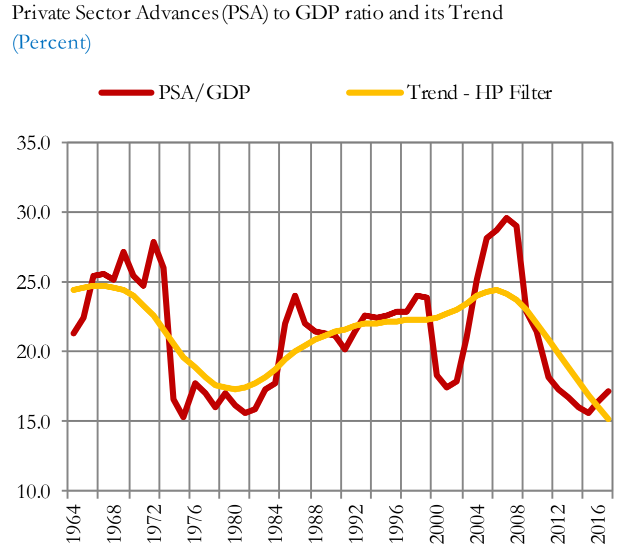
In this backdrop, a few facts may be worth considering in the context of the current rise in advances and behavior of NPLR:

1. In credit booms, advances, driven by optimistic sentiments, grow rapidly for an extended period not always supported by corresponding GDP growth.[117] The recent rise in advances, however, seems quite synchronized with the GDP growth. Private sector advances (PSA) to GDP ratio had been falling and remained below the long-term trend (HP Filter) until CY15 **(Figure 3.1.3)**. Thereafter, the ratio has started to pick up and just surpassed the trend in CY17. This means that the recent advances growth reflects genuine demand as economic activity has picked up pace.

Figure 3.1.3

Advances to GDP ratio has started to pick after long-lasting fall

Private Sector Advances (PSA) to GDP ratio and its Trend



Source; SBP

2. As highlighted earlier, there is a significant growth in fixed investment advances since last few years including CY17. Such long-term loans, generally, facilitate capacity building

[117] IMF classifies a credit expansion a boom if it exceeds the standard deviation of that country's credit fluctuations around a trend by multiple of a factor of 1.75 for more than 3-4 years (World Economic Outlook 2004, Chapter 4).

through investment in plants, machinery, technological upgradation and other capital goods. The enhanced capacity at firm's level brings in higher future production and profitability resulting in low probability of defaults.

3. Inflation has remained subdued and asset prices (e.g. equity instruments) has been fluctuating (instead of observing unidirectional upward trajectory) in the recent past. Absent any asset price bubbles, the "financial accelerator" impact is limited.

4. Banks have been lending to traditional sectors (such as textile, energy, sugar, agriculture etc.) and segments (e.g. corporate, SMEs, consumer etc.) of the economy as per their relative significance. They have not ventured into risky areas and exotic products (derivatives, securitization, alternative investments etc.) as generally associated with the availability of cheap liquidity.

5. Deposits, mostly the CASA, have provided the necessary funding support to meet the advances demand, though, some rise in borrowings has occurred in CY17.

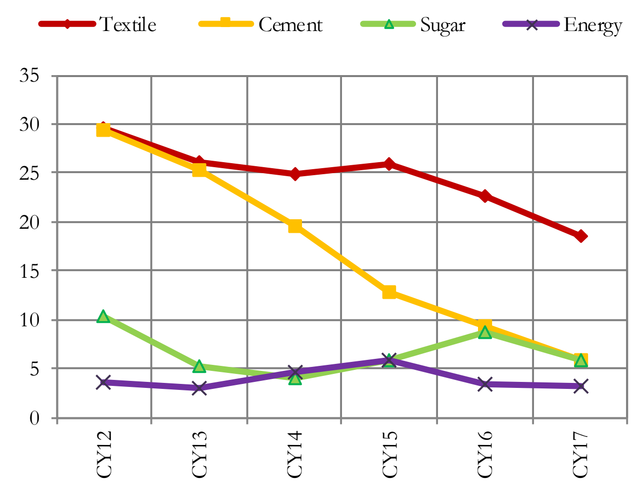
Concentration risk, though contained, needs close vigilance…

Since defaults of large borrowing groups/entities may impair banks' equity, SBP has taken several initiatives in this regard. This includes introduction of more stringent per party exposure limits (both, on entity and group level), ceiling on overall large exposure etc.[118,119] Because of such measures, the concentration risk has been assessed to be low in the banking sector.

Further, the size-wise analysis of listed corporates reveal that largest ones have the highest debt repayment capacity **(See chapter 5).** This provides additional comfort to the banking sector. Having said that, banks need to remain watchful of their large exposures due to their systemic significance.

Figure 3.1.4 (a)
Textile sector has the highest infection ratio

Sector-wise infection ratios
(Percent)



The asset quality improves across various sectors…

The recent improvement in asset quality is broad-based with decline in NPLRs of all major sectors and segments **(Figure 3.1.4 a & b)**. This is partly due to improving financials of corporates leading to higher repayment capacity and lower probability of defaults (**See Box 5.2 in Chapter 5**). Textile and cement sectors are showing sharp fall in NPLR since last few years and the momentum has continued during CY17. The decline in NPLR of energy sector is low, though; the ratio is already lowest amongst the major sectors. Segment-wise, SMEs, with highest NPLs ratio, have revealed a sharp decline in the ratio over the last few years.

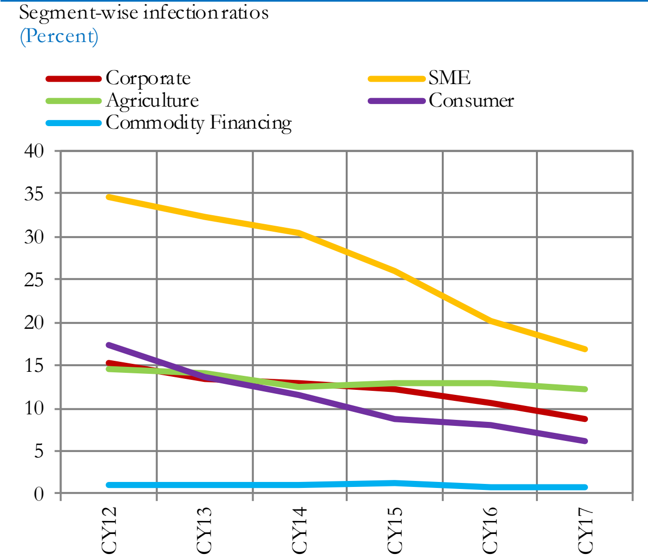
[118] http://www.sbp.org.pk/bprd/2017/CL11.htm

[119] BIS has also addressed this issue and published detailed guidelines on large exposure (https://www.bis.org/publ/bcbs283.pdf)

Besides, other segments are also showing gradual but continuous improvement in asset quality.

Figure 3.1.4 (b)

SME's infection ratio is falling yet highest

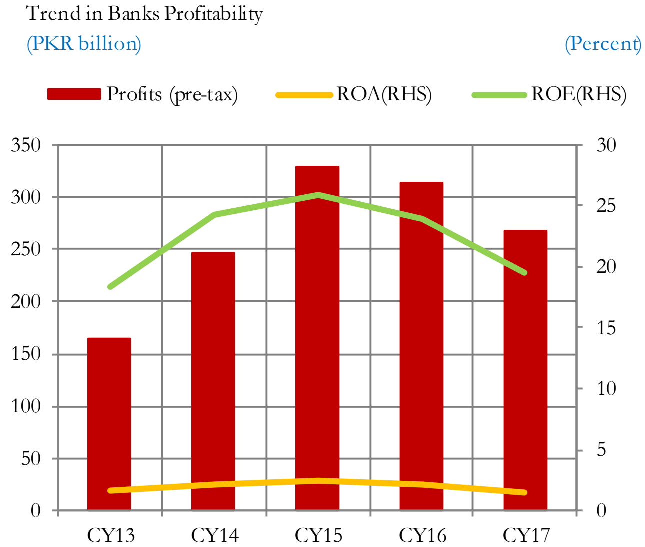


Source: SBP

percent in CY16) and Net Interest Margin (NIM) to 3.3 percent (3.7 percent in CY16) **(Figure 3.1.5)**.

Figure 3.1.5

Profitability indicators slightly moved downwards



Source: SBP

Earnings

Declining profitability raises stability concerns…

Banking sector has witnessed a dip in profit (before tax) (PBT) of 15.05 percent during CY17. This is the second consecutive yearly decline in profits. The drop in PBT during CY17 has mainly resulted from decline in non-interest income (by 4.1 percent) and higher administrative expenses (of 8.9 percent). On top of that, one-off settlement payment by a large bank on its foreign operations during Q3CY17 has further dented the profitability.[120]

Resultantly, all profitability indicators have deteriorated during CY17; after tax - Return on Assets (ROA) has declined to 0.9 percent (1.3 percent in CY16), ROE to 11.5 percent (14.4

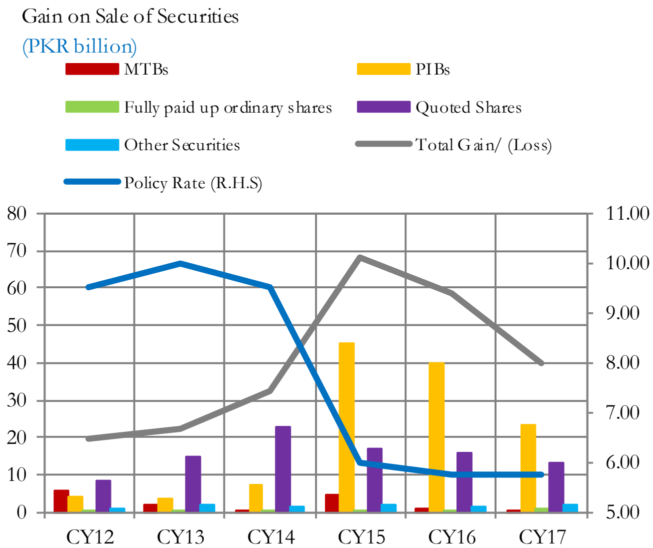
The non-interest income has declined, primarily, due to sharp reduction in gains on sale of securities. This is an outcome of persistent low interest rate **(Figure 3.1.6)**. Administrative expenses have surged, mainly, due to higher salary bills, allowances, expansion in the branch network, technology based initiatives for enhancing financial outreach etc.

In addition, low interest rates have also squeezed the net interest margin (NIM) of banks. High yielding GoP securities (mainly PIBs) have matured and are being replaced by short term MTBs or fresh PIBs, both having lower returns. While banks' investment in listed equity instruments is small due to the limit on exposure in equities, the sharp fall in equity prices during CY17 has also impacted the earnings through market-to-market losses **(See chapter 2)**[121].

[120] After adjusting this impact, the decline in profit (before tax) comes to 7.5 percent in CY17. This is still larger than the dip of 4.5 percent during CY16.

[121] During CY17, banks have observed loss of PKR 0.3 billion against sale of equity shares in sharp contrast to gain of PKR 5.9 billion in CY16.

Figure 3.1.6
Revaluation gains observed steep decline



Source: SBP

The DuPont analysis on ROE (after tax) of the banking sector reinforces the point that the key factor behind fall in earnings is sharp decline in non-interest income. There is 17.4 percent reduction in PBT/Net interest income (NII) ratio **(Table 3.1.2)**.

Table 3.1.2
Extended Du Pont Break of Banking Sector's ROE

	CY15	CY-16	CY-17
	Percent		
NI/PBT (a)	0.605	0.605	0.591
PBT/NII (b)	0.663	0.648	0.535
NII/Interest Income (c)	0.505	0.517	0.500
Interest Income/A (d)	0.075	0.063	0.058
A/E (e)	10.29	11.36	12.48
ROE (f = a x b x c x d x e)	15.63%	14.42%	11.53%

NI= Net Income, PBT=Profit before Tax, NII=Net Interest Income
A=Assets, E=Equity
Source: SBP

On the other hand, net interest income to gross interest income ratio is relatively stable (only decline of 2.3 percent) showing unwavering earning capacity of the banking sector from its earning assets. It may be worth noticing that the rise in leverage (including borrowings) has resisted the ROE from going further down in CY17. However, continuous rise in financial leverage (without a balanced growth in equity) may not be sustainable in the long-run.[122]

Government borrowing pattern also plays a role in the banking profitability…

The changing pattern of government borrowing from scheduled banks also affects their income stream. Switching of borrowing from banks to SBP (as observed during second half of CY16) or changing maturity preference of instruments (e.g. from PIBs to MTBs in CY17), leads to fluctuations in the path of return on investment (ROI).[123]

Profit of banking sector in future will depend on several factors…

The future profitability depends on a number of factors:

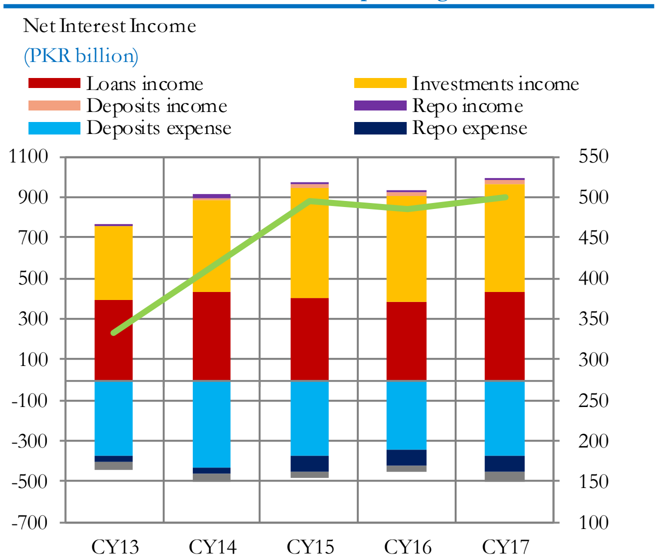
1. The continuity in the recent momentum of advances flows—particularly high yielding long-term loans—is the key for banks' earnings. Noticeably, the recent surge in financing volume has boosted Net Interest Income (NII) during CY17 **(Figure 3.1.7)**. NII has observed 2.9 percent growth during CY17 (2.3 percent decline in CY16) despite declining spread between average yields (on earning assets) and average cost (on interest bearing liabilities) throughout the year. The contribution of advances in interest income has

[122] Excessively high leverage raises the cost of borrowing and hence interest expenses. Eventually, this reduces the NII/Interest income ratio and hence ROE.
[123] It may be worth mentioning that the share of interest income from investments has increased from the low of 31.4 percent in Dec-10 to 58.3 percent in Jun-16 (53.6 percent in Dec-17). During the same period, government borrowing from schedule banks has increased from PKR 1,018.9 billion to PKR 5,752.6 billion.

risen to 43.1 percent in CY17 from 40.4 percent in CY16. On the contrary, investments' share has declined to 53.6 percent in CY17 from 56.2 percent in CY16. As such, earnings from the core intermediation function is accelerating, which may lift banks' earnings going forward.

Figure 3.1.7

Net Interest Income has witnessed a positive growth in CY17



Source: SBP

2. The reversion of equity prices may augment the banks' earnings, both, through direct (such as holdings of listed equities) and indirect exposure (through subsidiary AMCs etc.).

3. The recent tightening of monetary policy in January and May 2018 may further increase the net interest income.

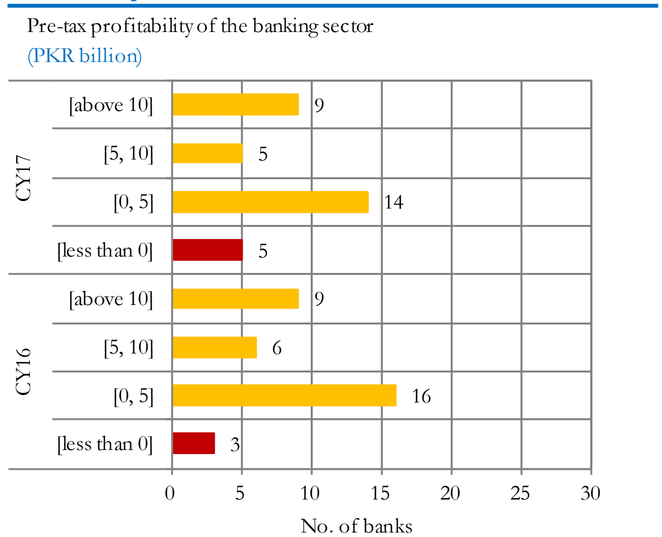
4. The idiosyncratic shock of settlement payment by a large bank is non-recurring in nature. After the imposition of penalty, the stock price of the relevant bank observed a sharp decline but recovered quickly. This indicates continuing stakeholders' confidence in the banking system. Moreover, the challenges being faced by overseas branches of domestic banks are being closely monitored and addressed (**See Box-3.1.2**).

The profitability has remained broad-based while loss making entities have negligible asset share in the industry …

The bank-wise distribution indicates a broad-based profit contribution as 29 banks posted profit with asset share of 97.60 percent in the industry **(Figure 3.1.8)**. On the other hand, the loss making banks (five) has asset share of only 2.40 percent. Further, a close analysis indicates that most of these banks are either under restructuring (or have recently gone through restructuring) or are newly established banks. Once restructuring concludes, these institutions are expected to support the profitability of the banking sector as a whole.

Figure 3.1.8

Bank-wise profit distribution has remained broad-based



Source: SBP

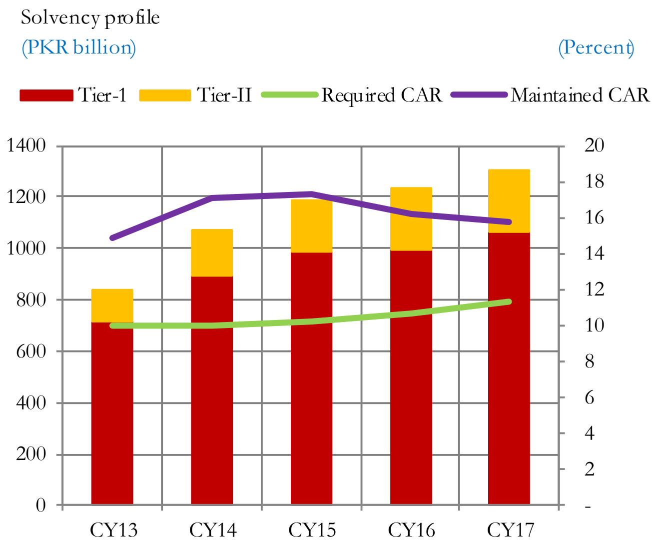
Solvency

CAR remains robust despite rise in financing activity…

The capital adequacy ratio (CAR) of the banking sector has adjusted downwards from 16.2 percent in

CY16 to 15.8 percent in CY17 **(Figure 3.1.9)**. The fall in the CAR during CY17 is solely attributed to proportionally higher growth (11.7 percent) in total risk weighted assets (TRWA), on the back of rise in financing activity **(Figure 3.1.10)**.[124] Despite this, the existing CAR is still well above the local minimum required level of 11.275 percent and global minimum benchmark of 9.875 percent.[125]

Figure 3.1.9
CAR of the banks has remained well above the benchmark



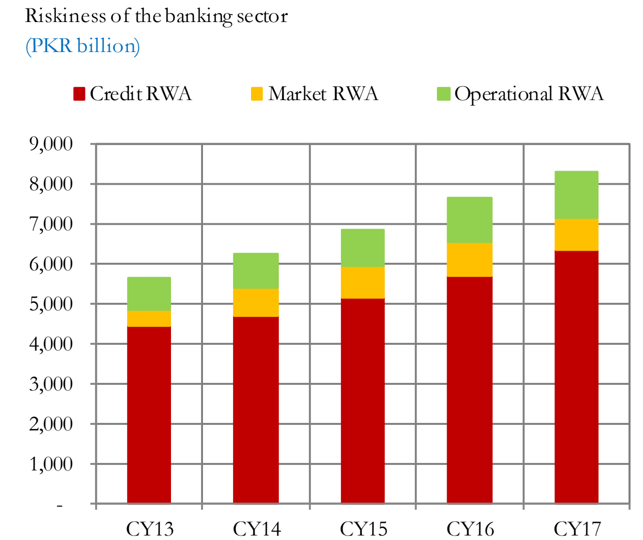
Source: SBP

Moreover, the leverage ratio has also slightly declined to 4.7 percent in CY17 from 5.1 percent in CY16. This remains higher than the minimum required level of 3.0 percent.

High quality Tier I capital dominates eligible capital…

Tier I capital has increased in CY17 while Tier II capital has observed a marginal slide. The former has moved up due to rise in retained earnings, increase in share capital by few banks and issuance of perpetual debt (i.e. additional Tier I capital). Positively, the major portion of eligible capital comprises of Tier I capital; Tier I CAR is 12.9 percent. This high quality capital has the most loss absorbing capacity and serves as the first line of defense.

Figure 3.1.10
Credit risk dominates the overall risk



Source: SBP

Tier II capital, on the contrary, has slightly receded due to decline in revaluation reserves despite higher recognition rate (on revaluation reserves) and off-loading of mutual funds portfolio.[126]

As per SBP's capital requirements, banks are required to raise their CAR, in a phased manner, to 12.5 percent by year-end 2019. In this backdrop, some of the capital enhancement by banks could be attributed to this forthcoming regulatory compulsion **(Table 3.1.3**).[127]

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124 If one-off settlement payment by one large bank (as discussed earlier) is adjusted, CAR would rise to 16.05 percent.
125 https://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf
126 As per Basel standards, 45 percent of revaluation reserves are counted towards Tier II capital. For rest 55 percent, a recognition rate is applied for inclusion in Tier II capital. Recognition rate has been increased from 60 percent in CY16 to 80 percent in CY17 ((See Q13:http://www.sbp.org.pk/bprd/basel/FAQs-Basel-III.pdf)
127 BP&RD Circular No.06 of 2013 (http://www.sbp.org.pk/bprd/2013/C6.htm)

Table 3.1.3

Banks need to enhance, phase-wise, CAR up till end year CY19

Ratio	Year End						As of Dec 31
	CY13	CY14	CY15	CY16	CY17	CY18	CY19
	Percent						
CET1	5.0	5.5	6.0	6.0	6.0	6.0	6.0
ADT-1	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Tier 1	6.5	7.0	7.5	7.5	7.5	7.5	7.5
Total Capital	10.0	10.0	10.0	10.0	10.0	10.0	10.0
CCB*			0.3	0.7	1.3	1.9	2.5
Total Capital Plus CCB	**10.0**	**10.0**	**10.3**	**10.7**	**11.3**	**11.9**	**12.5**

* Consisting of CET1 only

Source: SBP

Table 3.1.4

Capital Cushion CY17

	Existing	Simulated	Cushion
	PKR billion		
Capital	1,305.5	1,305.5	-
RWAs	8,282.2	11,578.7	3,296.5
CAR	15.8%	11.3%	

Source: SBP

Rise in credit risk weighted assets dominate…

Credit risk weighted assets (CRWAs) – having 77 percent share in total risk weighted assets (TRWA) – have surged by 11.0 percent during CY17. Noticeably, most of the credit portfolio falls in the bucket of unrated credit exposure, which attracts higher risk weight of 100 percent or more. However, the surplus CAR still provides available cushion for additional CRWA **(Table 3.1.4)**.

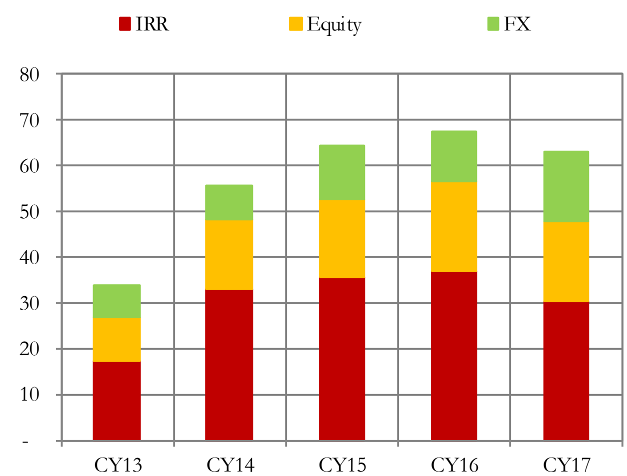
Lower duration of GoP securities reduces market risk…

Market Risk Weighted Assets (MRWAs), after observing consistent rise in the last few years, have reduced by 6.3 percent in CY17 **(Figure 3.1.11)**. There is marked reduction in capital charge for interest rate risk (market related). This is an outcome of reduced duration (i.e. risk sensitivity to bonds) owing to switching of banks' investment from long-term PIBs to short-term MTBs.[128,129]

Figure 3.1.11

Interest Rate Risk (IRR) has remained the major component of market risk

Market Risk Components



Source: SBP

Similarly, capital charge for listed equity instruments has reduced because of lower equity exposure of banks; an outcome of sharp decline in equity prices during CY17 **(See chapter 2).** On the other hand, the capital charge for FX has risen due to depreciation of PKR.

Operational risk weighted assets of the banking sector rise…

Operational Risk Weighted Assets (ORWAs) have observed a rise of 6.80 percent during CY17. Since most banks are using Basic Indicator Approach

128 As per Basel standards, capital charge is first calculated and then converted into MRWAs by multiplying the overall capital charge by 12.5.

129 As per Basel standards, interest rate risk has two components i.e. (i) issuer specific risk and (ii) general market related risk. The higher duration of the instruments, attract higher capital charge for general market related interest rate risk due to higher duration or interest rate risk sensitivity of the instrument.

(BIA), the ORWAs have risen due to increase in average audited income.

Considering banks are prone to a wide range of operational risks including frauds, forgeries, legal cases, IT failure, external issues etc., it may be desirable to assess the operational risk through actual loss data. SBP has been encouraging banks to develop operational risk management framework and gather actual loss data, which could then be used in advanced approaches to estimate ORWAs.[130]

Table 3.1.5

Distribution of Banks by CAR

	CY12	CY13	CY14	CY15	CY16	CY17
CAR<Required	5	5	3	3	4	4
Required < CAR < 15 percent	9	12	12	13	13	11
> 15 percent	24	21	22	19	17	18
Total	38	38	37	35	34	34

Source: SBP

Most of the banks have CAR well above minimum requirement…

Bank-wise distribution of CAR reveals that majority of banks have CAR above the required level **(Table 3.1.5)**. The number of CAR non-compliant banks has stayed at four in CY17. These banks have negligible asset share of 2.0 percent in the industry. Moreover, using tools such as stress testing, SBP continuously and proactively monitors the capital trend of the banking sector **(See Chapter 7)**. Besides, banks are actively pursued to implement their time bound capital enhancement plans.

Liquidity

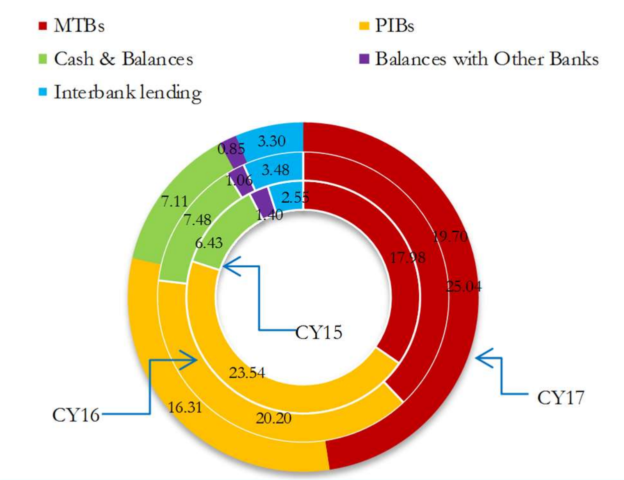
Banks have maintained strong fund-based liquidity due to their investment in government securities, which has observed addition of 18.5 percent during CY17 **(Figure 3.1.12)**. Further, placement of high portion of such securities in AFS and HFT categories ensures liquidity is at hand any time. The strong liquidity indicates banks' ability to meet obligations (including deposits) of wide spectrum of maturities.

Figure 3.1.12

High quality liquid assets ensure efficient liquidity management

Liquid Assets as a percentage of Total Assets

(Percent)



Source: SBP

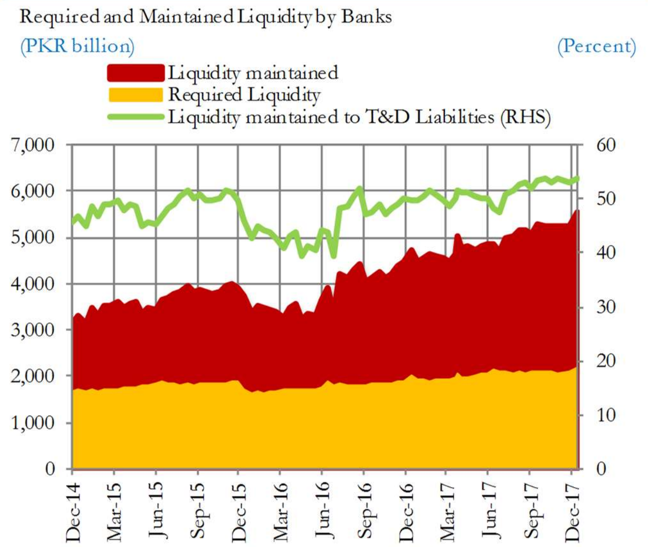
Liquidity indicators improve further…

Despite significant increase in asset base, liquid assets to total assets ratio has further strengthened to 54.0 percent during CY17 (53.7 percent in CY16). As of end December 2017, banks have maintained liquid asset to demand & time liabilities ratio of 53.8 percent (yearly average of 47.5 percent during CY17); much higher than required SLR and CRR

[130] BPRD Circular No.04 of 2014
http://www.sbp.org.pk/bprd/2014/C4.htm

ratios of 19 percent and 5 percent, respectively (against demand liabilities) **(Figure 3.1.13)**.[131]

Figure 3.1.13
Banks have maintained surplus liquidity

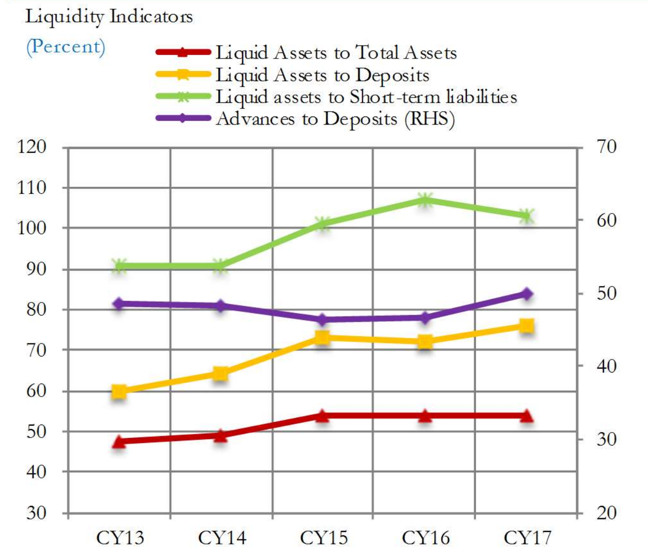


Source: SBP

Though liquid asset to short-term liabilities ratio has reduced somewhat, owing to large magnitude of financial borrowings during CY17, the ratio is still more than 100 percent **(Figure 3.1.14)**. All liquidity indicators are strong despite rise in "advances to deposit" ratio (advances are considered as less liquid assets).

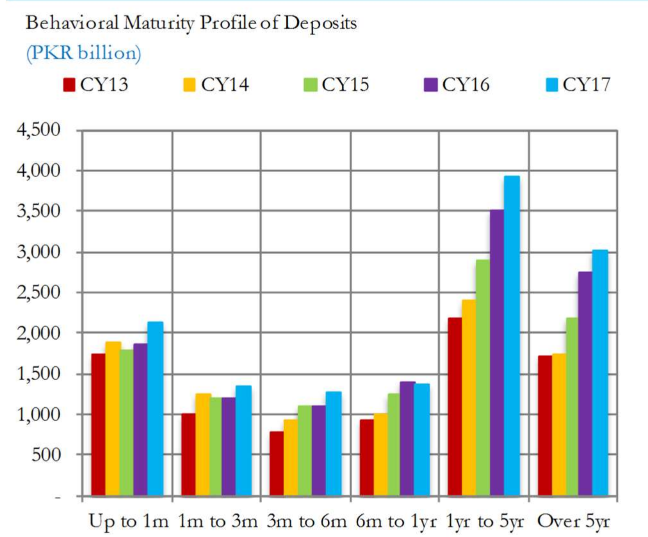
Since last few years, banks have deployed bulk of funds in term finance (i.e. fixed investment advances) while share of fixed deposits (in overall deposits) has shrunk. The share of term advances has risen from 24.1 percent (in overall domestic advances) in CY13 to 34.1 percent in CY17. On the other hand, the share of fixed deposit has reduced from 26.7 percent in 2013 to 21.8 percent in CY17. The risk of maturity mismatch seems to emerge in this backdrop.

Figure 3.1.14
Liquidity Indicators have stayed healthy



Source: SBP

Figure 3.1.15
Longer behavioral maturities of deposits have shielded banks against potential liquidity risks



Source: SBP

However, the risk appears hedged from two perspectives. First, banks are loaded with liquid govt. securities, which provide an intrinsic quick and reliable liquidity support at all times. Second, the

131 Time liabilities are exempt from the requirements of SLR and CRR.

pattern of behavioral maturity suggest that most of the deposits fall within the category of maturity over one year including a significant portion placed in maturity over five years **(Figure 3.1.15)**

Borrowings

Borrowings rise, still cover small portion of liabilities…

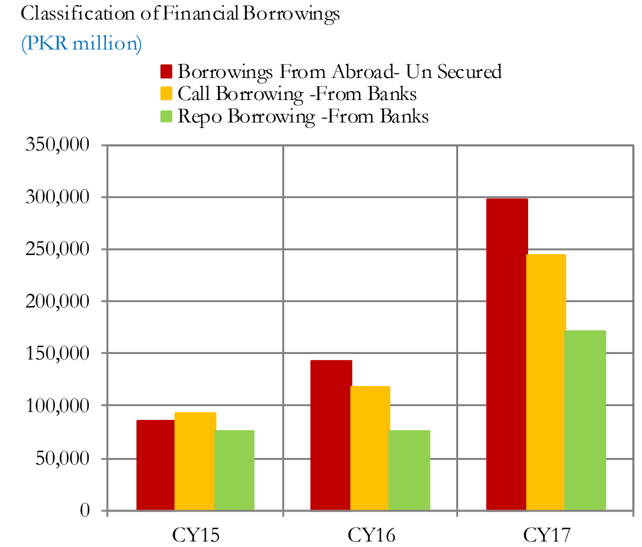
The borrowings have moved up during CY17 owing to asset expansion in the wake of unmatched deposit growth. Noticeably, deposits have decelerated to 10.3 percent during CY17 compared to 13.56 percent in CY16 as well as 5-year average of 13.61 percent during CY12-16.

Lower deposit growth has occurred due to squeeze in the growth of domestic remunerative deposits and scaling back of operations by few banks in overseas market.[132] Thus, with shrinking support from deposits, banks have relied heavily on borrowings (growth: 60.9 percent) as an alternative funding source to meet the required liquidity needs. Banks' weekly average outstanding borrowing of PKR 2.9 trillion during CY17 has been larger than the weekly outstanding average of PKR 2.2 trillion during CY16. Excluding repo borrowing from SBP, call and repo borrowings within the banks have also moved up **(Figure 3.1.16)**.

However, the pick-up in borrowings during CY17 does not reveal any immediate concerns because total borrowings still comprise small portion of overall liabilities and banks' ability to generate funds through core sources, i.e. deposits, remains intact **(Figure 3.1.17)**. Nevertheless, in case the borrowing momentum continues, the risk to financial stability would rise.

Figure 3.1.16

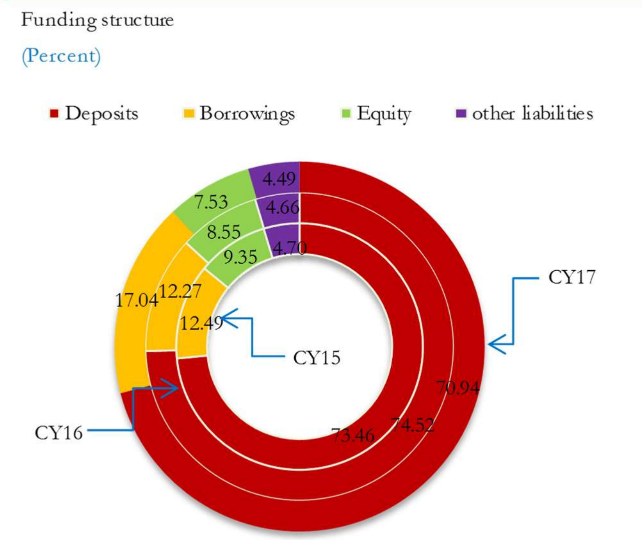
Banking borrowings have surged in all categories



Source: SBP

Figure 3.1.17

Deposits continued to be the main funding source



Source: SBP

Interconnectedness

Interconnectedness, within the banking sector, has remained at an elevated level, primarily, on account of higher volume of interbank transactions (i.e.

[132] See Quarterly Performance Review of Banking Sector, (October-December, 2017).

lendings, borrowings and fund placements). However, like the borrowings, overall volume of such interbank transactions is just a small portion of overall assets or liabilities reflecting negligible contagion risk.

Public Sector Exposure

Public sector exposure on banking balance sheet has slightly increased owing to higher volume on investment in government securities as well as direct loans to Public Sector Entities (PSEs). Though public sector exposure carries a limited credit risk (and that too only for PSEs), other risks still prevail including market risk (particularly on long-term instruments), change in government borrowing preferences (as discussed earlier) etc.

The outlook portrays mixed expectations for the banking sector…

The advances flow to the private sector is contingent upon the demand and supply conditions in the economy. If the growth momentum of the economy sustains, energy availability improves, exports rise due to PKR depreciation and better global demand prospects, and supportive policy measures remain in place, the advances to private sector may accelerate. However, rising cost of borrowing, uncertainties associated with upcoming elections, external sector vulnerabilities and gradual tightening of global financial conditions could restrain investment.

The restoration in deposit growth to its long-term trend is fundamental to sustaining advances growth. Besides income levels, this depends upon factors such as return on deposits, transaction costs including taxes, return on alternate avenues and public preference for cash.

Asset quality is likely to remain satisfactory. However, given the recent increase in interest rates, banks need to be vigilant in managing their credit risk.

Earnings of the banking sector, apart from growth in advances, depends upon the borrowing pattern and institutional preference of government as well as legal challenges faced by few banks.[133] Further, the recent rate rise may lead to narrowing down of gain on sale of securities.

The CAR may experience some adjustment because of probable rise in CRWAs and moderation in revaluation reserves. However, it is expected to remain well above the minimum prescribed level.

Another important element that may impact the banking sector in the coming years is the inclusion of the country in the FATF's grey list. Although a well established AML/CFT regime exist in the country, it is being further strengthened to meet the international requirements (**See Box 3.1.3**).

[133] Few large banks could face sizeable payments because of pension claims which have been recognized in their financials as of March 31, 2018.

Box 3.1.1: Growth Issues in Consumer Finance and SBP Measures

Consumer finance (CF) in Pakistan is one of the financially underserved segments of the credit market. It has not been able to grow steadily and achieve some level of maturity despite witnessing historic growth during CY03-07. In recent years, the growth in CF has been robust but financing to additional consumers appears quite moderate.[134]

Moreover, CF to GDP ratio of Pakistan is considerably lower than other emerging market economies (**Table 1**). One of the factors is weak mortgage financing which contributes only 17.83 percent to total CF. This is in sharp contrast to other emerging market economies where mortgage finance generally contributes around half of the CF.[135]

Table 1

Consumer Finance as Percentage of GDP - Cross Country Comparison

Country	FY14	FY15	FY16	FY17
	Percent			
Pakistan	1.15	1.17	1.20	1.29
India	7.71	8.05	8.72	9.86
Indonesia	38.43	38.53	38.60	39.20
Malaysia	34.05	35.16	35.11	33.69
Mexico	2.99	3.10	3.31	3.34
Philippines	7.14	7.96	8.78	9.44
Thailand	28.12	29.05	29.11	28.78

Source: SBP & Haver Analytics

As a result, unlike other jurisdictions, from stability point of view, CF poses meager threat to Pakistan's economy at present. Given its importance for economic growth and limited stability risk concerns, SBP has made mortgage financing one of its top priorities.

Over the past few years, CF has picked up momentum with an average annual growth of 12.47 percent during CY13-17. Particularly in CY17, CF has grown by 20.62 percent (YoY basis), highest since CY07. This is largely driven by growth in auto loans (34.61 percent) followed by mortgage loans (29.82 percent). Other than the secured nature of auto loans, banks' growing attraction towards auto industry, in recent years, is the increase in demand of automobiles.[136]

Table 2

Component-wise distribution of Consumer Finance

	CY13	CY14	CY15	CY16	CY17
	PKR Billion Outstanding				
Credit Cards	21.4	22.8	24.7	28.3	34.2
Auto Loans	55.8	70.9	95.1	125.9	169.5
Consumer Durable	0.2	0.3	0.3	0.3	0.7
Mortgage Loan	53.1	52.3	54.4	61.6	80.0
Other Personal Loans	142.6	147.7	161.1	155.7	164.1
Consumer Finance	273.2	294.0	335.6	371.8	448.5
Total Advances	4,505.5	4,930.0	5,330.1	6,013.1	7,029.4
Consumer Finance as %age of Total Advances	6.06	5.96	6.30	6.18	6.38

Source: SBP

Historically, low interest rates have encouraged the banking sector to increase CF due to *search-for-yield* motive. With easy monetary policy in vogue recently, banks have opted to take on more risk to maintain their interest income.[137] Moreover, ease in repayment capacity of the borrowers (induced by low interest rates) has led to higher demand for CF as well. Resultantly, as the CF has increased the infection ratio has come down to 6.21 percent in CY17 from 8.11 percent in CY16. Lower credit risk has provided further impetus to banks to take on more exposure in CF.

Despite recent momentum in CF, there are numerous impediments that the banks face. Consumer's low level of income discourages them to extend CF beyond a small pool of salaried individuals.

[134] The number of CF customers has increased by an average of 2.88 percent during CY14-17 as opposed to 13.30 percent increase in amount of CF.
[135] Analysis reveals that by removing mortgage finance, total CF declines by around half in case of India, Malaysia, Philippines and Turkey.
[136] According to the data published by Pakistan Automotive Manufacturers Association (PAMA), in CY17, the total number of automobiles produced has increased by 19.04 percent (39.97 percent in CY16), whereas, the number of automobiles sold has increased by 19.05 percent (40.67 percent in CY16).
[137] Spread of the banking sector declined to 2.18 percent in CY17 from 2.52 percent in CY16.

Moreover, structural problems in housing industry have hindered the potential growth of mortgage finance in Pakistan. Weak foreclosure standards, lengthy judicial procedures and non-automation of documentation are dis-incentivizing banks from going into mortgage financing. Moreover, prevailing real estate prices along with unfavorable terms and conditions of existing mortgage products make mortgage finance affordable only for high net worth individuals.[138]

In light of the aforementioned issues in CF, within its domain, SBP is playing an active role to facilitate CF in Pakistan.

1. In CY17, SBP with the support of World Bank has established Pakistan Mortgage Refinance Company (PMRC) to improve access of housing finance in Pakistan. Besides dealing with the existing market failures, the purpose of PMRC is to encourage fixed rate mortgages and longer maturity loans to allow lower-middle and middle class households to have access to mortgage finance.

2. SBP has revised Prudential Regulations (PRs) for housing finance. The main purpose was to increase the extent of additional housing finance and remove restriction on the frequency of property revaluation.[139]

3. The regulatory retail portfolio (including CF) limit under Basel Capital Framework has been enhanced to PKR 125.0 million from PKR 75.0 million. This development is expected to support the growth of credit to the retail sectors as well as SMEs.[140]

4. SBP also takes into account customer complaints in order to retain consumer confidence in the financial system. For this purpose SBP has launched Consumer Grievances Handling Mechanism (CGHM) and a dedicated helpline for banking customers.[141,142]

5. Following the international best practices, SBP has developed *Product Disclosure Requirements* and *Know Your Rights and Responsibilities as a Banks' Consumer*.[143,144] This will assist consumers in making informed decisions over diversified and complex financial products.

6. SBP in collaboration with Pakistan Banks Association (PBA) established the Electronic Credit Information Bureau (e-CIB). SBP collects and consolidate the monthly information of individual borrowers, which is accessible on request to any bank. This facilitates assessment of the credit worthiness of borrowers.

[138] The World Bank: Pakistan Housing Finance Project (P162095): http://documents.worldbank.org/curated/en/277261492752441488/pdf/ITM00184-P162095-04-21-2017-1492752439147.pdf
[139] IH&SMEFD Circular No. 3, 2017
[140] BPRD Circular No. 08, 2017
[141] BC&CPD Circular No. 01, 2016
[142] BC&CPD Circular No. 04, 2017
[143] BC&CPD Circular No. 2, 2016
[144] BC&CPD Circular No. 1, 2017

Box 3.1.2: Analysis of the Overseas Operations of Banks in CY17

Banks, generally, provide cross-jurisdictional financial services through foreign branches, subsidiaries, representative offices etc. Besides trade facilitation, such operations enable banks to reap some benefits including diversification (geographical, financial product-wise or through different currencies etc.), technology transfer, investment in human capital, business expansion with expanded market etc.

The banking sector of Pakistan has presence in various jurisdictions around the world. As of December 31, 2017, nine (9) local banks, having 117 branches, 17 representative office (ROs) and eight subsidiaries are operating in 36 jurisdictions including Export Processing Zone in Pakistan. Largest number of branches are operating in

Bangladesh and UAE (18 in each country) followed by Bahrain and Sri Lanka (13 in each country).

Foreign operations of banks are, generally exposed, to various risks including non-compliance to laws and regulations of host countries as well as to their changing macro financial conditions. Besides, legal issues could also create significant stress. Other than monetary loss, any materialization of such risks can expose the banks to reputational loss.

The foreign branches of local banks, though performing reasonably well, have recently been exposed to some critical risks. In 2017, one-off settlement payment made by a large local bank resulted in sizeable impact on its bottom line.

In this backdrop, it is imperative to assess the performance and soundness of foreign operations, particularly, their loss absorbing capacity.

The consolidated financials reveal that, the scaling back of operations by some banks in response to emerging challenges, the **asset** base of the overseas branches has slightly contracted by 3.99 percent during CY17 (Average 5-years' growth: 8.15 percent) **(Table 1**). However, the overseas operations still contribute 4.49 percent to the overall asset base of the banking sector as of end December, 2017.

Table 1

Consolidated Position of Overseas Branches of Banks

	CY15	CY16	CY17
Key Variables			
Assets	883.6	867.0	832.3
Gross Loans	421.3	458.4	463.7
Investments	228.8	273.8	234.2
Deposit	641.0	626.4	594.0
Pre-Tax Profit (YTD)	9.4	10.5	5.3
After-Tax Profit (YTD)	8.3	8.6	5.9
NPLs	62.1	66.0	78.3
Provisioning	40.2	60.0	68.5
NPLs-Net	21.9	5.9	9.8
Financial Soundness Indicators			
ADR	59.50	73.19	78.07
NPLs to Total Loans	14.70	14.39	16.88
Net NPLs to Net Loans	5.70	1.48	2.47
ROA	1.10	1.00	0.70

Source: SBP

The foreign branches seems to be playing relatively better financial intermediary roles than their local counterparts with advances to deposit ratio of 78.1 percent. During CY17, **Gross loans** have slightly risen to PKR 463.7 billion from PKR 458.4 billion in CY16. The major chunk of advances is disbursed to sectors including financial, automobile and transportation as well as individuals.

On the contrary, **investments** have declined by 14.5 percent during the same period due to divestment in federal govt. securities as well as bonds/TFCs etc.

In line with the asset growth trajectory, **deposits** have also contracted to PKR 234.2 billion (primarily due to non-remunerative current deposits) in CY17 from PKR 273.8 billion in CY16.

The asset quality of the foreign operations has declined a bit with rise in absolute Non-**performing loans** (NPLs) to PKR 12.3 billion and infection ratio to 16.88 percent in CY17. However, most of the bad loans are already provided-for with net NPLs to net loans ratio at 2.5 percent. Moreover, investigations reveal that NPLs are not broad based as most of the banks are having negligible infection ratio.

Profitability of the overseas banks' branches is not that encouraging in CY17 as pre-tax profit has declined to PKR 5.3 billion from PKR 10.5 billion in CY16. This is mainly on account of increased provisioning and administrative expenditures in CY17. Accordingly, return on asset (ROA) has slowed down to 0.7 percent in CY17 from 1.0 percent in CY16.

Overall, the overseas branches are contributing positively to the operations of the banks. However, the risks emanating from such operations demand a careful and in-depth review of the system and controls of these branches by the banks. Also, keeping in view that a significant portion of foreign business pertains to remittances and correspondent banking, it is imperative to strengthen the AML-CFT regime at these branches in line with best international practices. SBP, in its supervisory capacity, is working closely with the banks to address any concerns.

Box 3.1.3: FATF and AML/CFT Regime in Pakistan

Background

Integrity of a financial system against the misuse for money laundering and terrorist financing has emerged as a key policy concern, and international agencies and policy makers all over the world are making serious efforts to cope with these anti-social activities. In this regard, Financial Action Task Force (FATF), an inter-governmental body established in 1989, has emerged as a pivotal policy making body. It sets the standards and promotes effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to integrity of the international financial system. The FATF has developed a series of Recommendations that are recognized as the standard for combating money laundering and the financing of terrorism and proliferation of weapons of mass destruction. These recommendations form the basis for a coordinated response to different threats to the integrity of financial system and help ensure a level playing field for different stakeholders in the economies. First issued in 1990, the FATF Recommendations were revised in 1996, 2001, 2003, and then most recently in 2012 to ensure that they remain relevant to the dynamic environment and feasible for universal application.[145]

Pakistan's AML/CFT Regime and FATF

Policy makers in Pakistan have always appreciated the importance of financial system's integrity against misuse for money laundering and terrorist financing. The SBP introduced the policy framework on AML/ CFT in early 1990s, and since then it has evolved to address both international standards and dynamics of the local financial markets. The AML law, defining the legal obligations in respect of money laundering and terrorist financing and enjoining the roles and powers of different stakeholders and law enforcement agencies, was promulgated in 2007. To facilitate implementation of the law a full-fledged and independent Financial Monitoring Unit (a financial intelligence unit) has been established which, monitors suspicious transactions reports (STRs) from different economic agents, call reporting entities and, after carrying out due assessment, refers the potential cases of money laundering and terrorist financing to the respective investigation agency for further examination and prosecution. Besides, FMU shares financial intelligence with financial sector regulators when regulatory breaches are noted during analysis of STRs.

Pakistan is not a member of the FATF; the country is associated with the FATF through FATF-Style Regional Body (FSRB) i.e. Asia-Pacific Group on Money Laundering (APG), which assessed the country in 2005 and 2009 and followed up in the following years to address the identified observations. In Jul 2009, the last mutual evaluation report (MER) of Pakistan against the FATF's recommendations was published[146]. The report identified some deficiencies in the AML/CFT regime and suggested measures to overcome the underlying risks. In line with the assessment, Pakistani authorities has made strenuous efforts and introduced a number of reforms and improvements in legal, regulatory and operational frameworks to address the concerns with regard to compliance with international standards, and has been reporting progress to APG. Pursuant to third round of mutual evaluations under the FATF's revised standards and methodology, Pakistan's third assessment has also been initiated.

In recent years, the country has taken further measures to strengthen the AML/CFT regime, which include:

- Amendments in AML Act, 2010 (Dec 2015) to streamline it with international standards described by FATF.
- Addition of Fiscal offences under Sales Tax (Feb 2016).

[145] http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html

[146] http://www.apgml.org/documents/default.aspx?s=date&c=7&pcPage=6

- Addition of Directorate General (I&I Inland Revenue) of FBR as investigating and prosecuting agency under the AML law (Jun 2016).
- Addition of 'Insider Trading and Market Manipulation' as predicate offence in the schedule of AML Act, 2010 (Dec 2015).

Over the last year, SBP has taken additional measures to strengthen **Anti-Money Laundering (AML)/Combating Financing of Terrorism (CFT)** Regulations to align them with the international best practices. Some of the initiatives taken over the year include:

- SBP has issued revised Guidelines in Jun 2017 advising banks that the obligations/ prohibitions regarding proscribed entities and persons are applicable, on an ongoing basis, to proscribed/ designated entities and persons or to those who are known for their association with such entities and persons, whether under the proscribed/ designated name or with a different name.
- SBP has advised banks and Microfinance Banks to install biometric machines at all branches for instant customers' verification at the time of account opening.
- SBP has advised all financial institutions falling under its purview to refrain from dealing in or facilitate their customers to transact in Virtual Currencies / Initial Coin Offerings (ICOs) and to immediately report any such transaction to FMU as a suspicious transaction.
- SBP has revised AML/CFT regulations based on the findings of Pakistan's National Risk Assessment (NRA). The revisions require assessment of AML/CFT controls for asset side customers and products, placing adequate number of analysts to monitor and report suspicious transactions, assignment of AML/CFT compliance monitoring to Management Level Committee of bank responsible for risk and control; and putting in place procedures for maintaining data of account opening cases rejected, revision in customer risk ratings and accounts closed based on ML/TF risks.

Pakistan has a proactive, dynamic and robust AML/CFT regime, which comprises legal, regulatory, institutional and operational frameworks in line with international standards. The authorities have the required technical capacities to address challenges posed by the dynamic environment and adequately fulfill any international requirements.