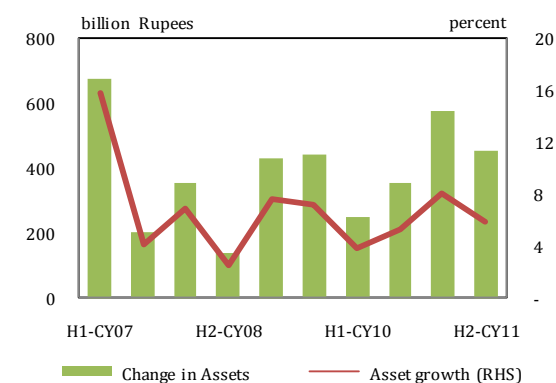


The banking sector was able to register a modest growth of 5.91 percent in H2-CY11 albeit the challenging domestic and external environment. However, advances saw a first ever half-yearly drop over a decade. The decline came from one off conversion of public sector circular debt and unpaid subsidy on account of Government commodity operation into Government securities. Private sector advances growth, though positive, remained subdued owing to high credit risk and resultant non-competitive risk-return matrix vis-à-vis public sector credit. Deposits with a sluggish increase of 4.7 percent remained the primary funding source, followed by borrowings from financial institutions. As against the recent trend of current account- saving account (CASA) driven increase in deposits, major boost to funding came from growth in fixed deposits during the period under review.

Figure 1.1

Changes in Banking Assets



The asset base of the banking sector increased on the back of banks' investment in Federal Government Securities...

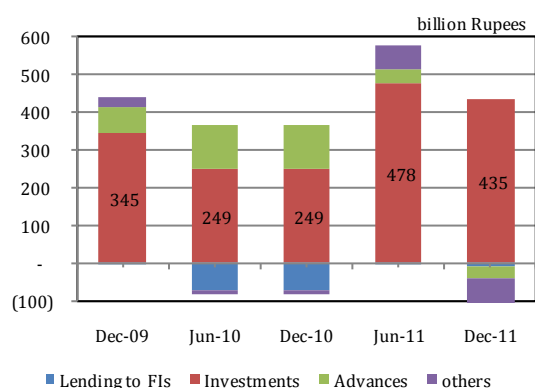
The asset base of the banking system registered a growth of Rs 456 billion (5.91 percent) in H2-CY11 (**Figure 1.1**). The key characteristic of this rise was excessive banks' investments in Government securities as Government continued to borrow from banking system to finance its budget deficit. As a result, investments surged by another 16.6 percent and their share in overall assets increased to 37.3 percent (30 percent in CY10) during the period under review.

.....while advances observed first ever dip

In stark contrast, gross advances saw a first half-yearly dip (Rs17 billion) in the last decade, due to decline in Public Sector advances. The drop came from one-off conversion of public sector inter corporate circular debt and unpaid subsidies on commodity finance through issuance of Market Treasury Bills (MTBs) and Pakistan Investment Bonds (PIBs) in November 2011 (**Figure 1.2**). Low-paced growth in private sector advances (2.3 percent) mainly resulted from seasonal demand for advances in the last quarter of the year.

Figure 1.2

Flows in Asset Components

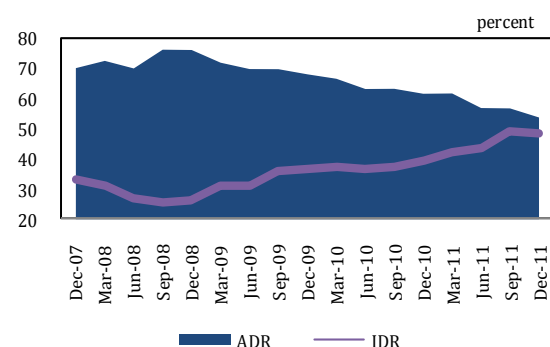


Funding was driven by slow deposit growth, borrowings, and equity

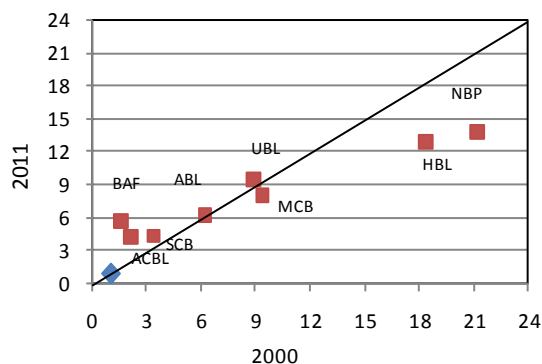
On the funding side, deposit growth decelerated during the half year under review; increase of 4.7 percent in H2-CY11 was far below the 9.43 percent increase during the first half. Further, composition of incremental customer deposits saw a shift as entire growth of Rs 279 billion came from remunerative and large-sized fixed and saving deposits. In addition, the foreign currency deposits also observed a conspicuous rise of Rs.77 billion on account of the downward pressure on Pak rupee.

Figure 1.3

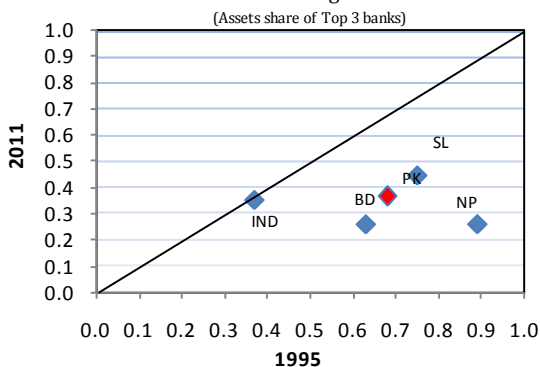
Shift in Asset Mix

**Figure 1.4**

Bank's Concentration in Pakistan

**Figure 1.5**

Bank's Concentration in SAARC Region



Borrowings from financial institutions, which contribute a small portion in overall funding structure and are transitory in nature, saw a jump of Rs.113 billion, which contributed almost 25 percent in overall increase in fund base. The major portion of this growth came from SBP repo borrowing for short-term liquidity management. The year to date profits and injections of fresh capital by a few banks augmented equity base of the system by Rs 62 billion, increasing its share in total assets by 23 bps to 9.6 percent.

The mirror image of IDR and ADR exhibits private sector credit crowding out

With massive increase in investments and continued stagnancy in advances, the composition of banking assets further tilted towards investments. And this led to increase in Investment to Deposit Ratio (IDR) to 49 percent (**Figure 1.3**), almost double the level in Sep-08. Over the past few years, banks, in wake of the rising credit risk and sluggish business environment, opted to invest heavily in government securities. As a result, the mirror imaged Advances to Deposit Ratio (ADR) significantly declined to 54 percent in Dec-11 (76.0 percent in Sep 2008).

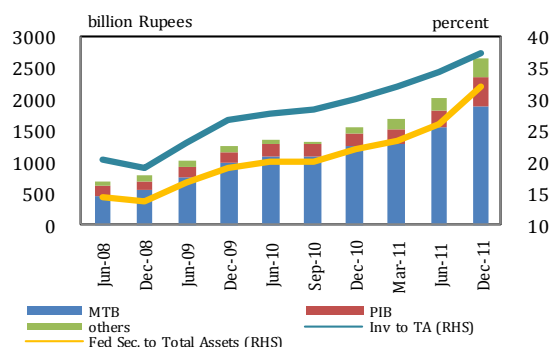
Though ADR and IDR vary across banks by size, however, ratios remained below the industry average in majority of the top ten banks, indicating the competitive edge available to these banks in raising deposits (76 percent share in total deposits) due to their extensive outreach and brand.

Concentration levels in terms of assets continue to improve

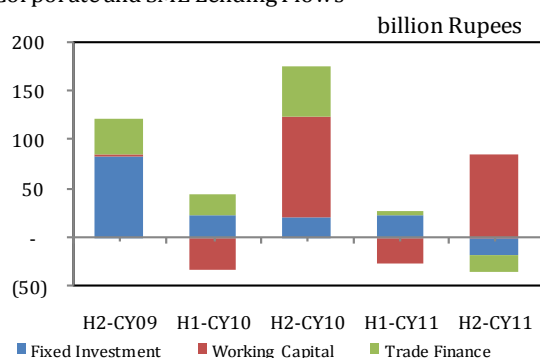
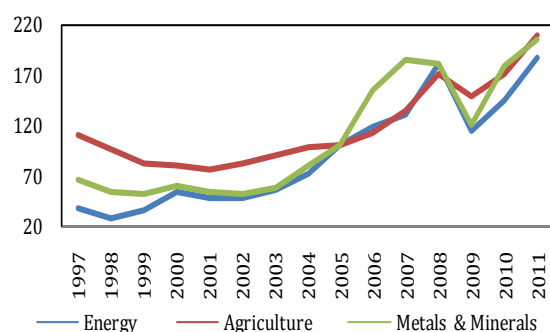
Over the years, top banks have shed their market share due to various structural and consolidation measures; the trend continued during the period under review, though at a slower pace. Analysis shows that small and medium sized banks expanded in size, thus increasing their share in assets base (**Figure 1.4**). Cross-country comparison also shows that concentration in the banking system of Pakistan has improved overtime (**Figure 1.5**).

Banks' exposure on Government continued to rise

As Government insatiate funding needs for budgetary support continued, banks' overall exposures to government reached new levels (**Figure 1.6**). Investment in treasury securities registered 32 percent growth in H2-CY11, much higher than 25 percent increase during the first half. Consequently, share of treasury securities augmented to 86 percent of the total investments and 33 percent of the total assets base.

Figure 1.6**Bank's Investments in Govt. Debt****Table 1.1: QoQ Incremental flows-Domestic Private Lending**

	billion Rupees				
	Q1	Q2	Q3	Q4	CY
CY09	(133)	(50)	(35)	145	(73)
CY10	18	(41)	(44)	236	168
CY11	39	(48)	(133)	197	55

Figure 1.7**Corporate and SME Lending Flows****Figure 1.8****World Commodity Prices Indices**

However, the overall monetary impact of the government borrowing was limited to the extent of Rs204 billion as government papers issued under settlement of circular debt was more of an accounting adjustment. The settlement envisaged issuing PIBs and MTBs (50 percent each), which led to 78 percent increase in the stock of PIBs on the books of banks. Various instruments settled also included TFCs issued by Pakistan Holding Company Limited (PHCL). As such, the share of banks investment in TFCs & PTC saw a hefty decline of 10 percentage points to 4.3 percent in H2-CY11.

In addition, the bearish behavior of capital market due to fragile macroeconomic conditions and precarious law and order situation shook the confidence of both domestic and foreign investor. With 9.2 percent fall in the KSE benchmark index, the banks investments in equities declined by 2 percent in H2-CY11.

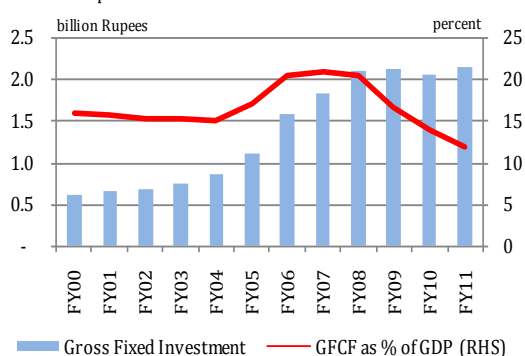
The gross lending to private sector (domestic operations) although registered a net increase of Rs 64 billion during the H2-CY11, however the increase was much lesser than the credit disbursement of Rs.188 billion (7.0 percent) in H2-CY10 and Rs.110 billion in H2-CY09. This sluggish pattern of private sector credit continued as demand dampened due to continuing energy shortages and unfavorable law and order conditions, making businesses shy away from taking new ventures and consolidate their balance sheets. On the supply side, increasing credit risk and availability of alternative risk free option also affected flow of banks' credit to private sector.

Domestic credit to private sector grew marginally...

The domestic private credit off-take usually follows a seasonal pattern with net retirements in 3rd quarter followed by an overriding credit off-take in the fourth quarter. However, a high magnitude of net retirements during Q3-CY11, as compared to the retirements in corresponding periods of last two years, kept the flow of credit to domestic private sector depressed during H2 CY11 (**Table 1.1**).

...while credit demand confined to working capital needs

The segment wise data reveals that most of credit increase came from decelerated working capital growth of Rs.85 billion (against off-take of Rs.102 billion in H2-CY10) while fixed investment and trade finance observed negative credit off-take (**Figure 1.7**). Continuously escalating global commodity

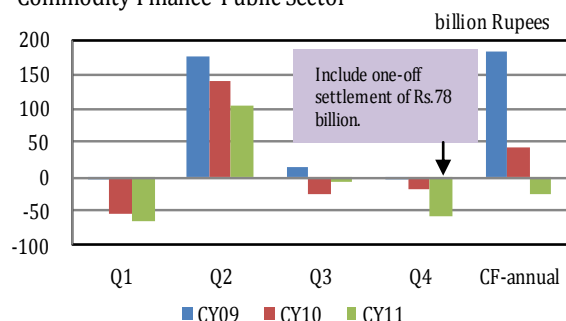
Figure 1.9**Gross Fixed Capital Formation**

prices⁹ especially the oil & raw material prices (**Figure 1.8**) and domestic inflation kept the demand for working capital finance alive. The driving factors behind the decline in credit flows for trade finance were deceleration in overall exports (specially the textile sector), owing to squeezed foreign demand in USA and Euro Zone, and domestic non-conductive economic environment. Further, retirements also came from importers whereas demand for EFS loans remained low during the period under review. However, demand for fixed investment declined due to the already installed but underutilized industrial capacity¹⁰.

The lackluster demand for fresh fixed investment financing during the last few years is also translating into a drop in Gross Fixed Capital Formation¹¹ to GDP ratio (**Figure 1.9**) which exhibits an overall tendency towards consumption led economy at the cost of potential investments. As empirical studies indicate financial stability goes side by side with economic development and stability¹², the continuation of this trend may have significant ramifications for banking and financial sector stability.

Though overall credit off-take was sluggish, sector wise credit demand varied (**Table 1.2**). An exceptional retirement (Rs.38 billion) was seen in the sugar sector in H2-CY11, much higher than the retirements (Rs.8 billion) in the same period last year. In fact, the inability of sugar mills to off-load their inventories before the start of crushing season on account of lower domestic prices kept the advances demand low in this sector. However, government purchased sugar stock to stabilize the prices, which facilitated the sugar sector settle their dues. The low credit demand in the textile sectors (spinning, weaving, finishing etc) was driven by lower raw material prices in domestic market and reduced global demand.

Cement sector also registered net retirements of Rs.0.2 billion in H2-CY11 due to squeezed construction activities in the economy. Other industries including electronics & electrical appliances and production & transmission of energy sectors also revealed negative credit demand. However, automobile & transportation sector somewhat recovered showing net credit off-take of Rs.2.8 billion in H2-CY11 against the net retirement

Figure 1.10**Commodity Finance-Public Sector****Table 1.2 Sector-wise Flow of Credit to Private Sector**

	H1-10	H2-10	H1-11	H2-11
Chemical and Pharmaceuticals	10.0	(3.2)	1.5	2.1
Textile	(53.4)	101.4	(37.5)	12.6
Cement	(4.3)	4.1	(13.7)	(0.2)
Sugar	19.5	(8.4)	48.5	(38.1)
Shoes and leather garments	0.5	0.8	2.9	5.2
Automobile and transportation equipment	(5.2)	(10.8)	3.1	2.9
Financial	(18.4)	0.5	10.3	18.7
Production and transmission of energy	34.5	15.5	29.8	(10.3)

⁹ The world commodity prices, after bottoming out in post global crisis, took a reversal again particularly in Jan-09 and exhibited a 35% rise during 2009-2011. The resurgence of prices was seen in most commodities (Energy, Agriculture, and Metal).

¹⁰ The State of Pakistan's Economy - Second Quarterly Report 2011 - 2012.

¹¹ A national account indicator of how much new value-add has been invested instead of consumed

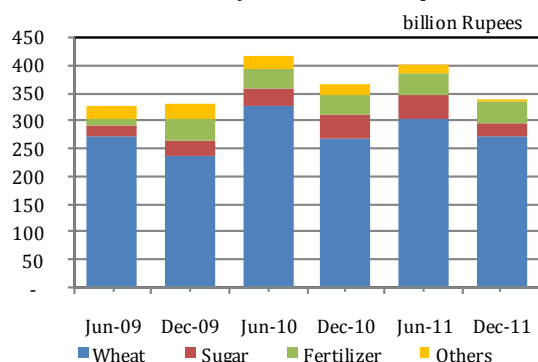
¹² Please see Levine (2011), King and Levine (1993), Pagano (1993), Roubini & Martin (1992), Khan and Senhadji (2000) and Papaioannou (2007).

of Rs.11 billion in H2-CY10. For the same reason, credit for agribusiness (recovering from dismal performance last year) and chemical & pharmaceutical also showed a positive credit demand in the period under review.

One-off settlement by the Government for commodity finance resulted in net retirements....

Figure 1.11

Public Sector Commodity Finance Break-up



In addition to settlement of inter-corporate circular debt, Government¹³ also settled Rs.78 billion¹⁴, against unpaid subsidy on account of public sector commodity operations. This led to net retirements of Rs 63 billion of commodity operations in H2-CY11 (**Figure 1.10**). Such retirements were profoundly seen in three major commodities i.e. wheat (Rs.31 billion), sugar (Rs20 billion), and rice (Rs12 billion).

...however, financing for procurement of wheat remains high

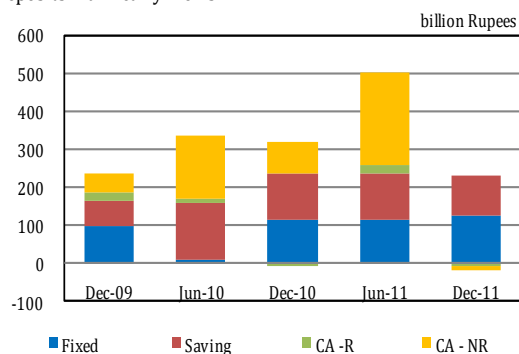
The bank-wise data reveals that major exposure on account of commodity financing to public sector is concentrated in five big banks (out of 23 commercial banks) with cumulative share of 73 percent in overall financing of Rs336 billion. The public sector financing needs revolve around the few commodities – wheat being a primary food crop of the country. As of end 2011, public sector enterprises availed Rs271 billion (81%) for wheat financing followed by Rs.41 billion (12%) for fertilizer and Rs.22 billion (7%) for sugar (**Figure 1.11**). It may be noteworthy that government borrowing for the commodity financing remained consistently high and rising during past few years owing to escalating global commodity prices and increasing wheat support price. With the increase in wheat support price by Rs100 per 40kg and decline in international wheat price, domestic financing and procurement needs are expected to increase considerably¹⁵.

Deposits registered a subdued growth

The second half of CY11 witnessed a slowdown in deposit growth compared to the same period last year (increase of Rs279 billion in H2-CY11 vis-à-vis Rs323 billion in H2-CY10). This deceleration in deposits is attributed to attractive

Figure 1.12

Deposits-Half Yearly Flows



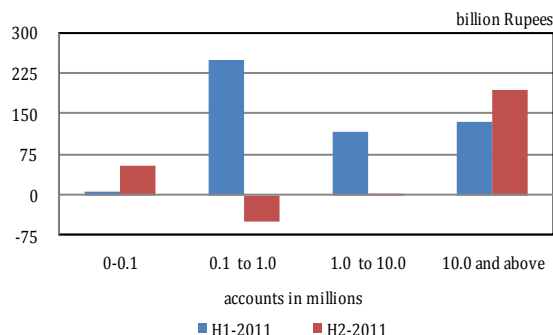
¹³ Banks have 77 percent exposure on public sector in terms of commodity finance.

¹⁴ Govt. borrowed around Rs.140 billion from commercial banks during April-October, 2011. However, in Nov-2011 govt. released on-off Rs.78 billion to procurement agencies for the settlement of accumulated subsidies.

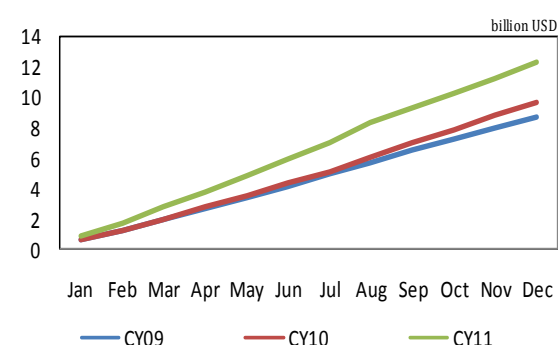
¹⁵ The public sector commodity finance for wheat procurement has increased to Rs 350 billion up from Rs 217 billion on 30th March, 2012.

Figure 1.13

Deposits Growth by Size

**Figure 1.14**

Workers' Remittances - cumulative Flows



National Saving Scheme (NSS) rate and increasing investment into Investors Portfolio Securities (IPS) account (see chapter 5). Most of the 4.7 percent increase in deposits came from remunerative deposits while non-remunerative deposits remained stagnant. Among the remunerative customer accounts, fixed and saving deposits collectively shared most of the increase in deposit base (**Figure 1.12**). In addition, financial institutions' deposits, with a surge of 34 percent, contributed 26 percent in the overall deposits growth. Due to the stagnancy in current deposits, the share of low cost Current Account – Saving Account (CASA) diluted over the half year, indicating a possibility of increase in cost of deposit for the system in coming months.

...with most of the increase contributed by the large depositors

As stated above, the fixed deposits inched up by Rs.128 billion during the period under review. However, the increase was not parallel in all maturity ladders. Almost 95 percent increase in fixed deposit was seen within the maturity ladder of 6 months to 2 years along with a relatively marginal increase in number of accounts from 0.45 million to 0.51 million. Fixed deposits with maturity of up to six months reduced by Rs.15 billion during H2-CY11. The data also reveals that overall deposit growth in H2-CY11 was mainly driven by large sized (exceeding Rs.10 million) deposits¹⁶ (**Figure 1.13**). The second best was the smaller sized deposits (Rs.0.1 million or below) which grew by Rs.52 billion.

Table 1.3: Remittance Growth in Top 20 Countries

Rank	Country				USD billion	
		2008	2009	2010	GDP 2010	Remittance to GDPL Ratio
1	India	49.98	49.47	54.03	1,727	3.13%
2	China	48.41	48.85	53.04	5,816	0.91%
3	Mexico	26.04	22.01	22.05	1,035	2.13%
4	Philippines	18.64	19.77	21.42	200	10.73%
5	France	16.60	15.87	15.63	2,671	0.59%
6	Germany	10.88	11.21	11.34	3,392	0.33%
7	Bangladesh	8.94	10.52	10.85	100	10.81%
8	Spain	11.84	10.37	10.51	1,407	0.75%
9	Belgium	10.29	10.52	10.18	469	2.17%
10	Nigeria	9.98	9.58	10.05	194	5.19%
11	Pakistan	7.04	8.72	9.69	166	5.85%
12	Korea, Rep.	10.73	8.91	8.71	1,014	0.86%
13	Vietnam	6.81	6.02	8.26	106	7.76%
14	Egypt	8.69	7.15	7.73	219	3.53%
15	Poland	10.45	8.13	7.61	469	1.62%
16	Lebanon	7.18	7.56	7.56	39	19.38%
17	UK	7.86	7.25	7.53	2,138	0.35%
18	Indonesia	6.79	6.79	6.92	707	0.98%
19	Italy	5.55	5.22	6.80	2,061	0.33%
20	Morocco	6.90	6.27	6.42	91	7.07%

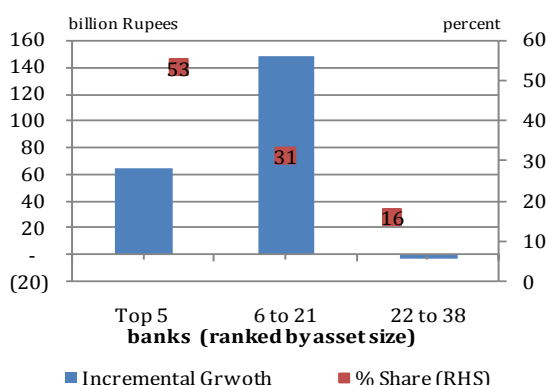
Source: World Bank

Among other factors, workers' foreign remittances (**Figure 1.14**) supported increase in banking sector deposits, thanks to joint efforts of SBP, Ministry of Finance, and Ministry of Overseas Pakistanis for developing an effective network through Pakistan Remittance Initiative (PRI). These efforts improved Pakistan's standing in global ranking in receipt of worker remittance, as World Bank's report/data reveals that in 2010 Pakistan ranked eleventh in terms of receipt of the worker remittances (**Table 1.3**). Besides strong growth in the quantum of foreign remittances, Pak rupee depreciation of 4.6 percent in H2-CY11 led to a strong growth in foreign currency deposits. Currency wise break-up of deposits show that foreign exchange deposit contributed almost 28 percent of the increase in deposits base which augmented their share in overall deposits to 13.5 percent from 12.9 percent in first half.

¹⁶ The large deposits mainly comprise corporate clients, Government or other institutional accounts.

Figure 1.15

Banks' contribution in Deposit Generation



Mid-sized banks outperformed the large banks in terms of customer deposit mobilization

During the period under review, mid-sized banks (6th to 21st in assets size representing 41 percent of the banking sector) contributed a major part in customer deposit collection and generated 70 percent of overall deposit flows of Rs.207 billion (**Figure 1.15**), while remaining deposits were mostly raised by the top five banks (53 percent share). Although the current deposit saw a marginal withdrawal in H2-CY11, the mid-sized banks managed to add fresh current deposits of Rs.36 billion. This dominating performance of mid-sized banks in mobilizing funds is an encouraging sign advocating the enhanced degree of competitiveness in the industry in terms of resource mobilization, and provision of efficient services. Further, the higher deposit generation also indicates the growing degree of customer trust on these institutions.

Liquidity strain pushed up the interbank borrowing

The share of banks' borrowing from financial institutions generally remains within the range of 8-10 percent of total liabilities and shows a transitory nature reflecting general liquidity conditions in the banking system. The period under review witnessed greater activity in these borrowings (Rs113 billion or 25 percent of liabilities increase) that was much higher than the normal threshold band. The major portion of banks' borrowing came from SBP under repo facility-generally availed to meet the short-term liquidity requirements. The stressed liquidity conditions and low deposit growth actually compelled banks to enhance borrowings from financial institutions.