

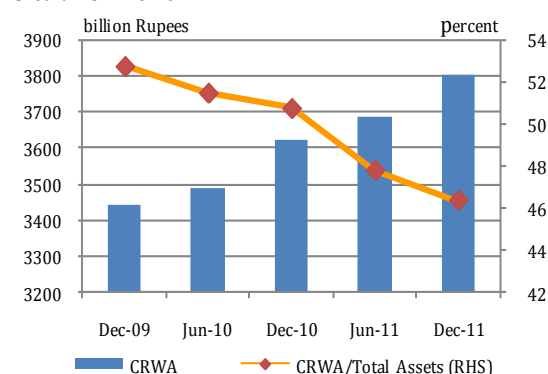
*Risk profile of the banking system offered a mixed picture. Despite tighter credit conditions and insatiate craving of banks to invest in government securities, the credit risk continues to be the dominant component of the risk profile of the banking sector. Although, NPLs marginally rise and PSCBs and mid-sized LPBs appear more prone to the credit risk, yet the credit risk remains manageable due to adequate provisions. Banks' liquidity profile strengthened by accumulation of government securities while growing share of term deposits in the funding mix kept the funding risk at bay. Despite some turbulence in financial markets, the market risk in the banking sector remains contained and managed.*

### Credit Risk

*Further tightening of credit conditions may be harmful*

**Figure 2.1**

Credit Risk Profile



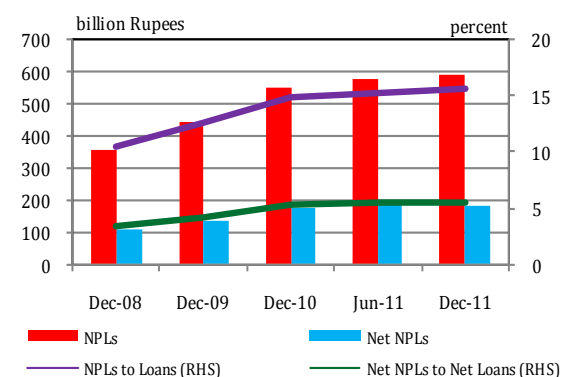
During H2-CY11, gross loans of the banking sector contracted by Rs17 billion. Besides low demand from the private sector, the credit conditions in Pakistan appear to be tightened as evident from the decreasing credit risk weighted assets (CRWA) to total assets ratio (**Figure 2.1**). Any further tightening of credit conditions could intensify the adverse feedback loop of weak macroeconomic activity, which could ultimately harm the resilience of the financial system as well. Consequently, the pass through of the recent hike in the floor on saving products by 100 basis points to the lending rates and its impact on the demand for credit requires vigilant monitoring.

### Credit risk dominates the risk profile despite cautious lending

Credit risk emanating from the loan portfolio of the banks remain the most significant and immediate threat to the financial stability of the banking sector. Despite credit contraction and recent trend of banks to park bulk of their incremental funds in safer assets, the credit risk remains the dominant component in the risk profile of the banking sector and has intensified since H1-CY11. During H2-CY11, in absolute terms the credit risk weighted assets (CRWA) grew by 3 percent or Rs. 118 billion (**Figure 2.1**). However, a much robust growth in assets (6 percent) on the back of investments in government papers markedly outpaced the relatively slower growth in CRWA. As a result, ratio of CRWA to total assets further regressed by 1.4 percent, dropping to 46.35 percent by the end of December 2011. However, falling CRWA to total assets over the last few years is not an indicator of lower credit risk; rather it simply suggests a strong flight to quality amid high NPLs. Banks have tried to manage higher infections by tightening their credit standards, and significantly restricting

**Figure 2.2**

Trends in Non Performing Loans



their lending to riskier sectors (eg: SMEs & Consumer). At the same time, banks have liberally increased their investments in government debt.

### *Non performance on loans elevate marginally...*

The adverse economic outlook and structural deficiencies in the economy continue to take their toll on the debt repayment capacity of the borrowers. In line with the theoretical prediction, the deterioration in economic indicators as measured by a faltering GDP growth rate has led to growth in NPLs. During H2-CY11, NPLs of the banking sector marginally increased from 15.3 to 15.7 percent, with the addition of another Rs12.4 billion to infected assets (**Figure 2.2**). Compared to a rise of Rs31.4 billion in NPLs during H1-CY11 the accumulation in NPLs is relatively lower in the half year under review. The reasons for the slowdown in the buildup of NPLs is due to rising investments in government securities and efforts made by banks to reschedule/restructure infected loans.

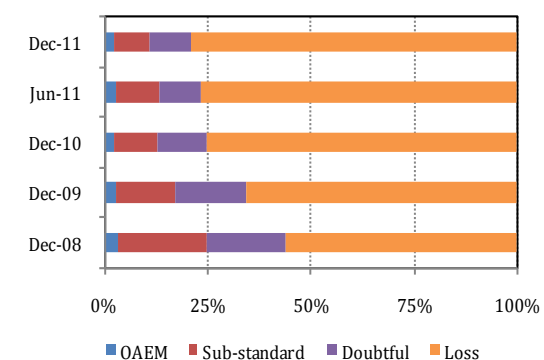
### *...with the bulk of NPLs classified in the loss category*

During H2-CY11, NPLs classified as *Loss* increased by another Rs24 billion due to ageing of previously classified loans and direct additions in this category. The addition in this category was about Rs31 billion during the first half of the calendar year. While there are some signs of deceleration of NPLs in *Loss* category, turnaround in NPLs growth is still out of sight. During H2-CY11, increase in loss category was the most significant compared to all other categories which actually witnessed a decrease. Given that about 79 percent of the NPLs of the banking sector are still classified in the loss category, recovery of these infected assets requires significant efforts by banks<sup>17</sup> (**Figure 2.3**).

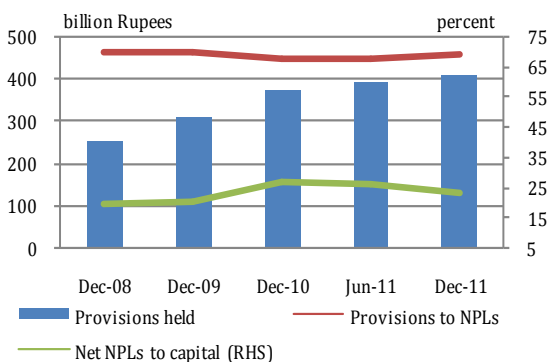
### *... yet, adequate provisioning keeps the risks covered and credit risk remains manageable*

The credit portfolio of banks appears to be adequately covered against anticipated losses. Provisions held increased by Rs17 billion during H2-CY11 corresponding to a 4 percent increase during the half year. The NPL coverage ratio (provisions to NPLs) of banks stood at 69.31 percent as of end December, 2011 up from 67.9 percent in as of end June, 2011 (**Figure**

**Figure 2.3**  
Category-wise Break-up of NPLs



**Figure 2.4**  
Provisions against NPLs



<sup>17</sup> Notwithstanding lower chances of recovery, these assets would not dent banks balance sheet any further, given that banks have made suitable provisions.

**2.4).** SBP allow banks to avail the benefit of forced sale value (FSV) of the securities held against advances to calculate required provisions. Although, the FSV benefit decreases their provisioning requirements and improves their bottom line, yet, to mitigate the associated moral hazard, banks are not allowed to pay cash or stock dividend from the increased profitability resulting from the benefit. Had this benefit not available, banks would have needed to make additional provisions of over Rs20 billion during CY11 (Rs33 billion on cumulative basis including additional provisions required for previous years).

The stress testing results of the credit exposures suggest that severe credit shocks may bring some banks under stress, however, the CAR of the banking system as a whole remains above minimum requirements.

#### *PSCBs and mid-sized LPBs appear more vulnerable to credit risk*

During the period under review, the increase in NPLs was largely distributed as most of the banks experienced an increase in NPLs whereas, only a handful of banks managed to decrease their NPLs.

Breakup of NPLs in terms of various banking groups reveals that both Public Sector Commercial Banks (PSCBs) and mid-sized LPBs (ranked 11-20 on the basis of total assets) had significantly higher infection ratios than the industry averages suggest heightened level of vulnerabilities of these groups against credit risk (**Table 2.1 & 2.2**). At group level, the infection ratio of PSCBs marginally decreased; however, there were significant differences within-group as sharp increase in the NPLs of one of the PSCBs was clouded by a more than offsetting decrease in the NPLs of another PSCB. Specialized banks have chronically high level of NPLs; structural changes including write-offs of unrecoverable loans are needed in this group of banks to arrest the prevailing situation.

**Table 2.1: Asset Quality by Bank Category**

	in percent				
	Jun-11	Dec-11			
	Infection Ratio	Infection Ratio	Net Infection Ratio	Provision Coverage	Net NPLs to Capital
PSCBs	21.5	21.1	10.1	58.2	41.8
LPBs	13.2	13.8	3.9	74.6	17.1
FBs	9.0	10.4	1.2	89.3	1.9
CBs	<b>14.8</b>	<b>15.3</b>	<b>5.1</b>	<b>69.9</b>	<b>21.6</b>
SBs	31.1	30.1	14.9	59.1	175.0
<b>All banks</b>	<b>15.3</b>	<b>15.7</b>	<b>5.4</b>	<b>69.3</b>	<b>23.1</b>

**Table 2.2: Asset Quality by Bank Size**

	in percent				
	Jun-11	Dec-11			
	Infection Ratio	Infection Ratio	Net Infection Ratio	Provision Coverage	Net NPLs to Capital
Top 5 banks	12.9	12.9	2.6	81.8	10.3
6-10 banks	11.3	12.0	3.2	75.8	17.2
11-20 banks	25.6	26.2	14.8	51.0	77.0
21-30 banks	15.9	13.4	6.7	53.8	17.4
<b>All banks</b>	<b>15.3</b>	<b>15.7</b>	<b>5.4</b>	<b>69.3</b>	<b>23.1</b>

The changes in the infection ratios of banks ranked 11-20 and 21-30 during the period under review is mainly because of movement of banks from one size group to the other. The higher infection ratios of mid-sized LPBs are reflective of their limited choice in attracting quality borrowers. Primarily, it is the large sized banks that have better outreach and access to low cost deposits, which allows them to attract more creditworthy borrowers by charging lower rates (**Table 2.2**). Going forward, if the economic performance continues to be

lackluster, the infected portfolio of these groups is likely to surge further.

#### *Textile sector's growing infection aggravates concentration risk*

Among the corporate sector, the infection ratio of textile and cement sectors is much higher than overall infection ratio. The persistent energy crisis is one of the main causes of high level of NPLs in both of these sectors. The continuing energy crisis forced the cement and textile industries to operate below capacity for over half of the year, which has crippled these industries and induced default on loans. Sharp increase in the input cost, bulk of which is the energy cost, further aggravated the situation for the cement industry.

Banks have significant exposure to textile sector. With around 18 percent share in aggregate loans of the banking sector, textile sector is the leading user of bank credit (**Table 2.3**). Though banks' significantly large exposure is understandable, given the share of textile sector in GDP and exports<sup>18</sup>, yet concentration of credit to this sector may pose threat of systemic risk and thus warrants a close watch. Owing to the large exposure, even small deterioration in the asset quality of textile sector can have serious implications for the solvency of some banks. This concentration becomes more critical given that textile sector already has a significantly higher infection ratio, which has further deteriorated to 27.9 percent during the half year under review. The stress tests show that an increase in the NPL ratio equivalent to maximum quarterly increase during the last three years would wipe out Rs48 billion of the banks' capital and would lower the Capital Adequacy Ratio by 64 basis points.

Energy sector, agribusiness and financing to individuals are other segments that are amongst large users of the bank credit and need to be monitored carefully for early warning signs of a major deterioration. During the period under review the infection ratio of agribusiness surged from 7.3 percent to 11.7 percent mainly inflicted by the torrential rains and floods during 2010 and 2011. The quantum of non-performing loans actually decreased in the sugar sector, however, infection ratio deteriorated because the reduction of loans to the sector outpaced the reduction in NPLs.

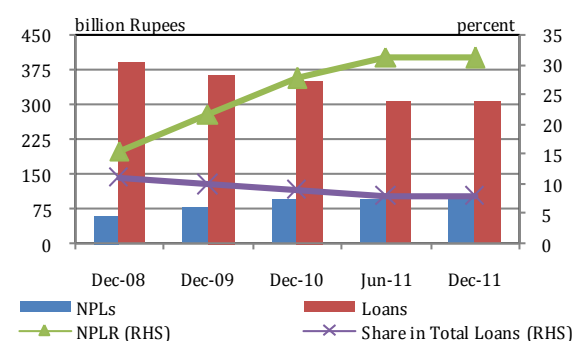
**Table 2.3: Credit and Infection Ratios by Sector**

	Share in Loans	in percent	
		Jun-11	Dec-11
Textile	18.2	26.8	27.9
Individuals	9.0	17.2	15.9
Energy	10.0	4.5	3.9
Agribusiness	8.2	7.3	11.7
Chemical & Pharma	4.0	8.6	9.1
Sugar	2.2	11.2	14.3
Cement	2.2	23.1	23.3
Others	46.1	13.9	15.0
<b>Total</b>	<b>100.0</b>	<b>15.3</b>	<b>16.2</b>

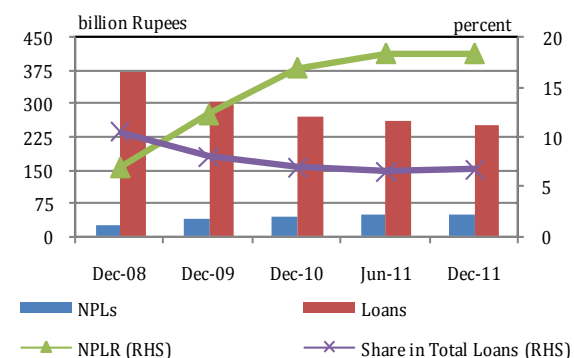
<sup>18</sup> The share of textiles in total exports accounted for over 55.6 percent during FY11 and its share in Large Scale Manufacturing is 32.6 percent.

**Figure 2.5**

Trends in SME Financing

**Figure 2.6**

Trends in Consumer Financing

**Table 2.4: NPL Ratio of Consumer Financing**

(Private sector only)	in percent		
	Share	Jun-11	Dec-11
Credit cards	9.34	21.12	20.50
Auto loans	20.52	9.45	9.71
Consumer durable	0.05	15.56	72.85
Mortgage loans	24.77	26.60	28.22
Other personal loans	45.32	16.63	16.33
<b>Total</b>	<b>100</b>	<b>18.04</b>	<b>18.34</b>

*SME and consumer finance don't show any significant signs of improvement...*

Credit to SMEs, which was persistently receding over the last three years, showed some signs of resistance to further decline. During H2-CY11, the credit to SMEs increased by a trivial amount of Rs1.7 billion. This increase in credit to SMEs came along with half a billion rupees decline in NPLs of the segment (**Figure 2.5**). This recent check on the dwindling credit to SMEs is a healthy sign, however, the decrease in credit for fixed investment and decrease in the number of borrowers in this segment by 26,000 or 13 percent is worrisome because SMEs employ a large proportion of labor force and non-availability of credit to SMEs may trigger more defaults and may have serious economic and social repercussions.

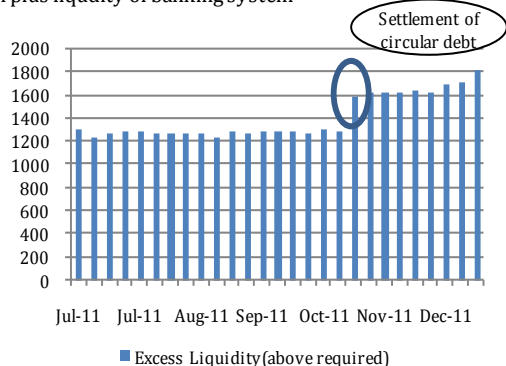
During H2-CY11, infection ratio for consumer finance inched up to 18.34 percent, prompting banks to further cut back their exposure. Consequently, the banks reduced their aggregate consumer financing by another Rs7 billion (**Figure 2.6**). The mortgage loans that makes up 25 percent of the total consumer financing suffers with infection rate of 28 percent .. The high level of default in this segment is due to the stagnant real estate prices coupled with high inflation-high interest rate conditions that make it difficult for borrowers to pay installments on variable rate loans taken during the low inflation – low interest rate times. The infection ratio in financing against consumer durables increased sharply during H2-CY11 to 73 percent and seemingly looks alarming. However, the high infection ratio is caused by a sharp reduction in the financing in this segment that decreased by almost 80 percent (**Table 2.4**). The number of borrowers availing consumer financing also decreased by over one hundred thousand or five percent during H2-CY11. Banks' growing reluctance for consumer finance, while understandable amid high infection ratios, is likely to affect the already lower level of access of households to bank credit. However, unless macroeconomic conditions improve significantly, banks are unlikely to resume interest in this segment soon.

*Volume of pending litigations adds to the banks' woes*

During H2-CY11, banks were able to recover Rs19 billion against the non-performing loans that constitute only 3 percent of the total non-performing portfolio of the banks. Banks are exposed to the risk of non recovery or late recovery of non-performing loans because of huge backlog of cases

**Figure 2.7**

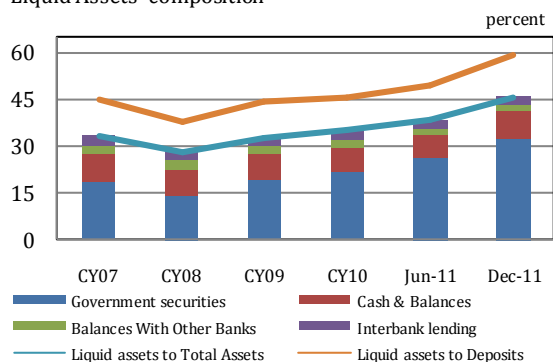
Surplus liquidity of banking system



pending with the courts that intensifies this risk. The volume of the backlog of pending cases is a lot more than the processing capacity of the concerned courts. According to the available records, over 56,000 recovery suits were pending with courts and banking tribunals during the first quarter of 2011. These cases jointly involve more than Rs200 billion of litigated amount. Over 14,000 of these cases are pending for more than 10 years. The relatively limited size and operational capacity of judiciary compared to the huge backlog of pending cases slows down the litigation process and it not only delays the recovery of the defaulted amount but also provides incentives to the borrowers to default on their commitments.

**Figure 2.8**

Liquid Assets' composition



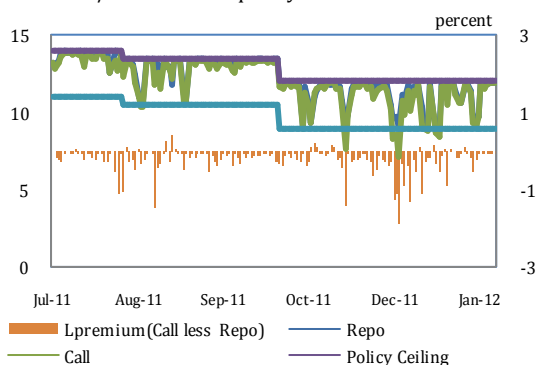
### Liquidity Risk:

*Statutory liquidity indicators exhibit a comfortable position on the back of rising investments...*

Banks continues to exhibit comfortable liquidity position attributable to consistent flow of deposits, though at decelerated pace, into investment portfolio. During the period under review, the level of liquidity maintained by the banking system surged to 64 percent of the time and demand liabilities (TDL) up from 53 percent in Jun-11 (against statutory requirements of 24 percent), with a major increase provided by one off settlements of inter-corporate circular debt (**Figure 2.7**).

**Figure 2.9**

Trends in O/N rates and Liquidity Premium

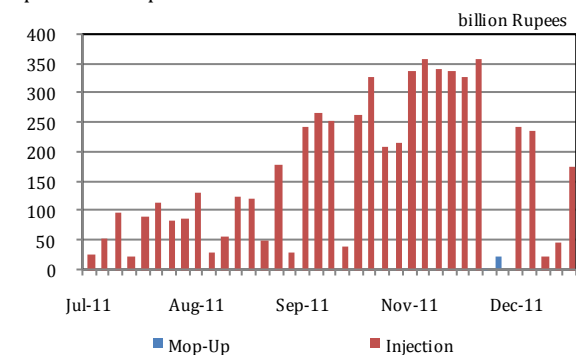


With banks' burgeoning exposure to government debt, various liquidity ratios surged over the half year; share of liquid assets in total assets increased from 38.2 to 45.5 percent (**Figure 2.8**), while liquid assets to deposits ratio reached 59.5 percent up by 10 percentage points. The improvement in liquidity condition is observable across the banking industry, as all banks had liquid assets to total assets ratio above 10 percent.

Similarly, growth in deposits and decline in advances portfolio brought about further improvement in the advances to deposits ratio (ADR); it declined to 54 percent by Dec-11, from 56.7 percent in June-11. Improved ADR though provides supports to enhanced liquidity of the system: its declining trend indicates the undesirable deleveraging of private sector credit.

**Figure 2.10**

Open Market Operations



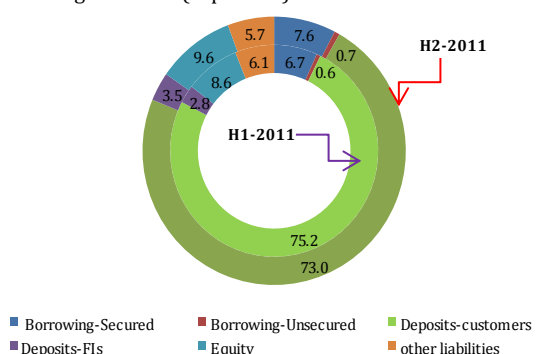
...though overnight market was strained due to uncertainty regarding cash flows

However, short-term liquidity remained somewhat strained during H2-CY11; with overnight rates remaining high and volatile (**Figure 2.9**). The higher volatility could be explained by more than anticipated Government borrowings from banking sector, continued decline in foreign financial flows, heavy oil payments and seasonal factors. This strain led SBP to make substantial net injections into the banking system (**Figure 2.10**), which is perceived as indirect monetization of fiscal deficit.

*Marginal shift in funding structure...*

**Figure 2.11**

Funding structure (in percent)



Banks' funding structure saw a marginal shift over the period under review mainly on account of surge in borrowing by 20 percent and sluggish 4.7 percent growth in deposits. As a result share of borrowing inched up to 8 percent, while the share of customer deposits declined marginally (**Figure 2.11**). Analysis of borrowing re-confirm the increased activity in repo borrowing (increase of 118 percent), to meet the short term cash requirements in relatively strained liquidity condition and low deposit growth.

*Visible growth of longer tenor deposits further shifted the maturity profile....*

**Figure 2.12**

Maturity Profile of Deposits



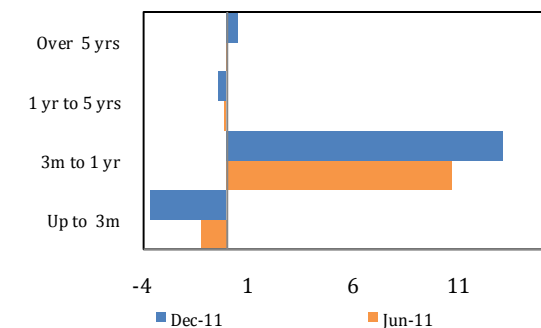
Maturity profile of the deposits continued the trend observed in the first half of the year. However, the period under review saw a shift in growth pattern of various deposit types; most of the increase was contributed by saving and fixed deposits, while current account deposits saw a negligible decline. As a result the share of deposits of one year and above sharply increased over the period to 47 percent from 39.4 percent (**Figure 2.12**). On the other hand, the share of deposits of less than one year registered further decline during the period under review, mainly on account of stagnant current deposits and SBP's revised instructions to report non-contractual deposits on the basis of their behavior<sup>19</sup>.

<sup>19</sup> This gap is mainly attributed to banks' adjustment to place demand deposits (the non-contractual liabilities which have a significant share in total liabilities) from 3-month bucket to longer time bucket based on their expected maturity after issuance of latest instruction in BSD circular letter no. 3 of 2011.



**Figure 2.13**

Maturity Gap (Assets-Liabilities) as percent of Assets

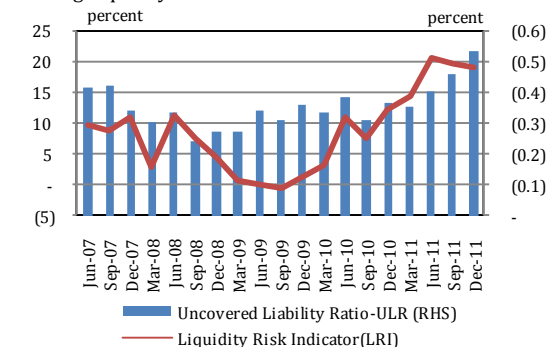


*Continuing positive maturity gap in short tenor buckets: an indication of re-pricing risk*

Tenor wise maturity gaps also observed some shift due to increase in short and medium term investments, in addition to changes in maturity profile of deposits. During H2-CY11, the gap between assets and liabilities increased to 13.06 percent for 3-months to 1-year time buckets (**Figure 2.13**). These shifts can be explained by substantial increase of investments in MTBs maturing within 3 months to 1 year. While the change in gaps of less than one year is a positive development in terms of short term liquidity risk management, it also reveals an increasing share of investments in banks' total assets. However, this trend can expose banks to reinvestment risk in a declining interest rate scenario.

**Figure 2.14**

Funding Liquidity Risk Indicators



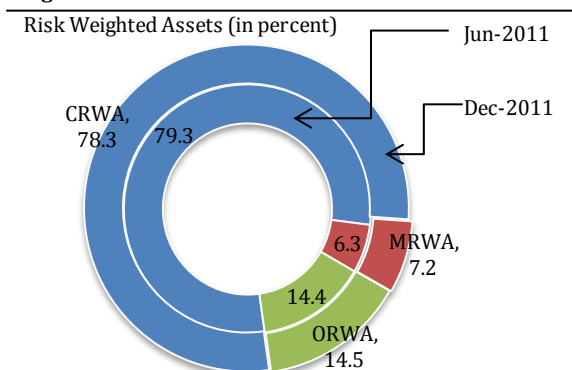
As Government securities continue to amplify in overall investment portfolio, the Uncovered Liability Ratio (ULR), showed further improvement in overall coverage of the liabilities (**Figure 2.14**). Similarly, Liquidity Risk Indicator (LRI) which measures the short term liquidity gap calculated for 30 day horizon indicates lower funding risk on the back of changing pattern of deposit mix towards longer tenor deposits (**Figure 2.14**). Positive results of both these indicators bode well for overall comfortable liquidity position in market.

*Banks exhibit resilience against liquidity shocks for 5 days and 30 days time period*

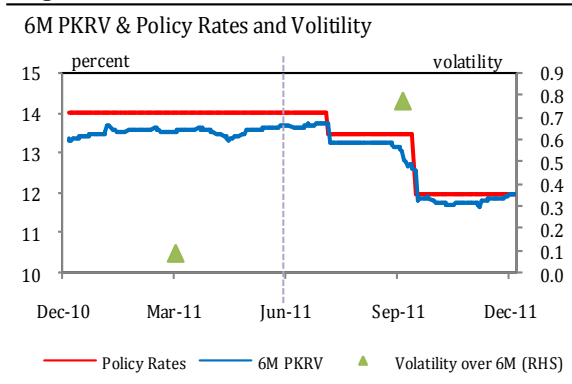
Stress testing results complement overall liquidity picture in the banking industry, as banks are found resilient to different liquidity shocks including withdrawal of customer deposits, whole sale deposits and shocks to recently introduced Basel III liquidity coverage ratio (LCR). Even a shock of 20 percent fall in the value of government securities would marginally reduce the post-shock LCR to 7.21, significantly higher than the minimum required level of '1' defined under Basel III. The liquidity coverage is quite broad based as no bank has LCR below 2 after this shock.



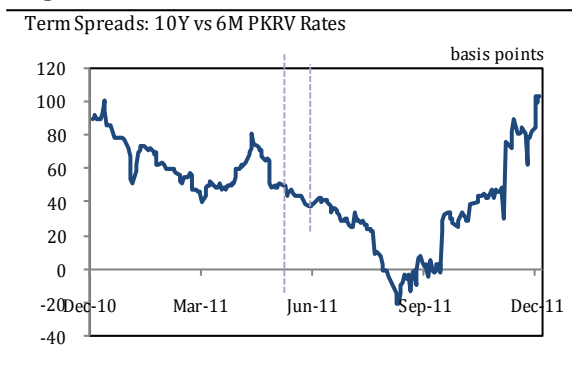
**Figure 2.15**



**Figure 2.16**



**Figure 2.17**



## Market Risk

### Market risk remains trivial under current measurement methods

The recent financial crisis highlighted the importance of market risk as a lot of variation in the asset prices was related to the market risk factors<sup>20</sup>. The mounting levels of uncertainty caused by concerns over the government's fiscal worries, mounting public debt and looming negative economic growth prospects seem to have affected the market sentiments. However, despite sizeable level of volatility in the domestic financial markets during the period under review, the contribution of market risk remains trivial in the overall risk profile of banks when measured in terms of current practices of calculating risk-weighted assets<sup>21</sup>. Market risk weighted assets (MRWA) constitute about 7 percent of the total risk weighted assets of the banking sector and the market risk remained contained partly due to prudent limits imposed by SBP on banks for taking market related risks. The marginal increase in the proportion of MRWA was on account of disproportional increase in investments in federal government securities relative to the increase in the private sector credit (Figure 2.15).

### Volatility increases in money market with a downward shift in the yield curve

During the period under review (H2-CY11), the money markets remained relatively more volatile compared to previous half year (H1-CY11). Higher volatility, an indication of the uncertainty and liquidity pressures, is a usual phenomenon when significant monetary policy announcements are expected or made and was triggered due to changes in SBP's monetary policy stance during H2-CY11. A decline in inflation and the need to boost private sector credit prompted SBP to ease the monetary policy stance; SBP responded by slashing the policy rates by 200 basis points in two episodes during H2-CY11 (Figure 2.16).

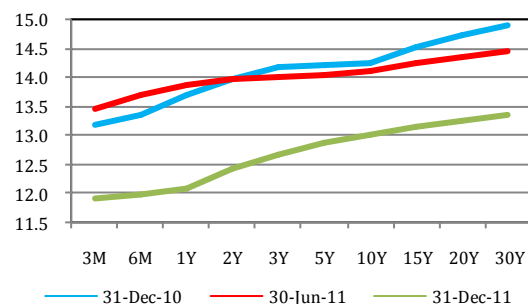
The term spread between 10 year and 6 month PKRV rates that was dwindling since May 2011 became negative in September 2011, signaling concerns of market over long term

<sup>20</sup> Berg, T. (2010), "The term structure of risk premia: new evidence from the financial crisis", European Centre Bank working paper series, No. 1165, Frankfurt.

<sup>21</sup> Throughout this section, risk weighted assets (RWA) are limited to RWA under Pillar-1 of Basel II capital accord, that is, interest rate risk in banking book is explicitly excluded from the analysis.

**Figure 2.18**

Yield Curves



economic outlook, growth and demand for long term funding. However, the term spread started to increase in September 2011 and took off following the 150 basis points cut in policy rates in October 2011. By the end December 2011 the term spread was 103 basis points (**Figure 2.17**). Consequently, besides a downward shift, the yield curve also steepened during the review period (**Figure 2.18**). The steepening of yield curve signals short term availability of liquidity along with higher inflation expectation and an overall reassurance about long term economic outlook, growth and demand for long term funding.

#### .....exposing banks to yield risk

During H2-CY11, the gap in RSA and RSL varied substantially across different time buckets, with banks continuing to face yield risk. However, the sharpening of yield curve during H2-CY11 has been less material for the banks as the yield curve swiveled around 3 year maturity (**Figure 2.18**), whereas banks have most of the positive gap in up to 1 year maturity (**Figure 2.19**). The positive gap in this time bucket is reflective of the banks' increasing exposure in the short term government securities and circular debt financing.

**Figure 2.19**

Gap (RSA-RSL) to Asset Ratio

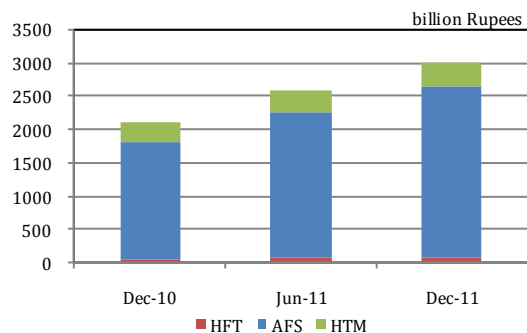


#### The rate sensitive gap sporadically exceeds the acceptable bounds

In banks a certain degree of gap between rate sensitive assets (RSA) and rate sensitive liabilities (RSL) is inevitable; generally a gap to asset ratio of +/- 10 percent is considered within tolerable range. During the period under review, the banks were able to effectively manage re-pricing risk as gap to asset ratio of the banking sector remained within to the acceptable limits in most of the time buckets. However, in 6-month to 1-year time bucket the gap between RSA and RSL was 11.5 percent of total assets, that is somewhat beyond the generally acceptable limits, exposing banks to a interest rate risk in decreasing interest rate scenario (**Figure 2.19**).

**Figure 2.20**

Classification of Investment

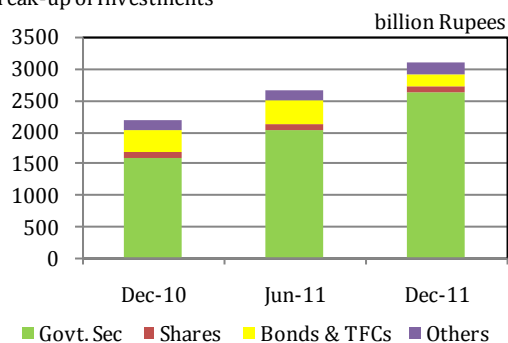


#### AFS classification restricts the bottom line benefiting from revaluation gains

During H2-CY11, banks continued with their strategy of classifying lion's share of their investments in the Available for Sale (AFS) category, with only small proportions in Held for Trading (HFT), Held to Maturity (HTM) and Strategic investment categories (**Figure 2.20**). As of 31<sup>st</sup> December 2011, less than 3 percent of the investment portfolio was

**Figure 2.21**

Break-up of Investments



classified as HFT whereas about 84 percent was held in AFS category, including substantial holdings of government securities (**Figure 2.21**). Following cut in policy rates, banks booked revaluation gains of Rs11.7 billion during CY-11. These gains were partially offset by revaluation deficit of Rs8.5 billion on shares and other investments. The revaluation gains / losses on AFS category are directly taken to the balance sheet without affecting the income statement; therefore, despite the net revaluation gains, the affect was not transferred to the income statement.

### *Stock market performance remained dismal....*

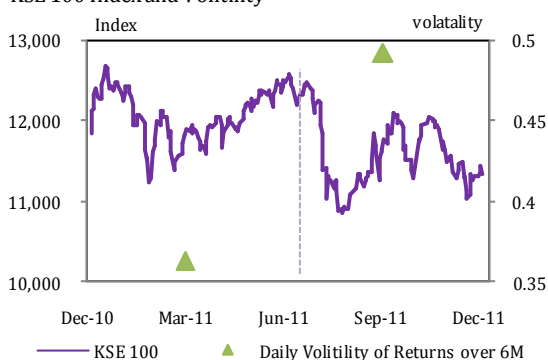
The soft rebound in equity prices that was witnessed in H1-CY11 appears to have come to an end during the period under review as during H2-CY11 the capital market functioning has deteriorated and equity prices have fallen sharply. During this period, KSE 100 index showed dismal performance. The index followed a general downward trend with some bouts of positive returns. The KSE 100 index closed at 11,347 points registering a loss of 5.6 percent during the half year and a loss of 9.2 percent during CY11 (**Figure 2.22**). During H2-CY11, the stock market volatility<sup>22</sup> increased as compared to H1-CY11, reflecting an increase in uncertainty amongst investors.

### *....while modest equity positions insulate banks from swings in stock prices*

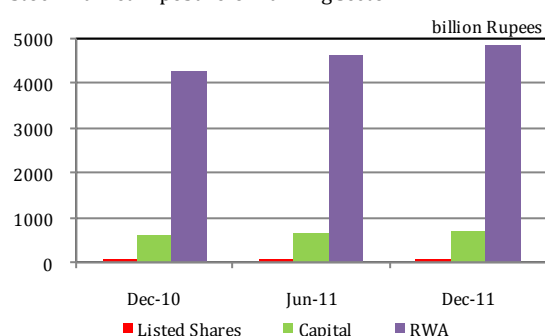
SBP has strict limits on the banks' exposure to the stock market. Banks are required to limit their stock market exposures to maximum of 20 percent of their own equity. Consequently banks' exposure to the stock market remains trivial. At the end of H2-CY11, banks had Rs91 billion in the stock market which constitutes a meager 1.5 percent of their total asset base and 3.2 percent of their investment portfolio (**Figure 2.23**). This relatively small exposure means that even big swings in the equity prices are not going to affect banks' profitability or solvency. Therefore, despite sharp decrease in equity prices, banks were able to weather the revaluation losses of Rs5.5 billion incurred on their stock market investments. Due to the limited exposure to stock market, banks can absorb even more severe decline in the stock prices; sensitivity analysis shows that if the prices of all listed shares drop by 50%, the CAR of the banks will decrease by only 76 basis points (see Chapter 3 for details).

**Figure 2.22**

KSE 100 Index and Volatility

**Figure 2.23**

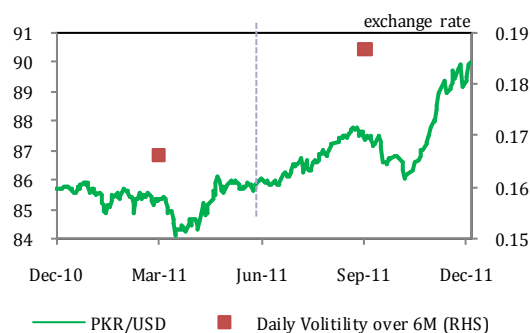
Stock Market Exposure of Banking Sector



<sup>22</sup> Volatility is calculated as daily standard deviation of KSE 100 Index returns over six- month period.

**Figure 2.24**

Evolution of PKR/USD Exchange Rates



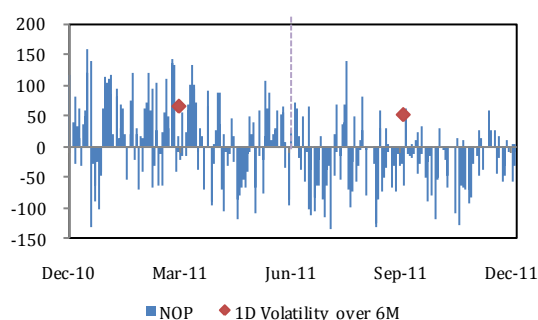
Other than the direct hit to the banks' health, a fall in equity prices also reduces the value of collateral which borrowers use against their borrowings, thereby diminishing the borrowers' ability to obtain loans and thus adding to the pro-cyclical pressures. For Pakistani banks, the effect of lost collateral value is, however, expected to remain small as the total volume of loans obtained from the banking system against shares as collateral was about Rs25 billion or less than 1 percent of the total loan portfolio.

*Healthy home remittances contained depreciation of PKR and NOP remains within manageable bounds*

During the period under review, Pakistan received a record USD 6.3 billion in home remittances, registering an improvement of 7 percent over the first half of 2011. Despite this positive development, PKR depreciated against USD closing at Rs/\$ 89.97<sup>23</sup> on December 30, 2011, thus shedding 3.98 rupees against USD during H2-CY11 and 4.26 rupees since beginning of CY11. The volatility of exchange rate during H2-CY11 was more than that during the first half of CY11 reflecting mounting concerns over growing economic challenges (**Figure 2.24**).

**Figure 2.25**

NOP of All Banks



During the period under review, overall Net Open Position (NOP) of banks remained within the manageable bounds of +/- US\$ 150 million or less than 2 percent of bank's capital. The volatility of NOP during the period was slightly more than that during H2-CY10; however, deviations from square position were mostly on the short side (**Figure 2.25**). Given, the depreciation of PKR against USD and other major currencies, banks on average would stand to lose from short open positions.

<sup>23</sup> Average of bid and offer exchange rates.