Chapter 1 Assessment of Financial Intermediation

The banking sector witnessed a decent though decelerated asset growth of 5.9 percent primarily funded by accelerated deposit growth and to some extent from equity in H1-CY12. The public sector emerged as dominant user of the bank credit perceptibly to finance energy sector and commodity operations, which helped lifting up the sluggish advances on banking books. Yet the consistently dampening private sector credit demand kept the overall credit growth in check. The soaring capital market activities along with optimistic anticipation of future capital gains attracted banks to invest in equity stock. The strong growth in deposits mainly came from surge in current accounts, saving accounts and short-term fixed deposits. Borrowings from financial institutions declined significantly mainly due to net retirement of repo borrowings.

Figure 1.1

Changes in Banking Assets

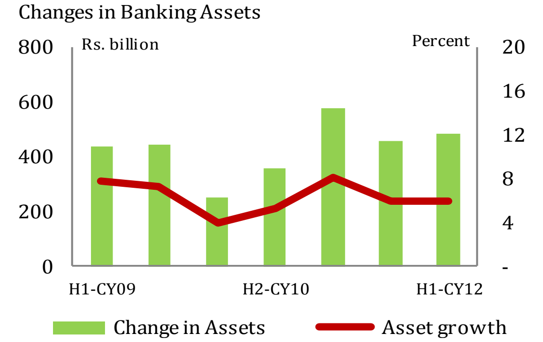


Figure 1.2

Flows in Asset Components (Rs. billion)

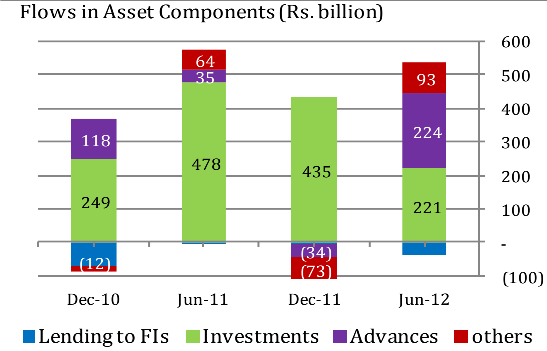
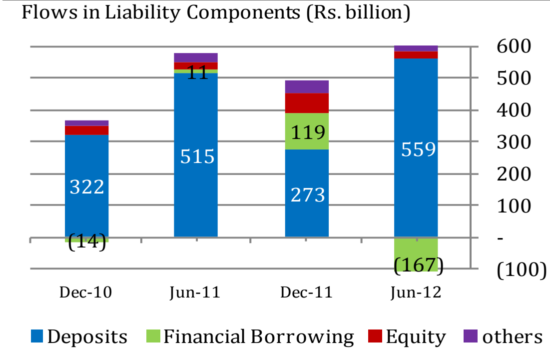


Figure 1.3

Flows in Liability Components (Rs. billion)



Banking sector asset growth led by healthy deposit growth

Well aligned with the dynamics of real economic activity and established seasonal pattern, healthy 9.0 percent increase in deposits facilitated the 5.9 percent growth in assets during H1-CY12 **(Figure 1.1)**. Unlike the past few years, expansion in assets was relatively broad based and shared by both advances and investments. Accordingly, asset mix of the banking system, with some marginal changes, remained the same **(Figure 1.2).**

PSEs remained the dominant user of funds…

As against the last year, increased demand for financing from PSEs lifted the sluggish advances; PSEs remained the dominant user of loans mostly to finance imperative energy sector and seasonal commodity operations. Similarly, majority of the growth in investments took place in listed shares and other investments, an outcome of improved equity market indices, while investment in government papers saw a moderate increase in H1-CY12.

…while private sector credit dipped due to both supply and demand side factors

The private sector advances, which have remained subdued for last few years, observed retirement of 1.9 percent in the first half of CY12. The supply of funds to private sector declined as Government borrowed heavily from the banking sector for budgetary support during the last few years to finance the increasingly rising fiscal deficit. This along with the sternness and persistence of ongoing economic slowdown over the last few years also affected demand for private sector credit. This outcome was not surprising given lackluster performance of the real sector, which persistently faced widening energy shortages, fragile law and order conditions, and rising local and geo political

Figure 1.4

Trend in ADR & IDR (percent)

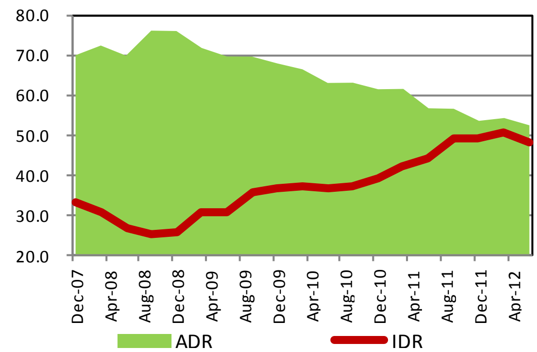
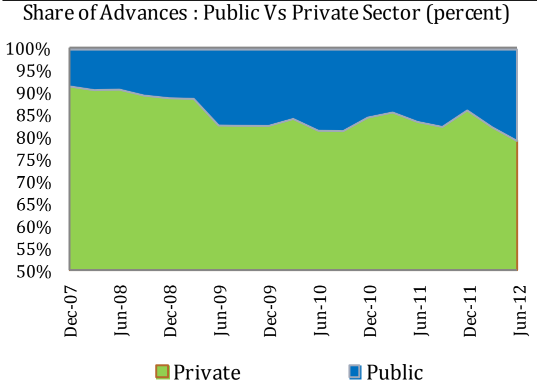


Table 1.1: Sector-wise Credit Flows in H1-CY12 (Rs. billion)

	Public Sector	Private Sector
Production/Energy	108.9	4.3
Sugar	2.4	35.9
Agri Business	29.2	9.4
Chemical & Pharmaceuticals	(0.4)	6.8
Financials	1.0	5.5
Cement	-	(17.8)
Shoes & Leather	-	(6.4)
Electronics and Electrical Appliances	-	(5.2)
Textile	-	(48.3)
of which		
Spinning	-	*(18.1)*
Composite	-	*(15.9)*
Weaving	-	*(6.2)*
Others	169.1	(6.7)
Total	**310.2**	**(62.7)**

Figure 1.5

Share of Advances : Public Vs Private Sector (percent)



uncertainties.

Steady deposit growth remained the main funding source …

During H1-CY12, deposits of the banking system registered a healthy increase of 9.0 percent compared to a moderate growth of 4.7 percent in H2-CY11 **(Figure 1.3)**. Though the increase was broad-based, major contribution came from Current Account & Saving Account (CASA) deposits, which jointly shared 82 percent of deposit growth. Among various factors, increase in saving deposit might have resulted from 100 bps increase in minimum rate floor on saving deposit[11] in May 2012. Besides, the decent growth of PKR denominated deposits, PKR value of the Foreign Currency (FCY) deposits increased by 11.1 percent due to continuous depreciation of PKR against USD.

Advances to deposit ratio of the banking sector saw a continuous decline during last five years due to sluggishness in private sector credit. Though the trend persisted during the period under review, rate of decline in ADR subsided due to improved credit disbursements and steady growth in customers' deposits **(Figure 1.4)**. In contrast, investment to deposits ratio (IDR), which almost doubled to 49 percent over the last five years, dipped marginally by 78 bps during the period under review. The decline resulted from a relatively stronger growth in deposits, which outpaced the moderate increase in investments.

In sharp contrast to H2-CY11, bank borrowing saw a hefty retirements to financial institutions including SBP[12] as government increased its reliance on the central bank borrowings particularly in the second quarter of CY12. The equity base of the banking sector inched up by 3.0 percent in H1-CY12 mainly through retention of rising profits.

Increased demand for production and transmission of energy and seasonal demand pushed up the Public Sector advances…

The public sector demand for funds contributed the entire growth of 6.6 percent in gross advances during H1-CY12. The government appetite for banks' funding characterized by rising fiscal deficit and squeezing foreign inflows continued in the period under review. However, the structure of the government borrowings shifted from budgetary needs to increased flow of

[11] Please see BPRD Circular No.1 of 2012.

[12] Please see SBP's Monetary Policy Statement of August 2012.

financing to PSEs for highly imperative production & transmission of energy and seasonal commodity operations **(Table 1.1).** The public sector advances actually surged by 63.0 percent during H1-CY12, which increased its share in total domestic advances to 21.5 percent in June 2012 as against 14.1 percent in Dec-11 **(Figure 1.5).** Though financing to the priority sector appears to be a positive development, yet it may add to floating and permanent government debt as government liquidated similar financing last year through conversion into Government bonds[13].

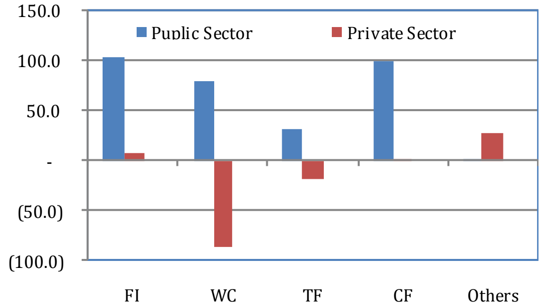
The challenging business environment with unresolved infrastructural issues owing to continuing energy shortages, weak global demand, and banks' continued cautious approach in the wake of heightened credit risk resulted in decline in private sector advances in H1-CY12. On aggregate, private sector advances contracted by 1.9 percent in contrast to 0.5 percent growth in corresponding period last year.

Analysis of end use of advances shows that corporate and SMEs sectors observed a decline in working capital and trade finance **(Figure 1.6).** In addition to a widespread scaling down in business, the receding demand in working capital may be attributed to drop in inflation both on domestic and external fronts. For example, inflation remained below target of 12 percent and Whole Sale Price Index (WPI) reduced from 18.3 percent in Dec 2011 to 10.4 percent in June 2012 **(Figure 1.7).** Similarly, reduction in global commodity prices was observed during June 2011-12 (energy, agriculture, and metal prices fell by 14 percent, 12 percent, and 21 percent respectively[14]). An observed rebuilding in the credit demand for fixed investment perceptibly for the enhancement in capacity building in sugar and other food industries was a welcome sign in H1-CY12 **(Table 1.2).**

Flows to trade finance remained subdued due to challenges on the global front marked by lingering sovereign debt crisis in Euro zone, receding global demand, volatility in oil prices etc. Further, outstanding EFS loans declined due to decrease in cotton prices, SBP's decision to link EFS facility with the overdue proceeds and narrowing gap between EFS rate and market mark up rates.

Figure 1.6

Segment-wise Credit Flows in H1-CY12 (Rs. billion)



FI: Fixed Investment, WC: Working Capital, TF: Trade Finance, CF: Commodity Finance

Figure 1.7

Trend in Inflation (percent)

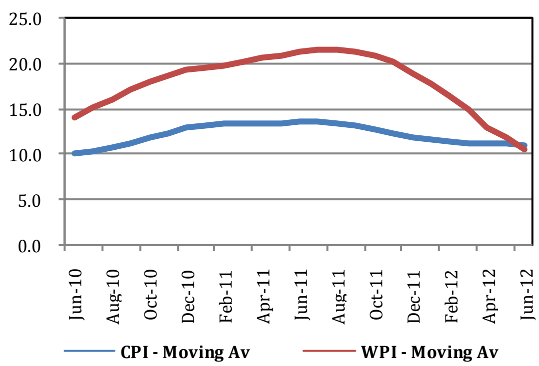


Table 1.2: Fixed Credit Disbursements to Private Sector in H1-CY12 (Rs. billion)	
Food Industry	24.9
of which	
Sugar Industry	*19.2*
Beverages	3.5
Tobacco Industry	2.3
Textile	4.8
Others	0.2
Total	**35.6**

13 Please see Financial Stability Review -2nd Half, 2011.
14 Source: World Bank

Figure 1.8

Public Sector Commodity Finance Break-up

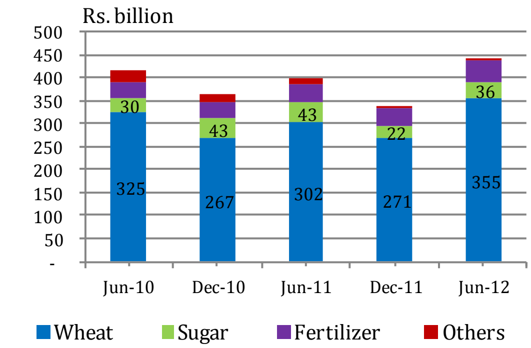
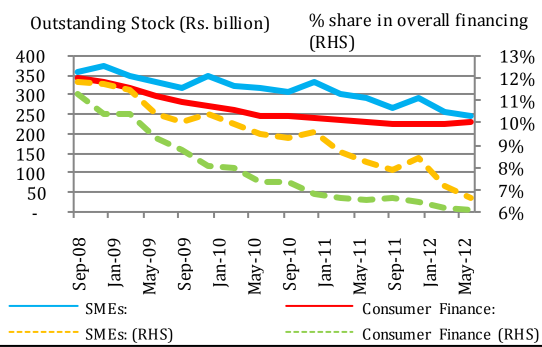


Figure 1.9

SMEs & Consumer Finacne contribution in Financial Intermediation



The credit appetite dropped in various economic sectors **(Table 1.1).** Textile sector, a major contributor to export earning of Pakistan and main user of bank credit in private sector, witnessed a net retirement. This is attributable to lower cotton prices and subdued export performance[15]. Revenues of cement sector improved owing to sharp rise in retail prices of the cement, which led to contraction in demand for working capital loans. However, seasonal credit demand led to improved credit flows to the sugar sector.

The seasonal commodity financing remained high for wheat procurement ...

As highlighted earlier, commodity finance remained one of the key factors behind enhancing the overall advances of the banking system. The seasonal commodity finance jumped by 31 percent in H1-2012 (13 percent in H1-CY11) mainly on account of increase in the wheat support price in November 2011[16] **(Figure 1.8)**. The procurement of fertilizer and Sugar were other key areas of commodity financing. Particularly, financing for fertilizer saw a substantial increase over the last three years due to enhanced imports of Urea, as fertilizer plants remained under utilized because of gas shortages. As a result, share of fertilizer financing reached to 11 percent of the commodity financing in H1-CY12 from about 4 percent in H1-CY09.

The stock of commodity financing surged to historically high levels during the first half of CY12. The rise in this self-liquidating financing can be considered extraordinary in view of the substantial financing cushion created through one-off settlement of Rs78 billions in H2-CY11. The Government borrowings for the commodity financing is expected to increase further in times ahead due to escalating global commodity prices, rise in wheat support price, and continuing shortages in gas supplies. Such a hasty recourse to borrowing may again pose a risk of accumulation of government liabilities.

...while the underserved SMEs and Consumer Finance Sectors plunged further

Over the last few years, banks exercised highly cautious approach in extending new credit facilities to SME sector in wake of deteriorating asset quality. Resultantly, banks' share in

[15] Please see The State of Pakistan's Economy - Third Quarterly Report 2011 – 2012.

[16] The government enhanced the wheat support price from Rs.950/40 kg to Rs.1050/40 kg in November 2011. Moreover, the Economic Coordination Committee (ECC), Government of Pakistan has further raised the support price of wheat to Rs.1200/40kg in November 2012.

Figure 1.10

Deposits-Half Yearly Flows (Rs. billion)

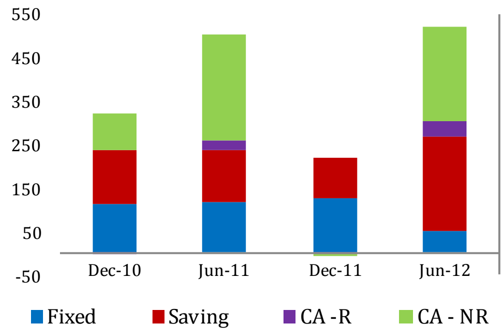


Figure 1.11

Workers' Remittances -cumulative Flows

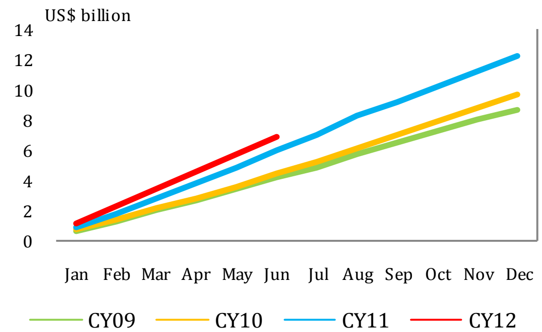


Table 1.3: Flow of Banks' Investment in Govt. Securities (Rs. billion)	H1-CY11	H2-CY11	H1-CY12
MTBs	309	321	27
PIBs	52	198	38
Others	78	118	(7)
Total investment in Govt. Securities	**439**	**637**	**59**
Total Investments	**485**	**435**	**222**
Investment in Govt. Securities to Total Investment (Percent)	*91%*	*147%*	*26%*

outstanding advances to SMEs gradually reduced to 6.6 percent in June 2012 as against 11.7 percent in December 2008 **(Figure 1.9).** In line with the industry trend, reduction in demand for working capital finance led to 15.8 percent (Rs. 46 billion) decline in financing to SMEs.

The situation was also not that encouraging for consumer finance. The financing stayed stagnant, though advances mix observed some shift across various segments in H1-CY12. For instance, banks squeezed credit card, auto, and mortgage financing owing to rising delinquency in these segments. On the contrary, increase in personal loans off-set the dip in other segments, as banks increased efforts to enhance financing to this segment through introducing new products.

More investment in non-government sector and debt instruments…

The budgetary borrowing from the banking sector saw some let up during the period under review[17] as growth in banks' investments in government papers decelerated **(Table 1.3).** The receding investment in government papers was more than off-set by increase in investments in shares and other investments. The improved corporate results and dividends, banks' anticipated decline in interest rate, and soaring stock market indices provided impetus for enhanced investments in equity market.

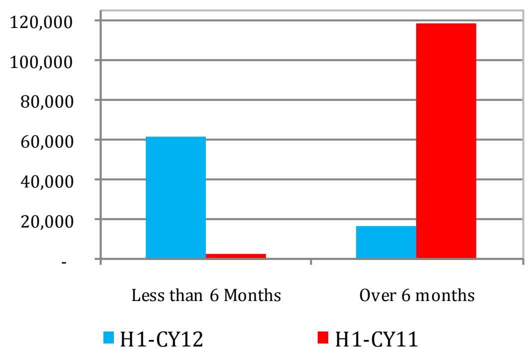
Growth in saving deposits and current deposits accounted for overall deposit growth…

The deposit base of the banking sector observed a strong 9.0 percent growth during H1-CY12 against sluggish increase of 4.7 percent in H2-CY11 (9.4 percent growth in H1-CY11). Major part of the fresh deposits in H1-CY12 was contributed by CASA deposits more so in the second quarter of CY12 **(Figure 1.10).** The driving factors behind the rise in deposits were consistently growing worker remittances and strong growth in Rupee denomination of foreign currency deposits **(Figure 1.11).** FCY deposits observed 11.1 percent growth during H1-CY12 as against a meager growth of 2.4 percent in corresponding period last year[18].

[17] Government found its way to central bank particularly in the second quarter of CY12 due to challenges in raising desirable funds from commercial banks at prevailing interest rates (Monetary Policy Statement, August 2012)
[18] Two factors contributed in FCY deposit growth i.e. (i) 5.2 percent depreciation in PKR against USD, and (ii) growth in the Foreign Currency denominated deposits.

Figure 1.12

Maturity- Wise Flows of Fixed Deposits (Rs. billion)



A closer look at distribution of deposits by category of deposit holders reveals that growth in the deposits of Government and Public Sector Enterprises (PSEs) decelerated in H1-CY12. On the contrary, growth in the deposits of corporate, personal, and Trust Fund & Non-Profit institutions improved in the same period[19].

There seems to be a gradual shift in the growth pattern of deposits from fixed deposits to CASA **(Figure 1.10).** The saving deposits of banking sector recorded a robust growth of 10.2 percent in H1-CY12, while fixed deposits observed a slow down. Interestingly, the maturity pattern of fixed deposit reveal a highly skewed growth; fixed deposits within less than six months maturity grew at 8.9 percent in H1-CY12 in contrast to a significant deceleration in most of long-term deposits **(Figure 1.12).** This phenomenon reflects both banks' marketing efforts to book shorter-term deposits in the backdrop of declining interest rate scenario and depositors' preference for liquidity without jeopardizing some minimum returns.

....while medium and large sized depositors contributed more

Table 1.4: Size-wise Composition of Deposits in H1-CY12

(Rs. billion)

	Outstanding Amount	*% Share*	**Flows in H1-CY12**	*% Share*
0-0.1 Mln	865	*14%*	21	*4%*
0.1 Mln to 1.0 Mln	2,000	*32%*	244	*46%*
1.0 Mln to 10.0 Mln	1,103	*18%*	133	*25%*
10.0 Mln and above	2,252	*36%*	133	*25%*
Total	**6,219**	*100%*	**531**	*100%*

During H1-CY12, medium and large-sized deposits (Rs.0.1 million to Rs.10 million) contributed 71 percent of the increase in deposit, which was considerably higher than their 50 percent share in total deposits **(Table 1.4).**

Banks made hefty retirements to financial institutions…

Table 1.5: Flow of Banks' Borrowing from Financial

(Rs. billion)

	H1-2011	**H2-2011**	**H1-2012**
Secured	**13.3**	**115.3**	**(179.5)**
(i) Borrowings From SBP:	6.0	110.0	(98.7)
of which			
Export Refinance	*(15.4)*	*1.1*	*(26.3)*
Others	*21.4*	*108.9*	*(72.5)*
(ii) Repurchase Agreement (Repo) borrowings	6.3	8.0	(80.3)
(iii) Others	1.0	(2.7)	(0.5)
Unsecured	**(1.9)**	**3.2**	**7.4**
(i) Call borrowings	2.6	(5.5)	9.0
accounts	(0.8)	(2.2)	1.7
(iii) Others	(3.7)	10.9	(3.3)
Total Borrowings	**11.5**	**118.5**	**(172.1)**

The borrowing from financial institutions, the volatile part of funding side, declined in the period under review as government decreased its reliance on borrowings from banks. The relative ease in the market liquidity toward the end of H1-CY12 and healthy deposit growth enabled banks to make net retirement of Rs172 billion to financial institutions as against the net-borrowing of Rs119 billion in previous half **(Table 1.5).** The repayments took place in the category of repo borrowings from both SBP & commercial banks in addition to marginal retirement of SBP's export refinance. Consequently, the share of "borrowing from financial institutions" reduced to 5.9 percent on June 30-2012 from 8.3 percent on December 31-2012.

Equity saw a moderate rise due to rise in profit levels

[19] Source: Statistical Bulletin (December 2012), State Bank of Pakistan

Equity of the banking system, representing 9.3 percent of the assets base, registered a growth of 3.0 percent in H1-CY12 compared to 3.6 percent in H1-CY11. This growth was attributable to accumulation on retained earnings due to improved profitability during the period under review. In addition, due to SBP policy of gradual enhancement in minimum capital requirements, banks enhanced their paid up capital either through bonus or right issues. Consequent to continuous strengthening of capital requirements, share of paid-up capital (i.e. permanent capital) in asset base increased to 5.3 percent in June 2012 from 5 percent in Dec-2011.