Financial Stability — Overview and outlook

The financial sector exhibited a modest growth during H1-CY12, despite uncertainties both at domestic and external front. Notwithstanding, this development, risks to the financial stability marginally increased as financing of twin deficits and unresolved structural issues[1] directly affected the financial sector and exerted pressure on financial markets. The enhanced reliance of the Government on financial sector for meeting the fiscal gap tilted the concentration of financial sector's balance sheet towards the public sector. Private sector credit contracted amid lower than expected economic growth[2] and high credit risk. The operating performance of the financial sector remained steady mainly driven by unprecedented profits of banks. The solvency indicators of banks remained robust though few banks faced challenges in meeting capital requirements. Further, a number of NBFIs continued to pose solvency concerns.

The **financial sector** registered a moderate growth of 6.5 percent during H1-CY12 (Table 1). Though, the growth in assets was broad based, major contributions came from banking sector and mutual funds. The balance sheet of the financial sector exhibited general risk aversion as flow of private sector credit contracted and overall asset quality worsened. The increase in earnings of the banking sector edged up the Return on Assets (ROA) of the system by 11 bps to 1.5 percent during H1-CY12.

Table 1: Assets Composition of the Financial Sector

	CY05	CY06	CY07	CY08	CY09	CY10	CY11	Jun-12
Assets (Rs. Billion)	5,202	6,028	7,117	7,712	8,867	9,655	11,107	11,818
Growth rate (percent)	15.1	14.5	19.4	8.4	15.0	8.9	15.0	6.5
Percent of total assets								
MFIs	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
NBFIs	7.6	7.8	8.0	7.6	5.3	4.4	4.7	5.2
Insurance	3.9	4.1	4.6	4.4	4.4	4.4	4.3	4.3
CDNS	18.0	16.1	14.6	14.8	16.6	17.3	17.2	17.0
Banks	70.4	71.9	72.7	73.0	73.5	73.8	73.6	73.2
Assets as percent of GDP								
MFIs	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2
NBFIs	5.6	5.7	6.0	5.1	3.4	2.6	2.7	3.0
Insurance	2.9	3.0	3.4	3.0	2.8	2.6	2.5	2.5
CDNS	13.3	11.8	11.0	9.9	10.7	10.2	9.9	9.7
Banks	51.8	53.4	54.7	49.0	47.3	43.3	42.2	41.9
Overall assets	73.7	74.0	75.2	67.2	64.4	58.8	57.4	57.2

In terms of composition, **banks** continued to dominate the financial sector, albeit a marginal decline in percentage of total assets. Given its large share and strong inter-linkages with other financial institutions and markets, the stability of the financial sector was largely driven by the performance and soundness of banks. The banking sector registered a decent growth of 5.9 percent during H1-CY12 on the back of rising deposits and improvements in the equity. The performance of the sector remained steady aided by healthy earnings, strong fund based liquidity, and high capital levels. However, the sector remained exposed to high credit risk, increasing concentration of government exposure on banks' balance sheets and decelerating interest margins.

[1] The unresolved structural issues include accumulating circular debt, losses stemming from public sector enterprises and higher interest payments (due to rising volume of government securities) on the public debt which continue to add to huge deficit being run by the Government, financed through borrowings from financial sector, which adversely affected private investment.
[2] Pakistan economy advanced at a modest rate of 3.7 percent during CY12 against the actual target of 4.3 percent.

The increasing concentration of public sector credit and dwindling flow of credit to private sector continued to reshape the asset-mix of the banking sector. The share of public sector exposure (investments plus loans) on banks' balance sheet almost matched that of private sector by the end of H1-CY12. Particularly, all of the 6.7 percent increment in advances came from disbursements to public sector enterprises (PSEs), that surged the public sector advances by 60 percent and its share in total advances to 21.5 percent in H1-CY12 (14.1 percent in Dec-11). Though this lower risk portfolio allowed banks to manage risk on their balance sheets in the prevailing difficult environment, it also limited asset diversification and financial intermediation between private savers and borrowers.

During the half year, the private sector credit contracted by 2 percent. This outcome came as a no surprise given the lackluster performance of the real sector; and low[3] businesses confidence due to security concerns, persistent energy shortages and rising local and geo political uncertainties. Further, the first half of the calendar year is usually marked with credit slow down owing to seasonal retirements by the leading borrowing segments. Accordingly, the private sector advances observed an all-around decline, particularly in working capital and trade finance. In addition to a widespread scaling down in businesses, the receding demand in working capital may also be attributed to a reduction in global prices (of metal, energy, and agriculture) and moderation in domestic inflation particularly the wholesale prices.

The trade finance witnessed a decline partly due to net retirements under Export Refinance (ERF), narrowing gap between refinance rates and market's mark-up rates, and rationalization of refinancing performance criteria. Similarly, the dip in the SME financing was on account of net retirements by the textile sector due to lower cotton prices and subdued export performance[4]. In addition, the government's heavy reliance on bank financing and economic slowdown, SMEs seem to be a low priority area for the banking sector. As such, SMEs continued to face problems in securing bank credit. The revenues of cement sector improved owing to sharp rise in retail prices of the cement, which contracted the demand for working capital loans of the sector. Sugar sector, however, observed increased flow of private sector financing largely resulting from usual seasonal pattern of credit demand and delayed start of the crushing season.

The demand for public sector advances mainly came from seasonal commodity procurement and production & transmission of energy (PTE). The stock of seasonal commodity finance surged to historically high levels, despite financing cushion created through one-off settlement[5] in H2-CY11. With increase in wheat support price[6] in the second half of 2012 and higher urea imports, the demand for commodity finance is expected to touch new highs in next season. Further, in wake of looming energy crisis and consequent rise in inter-corporate circular debt, banks' advances to PTE saw a sharp increase of 31 percent raising its share in overall advances to 12 percent. The concentration of advances to energy sector raised concerns, as most of the structural issues remained unresolved. The advances extended for public sector commodity operations and energy sector were generally backed by Government guarantees that may lead to further accumulation of additional government debt on banks' balance sheets. The increasing concentration of investment in Government securities is already posing re-investment risk that already materialized with the decline in market interest rates and deceleration in interest margin over the second half of CY12.

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[3] Overseas Investors Chamber of Commerce and Industry – Newsletter (November 2012)
Source: http://oicci.org/wp-content/uploads/2012/11/OICCI-nov2012.pdf

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

[5] Government made a one of settlement of Rs 78 billion of unpaid subsidy related to public sector commodity operation through issuance of Government bonds to banks in November, 2011, which provided cushion for further commodity financing.

[6] 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.

Credit risk increased further during H1-CY12 as a sizeable increase in NPLs pushed the infection rate up by 20 bps to 15.9 percent. With the influx of fresh NPLs, the provisions coverage declined to 66.3 percent and net NPLs edged up by 57 bps to 6 percent. The top five banks contributed towards most of the increase in NPLs, mainly in their corporate and SME portfolio. The continuing energy crisis, limited availability of natural gas, prevailing law and order situation and increasing cost of doing business kept on having its toll on the textile sector. The sector continued to add to the asset quality concerns of the banking system as its infection rate surged by 380 bps to 32 percent over the half year.

During H1-CY12, the deposits of the banking system registered a 9 percent growth while reliance on borrowings saw some let up. The driving factors behind the rise in deposits were consistently growing workers' remittances and strong 11 percent growth in foreign currency deposits due to 5.2 percent depreciation of PKR. The maturity profile of the deposit revealed a skewed growth in shorter maturities. The CASA deposits, which are transactional in nature, contributed mostly toward increase in fresh deposits, more so in the second quarter of CY12. Even the slow growing fixed deposits observed growth in short term deposits. This phenomenon reflects banks' marketing efforts to book short-term deposits in the backdrop of declining interest rate scenario and depositors' preference for liquidity without jeopardizing some minimum returns.

The borrowing from financial institutions declined in the period under review as government decreased reliance on banking sector for budgetary borrowings. The relative ease in the market liquidity towards the end of H1-CY12 and healthy deposit growth enabled banks to make net retirement to financial institutions during the period under review as against the net borrowing in previous half. Equity of the banking system that saw a moderate growth at the back of steady profits also provided support to the overall funding of the system.

The funding liquidity risk of the banking sector stayed well contained due to large stock of government bonds and steady flow of customer deposits. However, market liquidity remained constrained due to high and rising demand for funds from public sector and sluggish foreign inflows. Banks, therefore, preferred placement of government paper in Available for Sale (AFS) category of investment to enhance their ability to meet the liquidity needs albeit a lower capital charge. The strain in market liquidity led SBP to make substantial injections, during the first quarter of CY12. The injections subsided remarkably by end of second quarter as seasonal financing picked up and government increased its reliance on central bank borrowing. Despite slow down in investments in government securities, the base line liquidity indicators remained steady with marginal softening. The sensitivity analysis confirms that banks would stand resilient towards various liquidity shocks

The banking sector continued to sustain appreciable growth in earnings during the period under review, due to higher non-interest income and lower provisioning charge, though interest margins observed a deceleration. The pre-tax profits of banks improved YoY by 27 percent to Rs 98 billion in first half of 2012. The net interest margin (NIM) of banks was down YoY by 68 bps to 4.83 percent, mainly due to decrease in interest rates. However, higher non-interest income due to improved corporate dividends, gain on sale of securities, and decrease in provisions offset the impact of lower NIM. As a result, before-tax return on assets (ROA) edged up to 2.4 percent for H1-CY12 compared to 2.1 percent in the corresponding period last year.

Solvency position of the banking system remained steady and strong. The accumulation of profits and slow growing Risk Weighted Assets (RWA) aided in maintaining the Capital Adequacy Ratio (CAR) high at 15.1 percent during H1-CY12 well above the required minimum of 10 percent. Though most banks met the CAR, some continued to face challenges in strengthening their capital for meeting the prescribed regulatory Minimum Capital Requirement (MCR). Further, with the decline in provisioning coverage due to deterioration in asset quality, risk to banks' solvency increased as capital impairment ratio edged up by 230 bps to 26.5 percent. The banking sector, however, is expected to remain resilient in various stress scenarios due to strong capital position, though severe credit risk shock may bring a few banks under stress.

Islamic banks continue to make steady progress towards expanding their share in the overall banking industry, thanks to robust growth in deposits. The assets of Islamic banks expanded at almost double the pace of overall banking sector, which increased its share in total assets of the banking system by 54 bps to 8.2 percent during H1-CY12. An accelerated 16 percent surge in deposits provided for augmentation in asset base. The substantial flow of funds and ample available liquidity allowed Islamic banks to invest heavily in Government Ijara Sukuks. This not only facilitated Islamic Banking Institutions (IBIs) in improving liquidity management, but also enhanced the overall share of investment in the IBIs balance sheets to 48 percent. However, financing saw a marginal decline as flows to private sector subsided in line with overall risk aversion in the industry and deterioration in assets quality over the period due to increasing infection in few economic sectors.

The profit before tax of IBIs improved by 18 percent to Rs 5.9 billion during H1-CY12 owing to increasing investment income, non-mark-up income, and decline in provisions. However, ROA dipped marginally by 16 bps to 1.78 percent due to deceleration in financing margins and increasing cost. With rising retained earnings and assets growth mainly in risk free government securities, the solvency of IBI improved as evident from 16 bps increase in CAR to 18.1 percent.

The rising financial needs of the public sector and uncertain financial inflows also exerted pressure on **financial markets**. The surge in money market activities forced the central bank to make huge injections on continuous basis to ease out the market liquidity. The foreign exchange market also remained volatile on account of modest yet growing current account deficit and limited financial inflows, which dipped the foreign exchange reserves. In addition, foreign portfolio investment (FPI) declined despite substantial uptick in the equity markets. This coupled with market sentiments led to 5.2 percent depreciation of the PKR against the USD.

In contrast, the bullish equity market activity led to considerable improvement in stock indices during the H2-CY11. Stock markets in Pakistan actually outperformed the other leading advanced and emerging markets stock market during the first half of CY12. Much of the improvement in the index resulted from favorable corporate announcements, healthy payouts, promulgation of Capital Gains Tax Ordinance[7] and renewed institutional buying.

The improvements in the equity market and consistent flows of investments in government securities enhanced the asset base of the Non Banking Financial Institutions (NBFIs) by 30.2 percent during FY12. The phenomenal increase in net asset value (NAV) of mutual funds along with healthy growth in DFIs and Modarabas boosted asset base of NBFIs sector for second consecutive year. Borrowing continued as a major funding source of the sector, though deposits also picked up for leasing sector. Much of the growth in MFs was driven by enhanced interest in money market and income funds, due to their competitive returns and ample supply of risk free Government bonds. This combined with the tax incentives made the mutual funds more attractive for the institutional as well as the retail investors. However, the extraordinary rise in investments in volatile Money Market Funds (MMFs) and income funds (double the value in FY11) could have ramification for both mutual funds industry and the overall financial stability[8]. With the changes in tax regime[9] and expected changes in regulatory framework for the banks (discussed in detail in

[7] The ordinance to amend certain fiscal law (Ordinance III of 2012) was promulgated in April 2012 that later became the part of Finance Bill 2012.
[8]Recent report of IOSCO on MMFs provides a range of policy options including capital and liquidity requirements as per their risks to the financial stability.
[9]The income of banks is presently taxed as per the corporate tax rates, i.e., @35% of income before tax. However, the income generated by banks from investment in mutual funds was taxed at 10%. As per section 15 (61) of Finance Act 2012, dividend received from Money Market Funds and Income Funds shall be taxed at the rate of 25% for tax year 2013 and at the rate of 35% for tax years 2014 and onwards.

FSR of H2-2011)[10], the fund managers need to give due consideration to these developments while devising their future strategy.

NBFIs (excluding Mutual funds) observed slowdown in core business activity and rising delinquencies, which led to further shrinking of their loan portfolio and profitability indicators. The profits of NBFIs dipped by 45 percent to Rs 920 million due to heavy losses incurred by Investment Finance Companies (IFCs) and a couple of leasing companies, while improved earnings of Modarabas and DFIs provided for overall profitability of the sector. Accordingly, the ROA and ROE also observed decline over the year. The shrinking business, worsening asset quality and consequent losses posted by leasing and IFCs added to already growing solvency concerns related to these sub-sectors.

The **insurance industry** continued to play its role in spreading its coverage against financial risks albeit in a limited manner. The strong growth in life insurance business augmented the asset base of the insurance sector by 7.8 percent during H1-CY12. The life business attracted 34 percent higher net premiums on account of non-conventional policies particularly the unit linked contracts. Further, with a declining claims ratio and healthy returns on investments made in government securities, the life insurance sector improved its operating performance and soundness during H1-CY12.

The non-life net premiums reduced marginally owing to a challenging business environment and a consistent decline in auto finance. The claims ratio also deteriorated on the back of high concentration in motor insurance business and underwriting losses faced by a number of nonlife companies. However, healthy equity market returns improved the profitability and soundness of the nonlife service providers.

Payment systems continued efficient and reliable settlement of increasing interbank payments and securities transactions during the period under review. Pakistan Real time Interbank Settlement Mechanism (PRISM)-the large value and systemic payment system-minimized the settlement risk through efficient settlement of higher volume of large value transactions. The retail payments also observed moderate growth in volumes and values. With improvements in the Information Technology (IT) infrastructure of banks and increasing customers' interest in mobile and e-banking modes, the use of electronic payment channels witnessed a rapid expansion. The usage of Real Time Online Banking (RTOB) continued to provide momentum to the e-banking retail payment due to increasing number of online bank branches.

Future Outlook: The growth prospects of the financial sector will hinge upon the performance of the banking sector-representing major chunk of the financial sector assets. The banking sector is expected to post healthy profits during CY12, though interest margins may observe further deceleration due to declining interest rates. The structure of the banks' balance sheet, however, would be determined by the usual pattern of seasonal credit, escalating government budgetary needs, developments in resolution of structural issues and election year spending. Although banks are expected to remain liquid at the back of huge stock of risk free government securities, the rising demand for public sector credit means that banks have to make additional efforts for mobilization of fresh deposits and rely on retirement of public sector credit.

The high credit risk will continue as a major challenge. With a fall in interest rates and expected pick up of seasonal private sector credit, the infection ratios may subside a little bit. However, banks need to make concerted efforts and develop effective strategies for recovery of high level of NPLs.

[10] Basel Capital accord under look through approach for collective investment schemes, require banks to calculate capital charge on their mutual fund investments as if the underlying exposure/asset class is held by the banks themselves.

The banking sector is expected to remain resilient towards various stress scenarios due to strong CAR well above the required levels. However, persistent macro-environment issues will pose a stiff challenge for some banks in meeting capital requirements including CAR of 10 percent and MCR of PKR 9 billion.

The financial markets behavior will largely reflect developments on the economic front. With persistent and unpredictable public sector demand for funds, uncertain foreign inflow and expected repayments to IMF, the money market and FX market will remain under pressure.

Interest in mutual funds, behavior of the financial markets particularly the equity market and developments on the regulatory front would be a deciding factor behind the growth in the NBFIs. Insurance industry is likely to see growth in net premium revenues due to higher demand for life insurance, though the performance of general insurance would remain contingent upon revival of commercial activities.