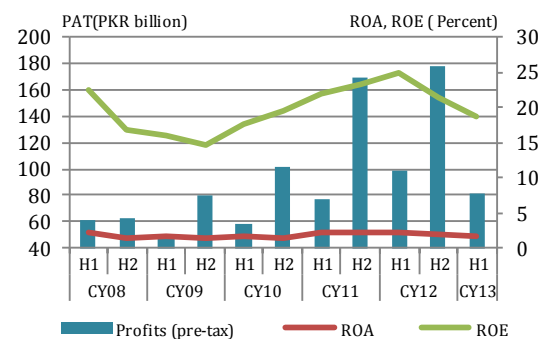


The banking sector continued to post reasonable profits; though at a slower pace, due to higher provisions charge and shrinking interest margins. The solvency of the system improved further due to increase in capital base; Capital Adequacy Ratio stood well above the minimum benchmark, while a few banks find it challenging to comply with capital requirements. With strong capital position, the banking sector is expected to remain resilient to various stress scenarios; however, credit concentration remains the key risk factor that needs continuous vigilance.

Figure 3.1

Trends in Bank Profitability



Earnings deteriorated due to squeezing interest margins ...

Profitability of the banking sector declined by 16.5 percent during H1-CY13 compared to the first half of CY12, largely due to higher provisions charge against the classified portfolio, increase in cost of borrowings and a decline in returns on lending activities. Nevertheless, the banking sector with a profit of PKR 82.1 billion remained the second best performing sector³² among the various sectors of the economy³³. The earning indicators of ROA and ROE also declined by 70bps and 640bps to 1.7 percent and 18.5 percent respectively (**Figure 3.1**).

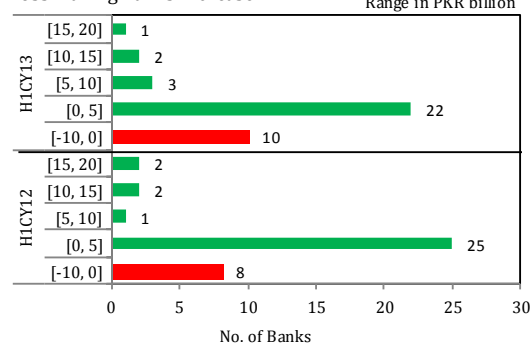
Table 3.1: Concentration of Earnings (percent share)

H1CY13	Share	ROA	ROE	AU	PM	NIM
Top 5	74.2	2.5	23.6	9.8	25.1	4.2
Top 6 to 10	21.1	1.7	23.9	9.0	18.6	3.4
Top 11 to 20	1.6	0.1	1.9	9.4	1.6	3.3
Top 21 to 30	3.1	0.8	7.0	8.8	9.1	4.1
Public Sector	14.6	1.3	13.3	9.2	14.1	3.2
Local Private	78.9	1.7	20.1	9.2	18.5	3.9
Foreign	2.8	1.9	11.2	7.9	23.7	4.7
Specialized	3.7	3.8	40.2	13.3	28.3	8.3
All Banks	100.0	1.7	18.6	9.5	18.0	3.9

Analysis of concentration in profitability showed top five banks lead in most of the earnings indicators followed by top 6-10 banks (**Table 3.1**). The share of large 5 banks in total profitability enhanced to 74.2 percent against 70.9 percent in corresponding period last year. The higher concentration mainly resulted from increase in loss making banks that provided for higher provisions against infected portfolio during H1-CY13 (**Figure 3.2**).

Figure 3.2

Loss Making Banks Increase

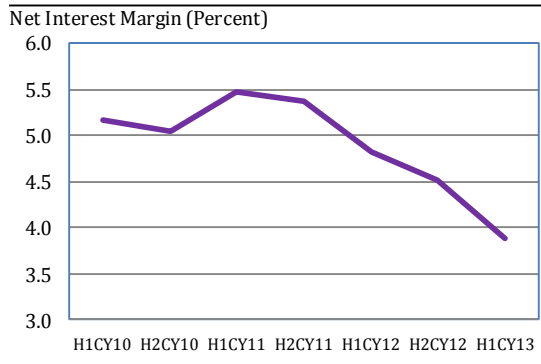


The declining interest rates along with increase in borrowing cost squeezed the interest margins over the last couple of years. Net Interest Margin (NIM) of the banking sector maintained this downward trend during H1-CY13 as it decreased to 3.9 percent against 4.8 percent in H1-CY12 (**Figure 3.3**).

³² The Oil and Gas sector was the largest in terms of profitability. During H1-CY13, the Profits before tax of the sector were in excess of PKR 250 billion.

³³ See Table 5.2 for sector-wise profitability.

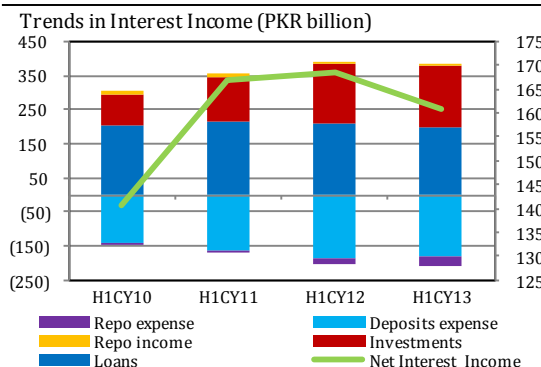
Figure 3.3



Declining returns on loans and increasing repo expenses reduced the NII.

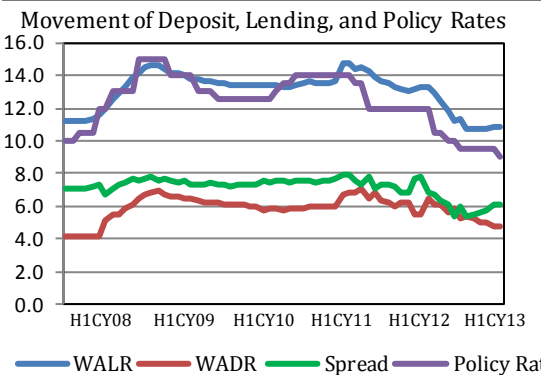
During the first half CY13, the banks' Net Interest Income (NII) declined by 18.4 percent (YoY) due to reduction in markup income on loans and advances (Figure 3.4). This decrease was no surprise given 300 bps cumulative decline in policy rate over the period July-12 to June-13, which impacted the returns on KIBOR linked earning assets. Meanwhile, an increase in volume based earnings on investments mostly in government securities curtailed the decline in the markup / interest earnings to just 1.1 percent (YoY).

Figure 3.4



In addition, the mark up expense increased by 1.4 percent (YoY) on account of heavy repo borrowings from the SBP. The level of borrowings almost doubled that led to an increase in overall expense. Interestingly, expense on deposits decreased by 1.3 percent (YoY) despite an increase in minimum saving rate (MSR) over the year. Analysis of the issue highlighted that cost of deposits decelerated over the last few years. It declined to 7 percent in Jun-13 from 8.1 percent a year ago. Further, the share of deposit cost in overall mark-up/interest expense reduced to 80.4 percent in Jun-13 from 82.6 percent in Jun-12.

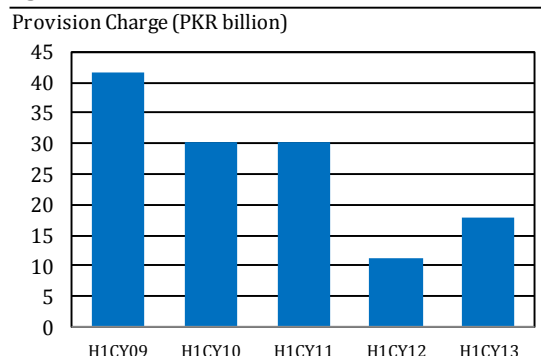
Figure 3.5



Minimum saving rate policy curtailed decline in WADR ...

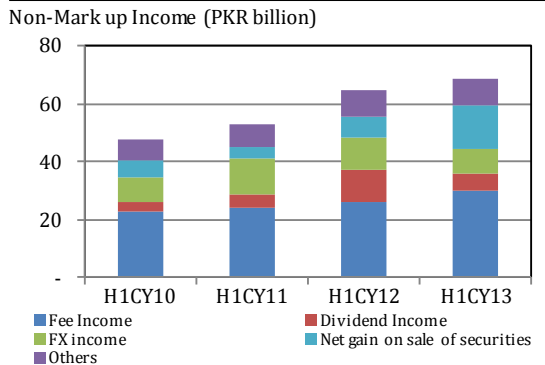
The trend of Weighted Average Lending Rate (WALR) and Weighted Average Deposit Rate (WADR) was quite synchronized with the SBP policy rate. Against the policy rate decline of 5 percentage points over Jun-11 to Jun-13, the WALR declined by 3.96 percentage points to 10.80 percent. The WADR also declined by 2.15 percentage points to 4.72 percent in Jun-13, which was relatively lower than the decrease in lending rates, a possible outcome of lifting up the minimum saving rate (Figure 3.5).

Figure 3.6



In addition to decline in interest income, increase in provisioning charge also dented the earnings of the banking system. After a significant decline in the provisioning and write-offs during H1-CY12, the provisions increased by 59 percent (YoY) in H1-CY13. The gradual wearing out of the FSV benefit and flow of fresh NPLs mainly increased the charge over the period under review (Figure 3.6).

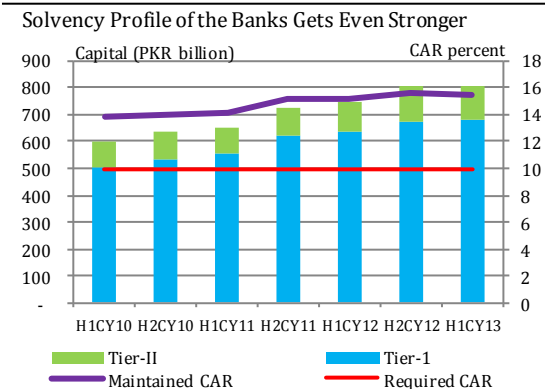
Figure 3.7



Non-mark up income kept earning at reasonable levels....

In sharp contrast to NII, the non-mark up income observed YoY increase of 6.3 percent during H1-CY13. The growth was largely supported by improved fee based income and gain on sale of securities including T-bills, PIBs and listed stocks³⁴ (Figure 3.7). The fee income, which contributed 43.5 percent towards non-markup earnings, improved by 14.1 percent. The dividend income, though a smaller component of non-mark up income declined by 43.8 percent indicating that banks maintained short-term interest in the stock market.

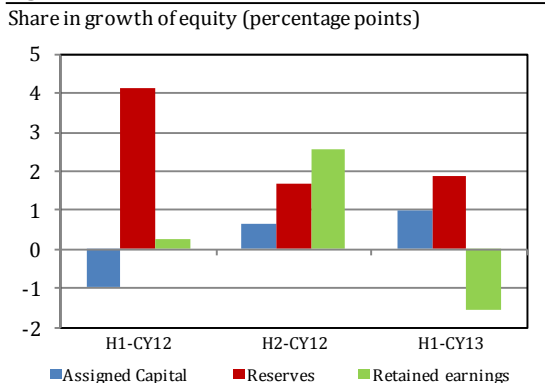
Figure 3.8



Solvency

The capitalization of the banking sector remained well above the local as well as Basel minima³⁵, though Capital Adequacy Ratio (CAR) marginally declined by 10 bps to 15.5 percent during H1-CY13 (Figure 3.8). The decline in capital adequacy primarily resulted from dip in retained earnings (Figure 3.9). The leverage ratio³⁶ stood at a comfortable level, well above the Basel-III standard of 3 percent. Most banks met the CAR, while some continued to face challenges in achieving the prescribed Minimum Capital Requirements (MCR).

Figure 3.9



Concentration analysis of solvency ratios showed that CAR of top 5 banks remained strong and well above the industry average (Table 3.2). With healthy profits over the years, banks have been able to enhance the capital base through internal capital accumulation that facilitated them in matching increase in RWAs and keeping the CAR high. The biggest increase in capital was observed in smaller banks (21-30 bracket). However, due to growth in MRWAs as well as increase in classified portfolio in some of these banks witnessed somewhat deteriorated capital ratios. Moreover, leverage represented by capital to assets ratio increased due to growth in credit mainly in investment portfolio during H1-CY13 (Table 3.2).

CRWA decreased slightly...

Given the decline in private sector credit, CRWA witnessed a decrease of 2.6 percent during H1-CY13. As a result, the share of CRWA in total RWA dipped to 76.7 percent in H1-CY13 from 78

³⁴ Banks benefited from taking long position in the declining interest rate scenario and therefore gained on the sale of government securities held with them, while improved valuation of the strongly performing stock indices facilitated in booking gain on sale of quoted shares.

³⁵ Banks are required to maintain minimum CAR of 10 percent.

³⁶ The leverage ratio is measured as the ratio of adjusted tier-I capital to adjusted on-balance sheet and off-balance sheet assets

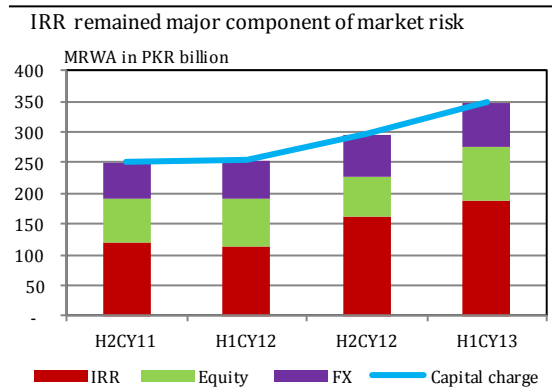
Table 3.2: Bank Category-Wise Solvency Ratios

	in percent					
	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	H2-CY12	H1-CY13	H2-CY12	H1-CY13	H2-CY12	H1-CY13
Top 5	16.7	16.5	13.8	13.7	10.1	9.9
6 to 10	13.6	13.7	10.7	10.7	6.8	6.9
11 to 20	11.5	11.7	9.8	10.1	8.0	7.7
21 to 30	18.6	16.5	19.1	16.5	12.0	11.8
PSCB	16.7	15.8	13.9	12.7	10.3	9.6
LPB	14.9	15.0	12.4	12.7	8.6	8.5
FB	30.7	26.4	30.5	26.2	16.5	16.3
SB	12.3	13.7	6.8	7.8	8.3	10.5
Industry	15.6	15.5	13.0	13.0	9.1	8.9

Table 3.3: RWAs to Original Exposure

Claims on	CY12			HCY13		
	Original Exposure	Risk Adjusted Amount	RWA to Original Exposure	Original Exposure	Risk Adjusted Amount	RWA to Original Exposure
GoP	2,432	-	-	2,583	-	-
PSEs	630	60	9.6	634	58	9.1
Banks	237	90	37.8	207	88	42.6
Corporates (excluding equity exposures)	2,167	1,784	82.3	2,105	1,767	84.0
Categorized as retail portfolio	575	376	65.4	549	356	64.8
Past due loans	202	195	96.3	198	194	98.0
Total On Balance Sheet Exposures	7,763	3,390	43.7	7,920	3,338	42.2
Total Off Balance Sheet Exposures	3,885	604	15.5	4,022	647	16.1

Figure 3.10



percent in H2-CY12. A look at the source of the changes show that most of the increase in on-balance sheet exposure during H1-CY13 resulted from an increased financing for public sector commodity procurement operations, which carry zero risk weight. The claims on most of the other categories either decreased or remained unchanged, which decreased the overall risk adjusted claims. Meanwhile credit risk adjusted off-balance sheet claims inched up due to increase in trade related contingencies and commitments (Table 3.3).

...while MRWA continued to grow

MRWA witnessed a sizeable growth of 16.6 percent that enhanced its share in total RWAs by 120 bps to 8.3 percent in H1-CY13. Among the MRWA, Interest rate risk (IRR) provided for most of the increase in capital charge due to 17.4 percent increase in stock of investments in long term-PIBs. With 49.8 percent growth in equity investments of the banks, the associated capital charge also grew by 40.7 percent, while foreign currency positions related capital charge rose modestly by 3.1 percent during the period under review (Figure 3.10).

...whilst the riskiness of banking sector remained subdued...

Given the reduction in CRWA, the overall riskiness of the banking sector (CRWA assets to average earning assets) continued to subside. This came as a no surprise as major part of the 10.5 percent expansion in earning assets during H1-CY13 carried low risk weights. Since CRWA declined by 0.38 percent, share of CRWA as a percentage of average earning assets declined by 5.3 percentage points in H1-CY13. This trend though favorable in short run, may compromise risk management capacity of the banking sector in future (Figure 3.11).

Figure 3.11

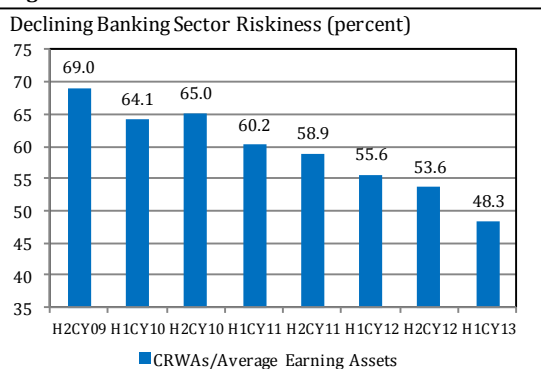


Figure 3.12

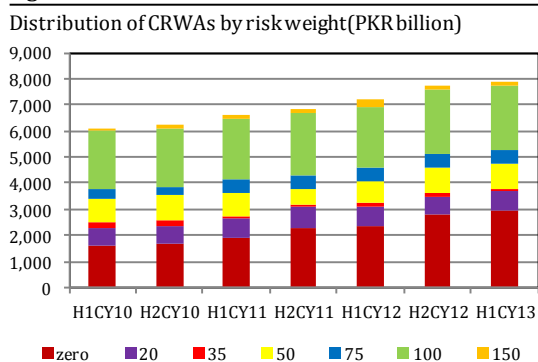
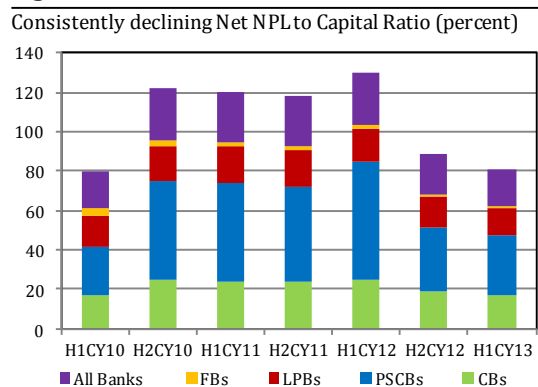


Table 3.4: Distribution of Banks by CAR

	in percent			Total
	Less than 10	10 to 15	over 15	
H1CY10	6	15	19	40
H2CY10	5	13	20	38
H1CY11	5	12	21	38
H2CY11	5	10	23	38
H1CY12	5	11	22	38
H2CY12	5	9	24	38
H1CY13	5	11	22	38

Figure 3.13



Lower riskiness can be also traced into rising level of low risk weighted assets in the balance sheets of banks. In line with the large share of public sector investments, share of zero risk weighted asset reached its highest level of 36.9 percent during H1-CY13 from 36 percent in H2-CY12. Moreover, share of assets with risk weight of 20 percent increased to 9.8 percent of total CRWAs portfolio due to increase in exposure towards entities with better credit ratings. On the flip side, share of assets carrying 50 and 100 percent risk weight (usually assigned to the advances extended to unrated borrowers) continued to decline, an outcome of slow growth in private sector credit (**Figure 3.12**).

A higher capital base above the regulatory requirements provided banks with sufficient cushion against unexpected idiosyncratic shocks and severe macroeconomic conditions. As a part of its policy to strengthen common equity base of banks, the SBP over the period has enhanced the MCR requirements in gradual manner. The outcome of this approach is obvious in comfortable CAR of most banks. (**Table 3.4**). Banks falling short of minimum CAR represent merely 6.6 percent of total asset of the industry and as such do not pose any serious concern to the solvency of the banking sector.

Improved credit quality provided a breathing space for overall solvency profile of banking system

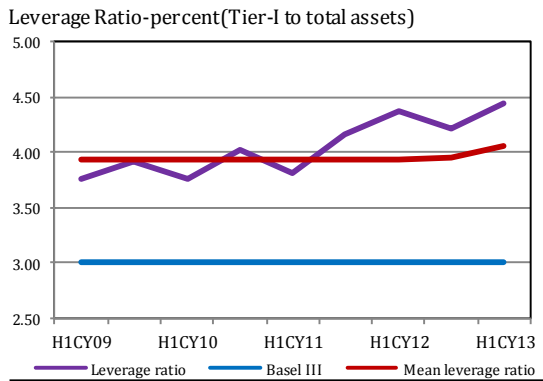
Solvency risks from changes in credit quality continued to pacify during period under review, as capital impairment ratio (Net NPLs to Capital), an indicator of fraction of banks' equity that could be impaired by uncovered loan losses, improved significantly during H1-CY13. Though this improvement was broad based and observed across all categories of banks, the most profound impact was observed in LPBs category where the ratio came down from 15.9 percent in H2-CY12 to 13.7 percent in H1-CY13 (**Figure 3.13**).

Banking system leverage remained well within the prescribed limit

The leverage ratio³⁷ for banking sector of Pakistan continued to improve at the back of rising equity levels. During H1-CY13, ratio increased by 24 bps due to inhibited growth in the on-balance

³⁷ Leverage ratio is defined as Tier-I capital as proportion of total assets (adjusted both sides for intangible assets). The inverse of leverage ratio is call leverage multiples. This ratio is not yet applicable in Pakistan.

Figure 3.14



sheet exposure relative to Tier-I capital. On aggregate basis, leverage ratio stood at 4.4 percent in H1-CY13, much higher than the minimum of 3 percent set by the Basel Committee on Banking Supervision (**Figure 3.14**). With a comfortable level of this non-risk based indicator and potential of growth in the economy, banking industry enjoys enough buffer to further increase its leverage in the future (**Table 3.5**).

Resilience of the banking system

The banking system continued to exhibit resilience to various shocks under stress due to strong CAR of 15.5 percent. The stress shocks on the credit, market, liquidity and contagion risk on the banking sector reaffirms that system is satisfactorily placed to withstand the stress shocks³⁸. Importantly, all banks with before-shock CAR of above 13.1%, including top 5 banks of the industry, would comfortably bear the solvency shocks.

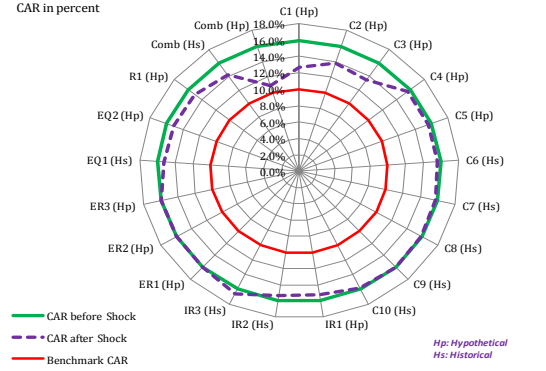
Table 3.5: Capital Cushion H1-CY13

	amount in billion Rupees, ratio in percent		
	Existing	Simulated	Cushion
Capital	807	807	-
RWAs	5,222	8,073	2,851
CAR	15.5%	10.0%	

Under sensitivity analysis, the after-shock CAR of the system would stay strong, though certain shocks to the credit risk portfolio would have significant impact on the solvency profile of the banking system. The credit shocks including shock (C-1) assuming an increase in NPLs equivalent to 10 percent of performing loans, (C-2) default of top 3 private sector individual borrowers (fund based exposures only), and (C-3) a shock of default of top three borrowers (both fund and non-fund based) would decrease the after-shock CAR of the banking system up to 333 bps (**Figure 3.15**). Keeping in view their systemic implication of high concentration of top corporate and group exposure, banks need close monitoring of such exposures.

Figure 3.15

Impact of Sensitivity Tests on Solvency of the Banking System - June-2013
CAR in percent



Despite considerable rise in MRWA, overall 8.3 percent share continued to present a subdued market risk profile. As a result, market risk related sensitivity shocks had minimal effect on the solvency profile of banks (maximum decline of 85 bps in CAR). Similarly, analysis of liquidity stress tests, which envisaged significant withdrawals of deposits and volatile funds, and dip in value of liquid securities, showed that the ample fund based liquidity in the system would provide enough cushion to meet significant withdrawals of deposits and volatile funds. Similarly, haircut on value of government securities, would marginally decline the liquidity coverage ratio (LCR) as defined under Basel-III framework, would stay well above the minimum acceptable value of LCR of 1.

³⁸ For number of banks failing stress scenarios, see Annexure 1.15