Financial Stability Overview

The domestic macroeconomic environment remained sluggish for yet another year as GDP grew by a modest 3.7 percent well below the target of 4.3 percent. Severe energy shortages, challenging economic environment, and law and order conditions hampered economic activities in the country. However, decrease in inflation to 7.4 percent during H2FY13[1] was an achievement thanks largely to stable international food and oil prices. Moreover, the twin deficits kept on posing challenges to relatively constrained market liquidity and depleting international reserves. Though, current account deficit was still manageable, the fiscal deficit worsened to 8 percent of GDP against the target of 4.7 percent leading to crowding-out of private sector lending and limiting economic recovery prospects.

In stark contrast, the financial sector of the country presented somewhat stable outlook, though its risk appetite remained largely averse and consequently stayed least affected from relatively restrained real sector. The asset base of the financial sector increased by 4.2 percent during H1-CY13, which also enhanced its share in GDP from 57.5 percent to 60 percent (**Table 1**). Improvements in the asset base were broad based as all segments of the financial sector increased in size. Assets of banks increased largely on account of healthy build up in deposits that translated into further accumulation of Government securities, with some increase coming from settlement of circular debt in June-July, 2013. Further, with high fiscal needs and drying external inflows such as loans and grants, the domestic debt in form of National Savings instruments issued by the CDNS posted major increase as banks provided households and businesses an alternate avenue for savings at reasonably higher returns. Similarly, the insurance sector thrived as its asset base augmented due to improved life insurance business during the period. The growth in assets of NBFIs came at the back of healthy increase in the NAV of the mutual funds.

Table 1: Assets Composition of the Financial Sector

	CY06	CY07	CY08	CY09	CY10	CY11	H1CY12	H2CY12	H1CY13
Assets (PKR Billion)	6,028	7,117	7,712	8,867	9,655	11,107	11,818	13,181	13,739
Growth rate (Percent)	14.5	19.4	8.4	15.0	8.9	15.0	6.5	11.5	4.2
Percent of Total Assets									
MFIs	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.4
NBFIs	7.8	8.0	7.6	5.3	4.4	4.7	5.2	4.2	4.2
Insurance	4.1	4.6	4.4	4.4	4.4	4.3	4.3	4.3	4.5
CDNS	16.1	14.6	14.8	16.6	17.3	17.2	17.0	17.2	17.4
Banks	71.9	72.7	73.0	73.5	73.8	73.6	73.2	74.0	73.4
Assets as Percent of GDP									
MFIs	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.3
NBFIs	5.7	6.0	5.1	3.4	2.6	2.7	3.0	2.4	2.5
Insurance	3.0	3.4	3.0	2.8	2.6	2.5	2.5	2.5	2.7
CDNS	11.8	11.0	9.9	10.7	10.2	9.9	9.7	9.9	10.5
Banks	53.4	54.7	49.0	47.3	43.3	42.2	41.9	42.6	44.0
Overall assets	74.0	75.2	67.2	64.4	58.8	57.4	57.2	57.5	60.0

Banking Sector, which is the backbone of the financial sector due to its immense share and strong forward and backward linkages with the rest of the sector, witnessed a 3.9 percent increase in its asset base. The modest growth was contributed by an expansion in deposits by 6.2 percent which also helped banks to retire loans in the interbank

[1] Inflation stood at 9.7 percent as of December 31, 2012.

market and repo borrowings from the central bank. With an increase in financing to public sector enterprises (PSEs) and growing fiscal needs of the Government, the public sector exposure gained further weight on banks' balance sheet to reach 44.5 percent of the total credit extended. This, while limiting the availability of funds to private sector also compromised the financial intermediation function as reflected in further decline in Advances to Deposit Ratio (ADR) to 48.1 percent during H1-CY13.

The **advances** to private sector, which remained quite subdued during the last few years, further declined by 2.4 percent resulting in 0.5 percent dip in overall lending portfolio. A host of factors contributed to this decrease viz: deceleration of credit demand from sugar sector due to the Government purchases of sugar and exceptional growth in sugar export[2], seasonal net-retirement by textile sector[3], repayments by the energy sector subsequent to settlement of circular debt, and banks' cautious approach in extending fresh advances due to high credit risk, in addition to lower credit demand in the wake of challenging business conditions. Given the concentration of majority assets in top 5 banks, the bulk of retirements remained confined to these banks.

The seasonal credit for financing public sector commodity procurement operations was the only prominent flow during the year. The commodity finance, with an increase of 7.2 percent, saw a new peak in H1-CY13 as wheat financing increased by 26 percent due to increase in support price[4]. As highlighted in the earlier FSRs, this self-liquidating financing is on the rise and a key source of concentration in banks' balance sheet. Non-payment of the piling up subsidies is the major issue, which accounted for 37.6 percent of the total outstanding finance, in addition to stock losses due to multiple reasons[5] and increase in administrative prices of wheat. Given the importance of commodity procurement, it is imperative to address the above issues, particularly its liquidation mechanism needs reconsideration to mitigate risks arising from its continuous growth and concentration on banks' balance sheets.

Another area of concern has been the increasing concentration of loans in few economic sectors, particularly in "Production & Transmission of Energy Sector (PTES)". Historically, the textile sector is the key user of the advances; however, over the last few years and more specifically during CY12, banks' credit exposure in PTES increased significantly and touched 12.3 percent of the gross loan portfolio. However, government settled inter corporate circular debt in June-July, 2013, which led to net retirement of PKR 50 billion in PTES and decreased its share in advances to 10.6 percent during the period under review. Although settlement of circular debt is expected to improve energy supply in the short term, resolution of the structural issues is necessary from long term perspective that will create financing space for banks to enhance private sector credit.

The asset quality of banks' portfolio marginally deteriorated as NPL to loan ratio increased by 26 bps to 14.8 percent during the first half of CY13. With phasing out of Forced Sale Value (FSV) benefit and significant downgrades in infected portfolio, the provisioning requirements also increased. Nonetheless, banks maintained provisions of almost 104 percent of the required level largely due to general reserve created by banks for consumer finance portfolio[6]. Similarly, an increase in specific provisions improved provision coverage ratio to 73.2 percent in H1-CY13 compared to 71.5 percent in H2-CY12. Higher provisions also reduced the Net NPL to loan ratio to 4.4 percent and with an

[2] SBP third Quarterly Report – CY13.

[3] The amount of retirements during H1-CY13 was lower than in H1-CY12.

[4] In Sep-12 support price for wheat was increased from PKR 1050/40kg to PKR 1200/40kg.

[5] Annual Report on State of Pakistan's Economy 2012-13.

[6] Total provision exceed the required provisions as bank create general provision under various Prudential Regulations, particularly for the Consumer Finance(CF) portfolio to protect banks from the risks associated with the economic cyclical nature of this business. In terms of regulation R-4 of the Prudential Regulation for CF, banks are required to maintain a general reserve at least equivalent to 1.5 percent of the consumer portfolio which is fully secured and 5 percent of the consumer portfolio which is unsecured.

increase in the equity base by 2.3 percent, the risk to capital decreased as capital impairment (Net NPL to Capital) ratio improved to 18.3 percent.

Importantly, the accumulation of infected portfolio decelerated in recent times. Among various reasons, banks restructured lending portfolio of promising borrowers affected by economic factors, which lowerd the stock of infected portfolio. The slowdown positivly impacted the overall infections ratios; the gross infections ratio saw a steady decline from a peak of 16.7 percent in Sep-11 to 14.8 percent in Jun-13. Provisions coverage ratio also improved as partially provided for the portfolio moved into fully provided for category. With dampening credit flows, incidence of NPLs lowered on bank gross income. The provisions charge came down to 7.8 percent of gross income in Jun-13, which consistently stayed above 10 percent for CY07-CY11 (**see Box 2.1**).

The overall liquidity profile of the banking sector remained steady during the first half of CY13 on account of healthy deposit inflows. Further, settlement of circular debt partially in cash and net retirement of private sector loans improved the funding liquidity of the banks. Consequently, the liquidity indicators continued to remain strong resulting in an overall stable liquidity position, though fiscal funding need and limited foreign financial flows kept the government borrowing needs high and market liquidity under stress. Meanwhile, the market risk increased marginally as a result of accumulation of longer term of PIBs, which increased the interest rate risk of banks. Further, as equity markets continued on bullish run thereby attracting institutional investors seeking higher returns, banks increased equity exposures by 14.5 percent. However, the regulatory limits placed by the State Bank on such exposures kept the equity exposures and related risk quite confined.

Banks had reasonable earning during H1-CY13 (pre-tax amount of PKR 82.1 billion) though 16.7 percent less compared to the corresponding half year of CY12. Still, the banking sector remained second highest in terms of profit accumulation among various sectors listed on the equity market. The drop in profits was largely on account of decline in net mark up income, higher provisioning charge and expensive repo borrowings. The declining interest rate environment on the one end decreased the returns on KIBOR linked financial products while on the other side reduced returns on the rising stock of short terms investment in T-Bills. Accordingly, Net Interest Margins (NIM) lowered by 90 bps to 3.9 percent and ROA dipped by 30 bps to 1.1 percent.

The solvency profile of the banks remained steady as CAR of the banking industry stood at 15.5 percent during the first half CY13, well above required minima of 10 percent. The buildup of profit and increase in Minimum Capital Requirements facilitated industry in maintaining such a high CAR. Further, the Leverage Ratio (Tier-1 Capital to total assets ratio) improved to 4.4 percent due to inhibited growth in the on-balance sheet exposures. The results of stress test exercise further substantiated resilience of the banking sector, though concentrated exposures to top corporate borrowers did pose significant risk, which require vigilant monitoring.

The Islamic banking exhibited a stronger growth of 7.9 percent in assets buildup during H1-CY13 outpacing 3.9 percent growth in conventional banking. The share of Islamic banking assets also inched up to 9.0 percent[7], while that of deposits crossed 10 percent mark. Both investment and financing activities facilitated the surge in share of Islamic banking industry; financing activities increased by 11.2 percent due to doubling of Musharikah financing (sharing based mode) and healthy growth in long term Ijarah and Diminishing Musharikah (DM) along with Murabah financing for commodity procurement operations. Meanwhile, the investment grew by 11.2 percent largely confined to Ijara Sukuks. The asset quality indicators improved marginally on account of higher growth in financing. The liquidity

[7] As of December 31, 2012, share of Islamic banking assets and deposits was 8.6 percent and 9.7 percent respectively.

management and higher operating and provisioning expenses remained major challenges for the Islamic banks which also declined the profitability of the Islamic banking by 27 percent over the review period.

The domestic financial markets presented a mixed picture during the period under review. The money market witnessed frequent episodes of strain on market liquidity due to unpredictable government borrowings. However, timely liquidity provision by the central and heavy discounting alleviated the market liquidity stress. Similarly, the foreign exchange market also observed volatility due to drying up of Foreign Exchange (FX) inflows amid unfavorable Balance of Payment (BOP) situation and declining FX reserves held with the SBP. As a result, the FX market witnessed increased volatility though prudent interventions by the SBP enabled the PKR/USD exchange rate to depreciate only modestly by 2.5 percent. Meanwhile, bullish run continued in the equity market as KSE-100 index surged by yet another 24.2 percent on strong corporate sector profitability, expectations of higher dividend payouts and smooth political transition after the general elections in May CY13.

The NBFIs also witnessed moderate growth in the asset base at the back of favorable developments in mutual funds industry. The asset base of NBFIs increased by 4.7 percent to PKR 577 billion of which the Net Asset Value (NAV) of the mutual funds shared 62.7 percent increase. In addition, the performance of leasing, DFIs and Modarabas also improved, while Investment Finance Companies (IFCs) continued to face the survival challenge. The mutual funds thrived at the back of booming equity market funds while NAV of money market funds decelerated. Similarly, the leasing companies witnessed a 4.1 percent growth in its business mainly in vehicle and machinery leasing activities. The operating performance of the NBFIs (excluding Mutual Funds) improved significantly during H1-CY13 owing to prudent expense management and increased profitability to PKR 3.8 billion as against PKR 0.9 billion during last year.

The insurance sector further expanded its asset size and improved penetration during the period under review. The assets of insurance and reinsurance increased by 8.4 percent with a significant contribution coming from the life insurance segment. Similarly, the penetration of the sector also improved as it accumulated 16.8 percent higher gross premiums during H1-CY13. The robust growth in premiums was largely due to rising concerns for security against financial losses as well as increasing auto finance and personal loans by banks. The life insurance business witnessed an increase of 17.4 percent in gross premiums, however, rising claims ratio and increased underwriting expenses contained the growth in its profitability. In contrast, the non life service providers posted substantially higher profits, due to decline in claims ratio at the back of high reinsurance coverage and capital gains from equity market investments.

The payment system continued to remain efficient and more reliable while ensuring mitigation of settlement, IT security and other related risks. Pakistan Real time Interbank Settlement System (PRISM) continued to perform efficiently in managing high value interbank settlements. Further, with the support from timely Intra-day Liquidity Facility (ILF) the downtime and gridlocks in the PRISM virtually diminished. Meanwhile in retail payments, the conventional paper based transaction dominated including cheques and other bank instruments. The e-banking modes witnessed increased share in retail payments as its share in transaction increased to 22.6 percent in H1-CY13. Though the payment system performance continued uphill, the high downtime of ATMs pose concern over the reliability of technology used in the banking sector.