

## 2 Risk Analysis of the Banking Sector

The risk profile of the banking sector mainly comprising of Credit, Liquidity and Market risks has remained subdued during the period under review. Credit risk, as measured by the Non-Performing Loans Ratio (NPLR) or infection ratio, has subsided. NPLR has declined by 91 bps in CY15 to record 11.4 percent; though stock of NPLs has registered a marginal rise. Textile sector's infection ratio has increased making it more vulnerable to credit risk. Whereas, decelerating trend of cash recoveries against NPLs may lead to build up in stock of NPLs. Despite some growth in non-core liabilities, funding liquidity of the banking sector, by virtue of large holdings of government securities, remains healthy. Market risk profile of the banking system is well contained, though banks may face revaluation risk in a rising interest rate scenario.

### Credit Risk

NPLR is declining amid nominal increase in stock of non-performing loans (NPLs)...

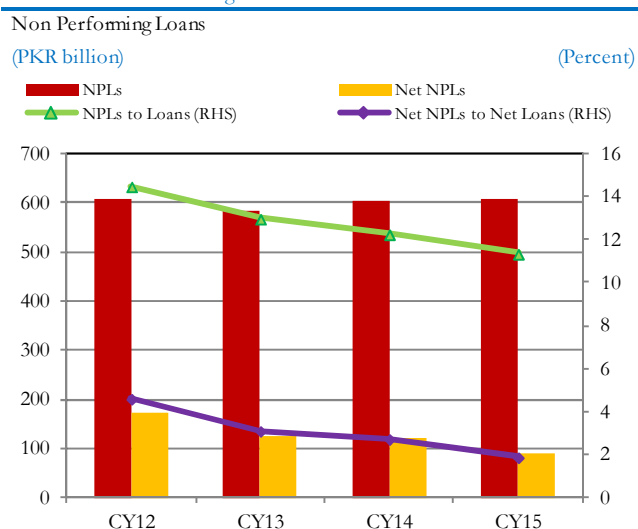
Asset quality of the banking system has observed gradual improvement over the last few years, a trend which continued during CY15. The NPLR at 11.4 percent, as of end CY15, has come down from a high of 14.5 percent in CY12. NPLR has steadily declined; 12.3 percent in CY14 and 13.0 percent in CY13 (Figure 2.1). Besides some improvements in domestic macroeconomic conditions such as falling interest rates which has led to gradual rise in credit off-take, this decline can also be attributed to banks' recovery efforts and conducive regulatory environment.

The stock of NPLs has been hovering around PKR 600 billion since CY12 (Figure 2.1). During CY15, NPLs inched up slightly by PKR 0.74 billion (or 0.12 percent YoY) to reach PKR 605.44 billion as compared to PKR 604.70 billion in CY14. The inflow of new NPLs in 2015 has almost been offset by cash recoveries (61.8 percent of fresh NPLs), write offs (13.7 percent) and restructuring and upgrade of existing NPLs (23.5 percent). The marginal rise in NPLs is mainly concentrated in textiles and textile related activities (trade and commodity finance).

With static NPLs, the improvement in infection ratio can also be attributed to growth in private sector advances. On YoY basis, gross advances have grown by 7.4 percent in CY13, 9.4 percent in CY14 and 8.1 percent in CY15, respectively.

Figure 2.1

Stock of NPLs almost Stagnant



Source: FSD, SBP

The containment of NPLs and improving NPLR are healthy signs for the banking sector's credit risk. Nevertheless, expected slower cash recoveries in the future and stagnant stock of NPLs may pose a risk to the declining trend of infection ratio leading to higher credit risk.

*Among different categories of banks, Public Sector Commercial Banks (PSCBs) and Medium-sized banks appear to be vulnerable to credit risk...*

In contrast to the overall trend, PSCBs' infection ratio has been increasing since CY13 and in CY15 it has increased by 50bps to reach 18.3 percent (Table 2.1). During CY15, stock of NPLs of PSCBs has grown by 4.2

percent (YoY) which again highlights the inherent weaknesses in the credit risk management system of these banks. NPL stock of most of the PSCBs has surged during CY15.

On the other hand, infection ratio of local private banks (LPBs) has declined from 11.4 percent in CY13 to 9.3 percent in CY15. LPBs appear to be managing their credit risk better than PSCBs.

In case of Foreign Banks (FBs), infection ratio rose by 20bps in CY15 mainly due to proportionally higher decline in advances (35 percent, YoY) as compared to decline in NPLs (33 percent, YoY). FBs, however, have the lowest NPLR among all banking categories.

**Table 2.1**  
Asset Quality by Bank Category

Bank Category	CY13		CY14		CY15	
	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio
percent						
PSCBs	17.0	71.2	17.8	71.2	18.3	79.1
LPBs	11.4	82.5	10.4	85.2	9.3	89.8
FBs	10.1	101.1	7.6	102.0	7.8	100.4
<b>CBs</b>	<b>12.6</b>	<b>79.4</b>	<b>11.9</b>	<b>80.9</b>	<b>11.1</b>	<b>86.3</b>
SBs	25.5	62.3	23.3	61.1	18.9	59.3
<b>All banks</b>	<b>13.0</b>	<b>78.4</b>	<b>12.3</b>	<b>79.8</b>	<b>11.4</b>	<b>84.9</b>

Source: FSD, SBP

In terms of size, there is gradual improvement in infection ratios for large and small banks, irrespective of their shareholdings, since CY13 (**Table 2.2**). However, gross NPLR of medium-sized<sup>56</sup> banks have increased as they are struggling to reduce their infection ratios and bring them down to industry average. It appears that some of these banks are unable to attract quality borrowers and legacy debts persist. Further, another cause of concern is that this category of banks has a lower provision coverage ratio.

Banks falling in the lowest quartile (very small-size) also have high NPLR (21.2 percent) but they possess sufficient coverage (92.5 percent). Thus, these banks due to their limited systemic impact (2 percent share in

<sup>56</sup> At the end of CY15, medium-sized banks have 22% share in advances and 32% share in NPLs stock.

advances and 3 percent shares in NPLs) and adequate coverage to NPLS do not represent the weakest link.

**Table 2.2**  
Asset Quality by Bank Size

Bank Category	CY13		CY14		CY15	
	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio	Infection Ratio	Provision Coverage Ratio
percent						
Quartile 4 (Large)	12.2	81.6	11.8	80.4	9.8	92.0
Quartile 3 (Medium)	14.8	70.0	13.9	78.0	16.4	74.9
Quartile 2 (Small)	13.1	65.8	9.9	73.5	9.5	72.2
Quartile 1 (Very Small)	21.1	92.9	19.6	92.4	21.2	92.5
<b>All banks</b>	<b>13.0</b>	<b>78.4</b>	<b>12.3</b>	<b>79.8</b>	<b>11.4</b>	<b>84.9</b>

Source: FSD, SBP

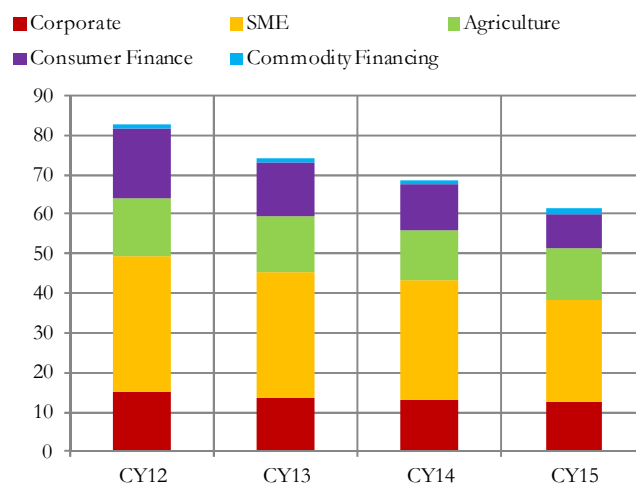
*Corporates becoming less riskier; while SMEs, despite improvements, carry higher credit risk...*

In terms of segments, NPLR has improved across most categories (Corporate, SMEs, Consumers) since CY12 (**Figure 2.2**). From 15.0 percent in CY12, NPLR of corporates has come down to 12.30 percent in CY15. The level is still high but the declining trend is encouraging. If the corporate infection ratio continues to improve, it would not only motivate banks to take on more risks but also help corporates get loans at reasonable rates.

**Figure 2.2**  
SME sector has the highest infection ratio

Infection Ratio by Major Segments

(Percent)



Source: FSD, SBP

SMEs, with highest infection ratio (26 percent) in CY15, still remain the most risky sector for the banks to lend. Historically, SMEs have higher NPLs due to operating vulnerabilities like lack of financial resources, limited technical upgrading and lack of training<sup>57</sup>. However, with recent improvements in macro environment, especially the cost of borrowings, SMEs are expected to fare better and downward trend in their infection ratio is expected to continue.

*Rising NPLs intensify textile, sugar, and energy sectors' concentration risk...*

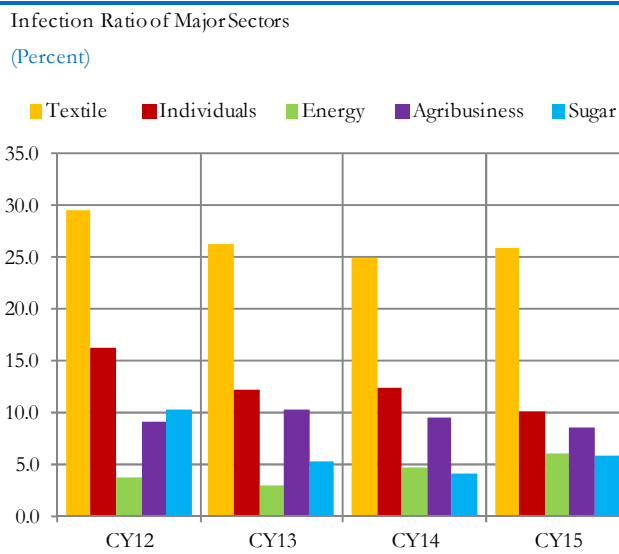
In terms of concentration, textile sector still represents one of the largest sectors as its share in total advances, though declining<sup>58</sup>, is still sizeable (14.3 percent in CY15). In contrast, the infection ratio has been almost stagnant during the last three years and have hovered around 26 percent in CY15 (**Figure 2.3**). Persistent risk in the textile sector has made it more vulnerable for the lenders. Advances to the textile sector in CY15 have declined by 3.8 percent (YoY). Subdued commodity prices in international markets, slowdown in global demand, and energy shortfall has also led to the decline in demand for credit by the sector. Being the largest sector in terms of exposure, high infection ratio of textile sector has systemic implications (**See Box 2.1**).

Sugar sector, though not huge in terms of exposure (2.72 percent in CY15) but important for other reasons, has also exhibited slight rise in infection ratio in the wake of surplus sugar production and lower international sugar prices. However, keeping in view its small share, the sugar sector represents limited systemic risk to the banking sector (**See Box 2.2**).

Apart from these two sectors, energy sector advances grew by 9.7 percent whereas its infection ratio worsened by 1.3 percent over the last year. Due to the rising exposure of banks on energy sector and persistence of circular debt issue<sup>59</sup>, banks need to put in place proper

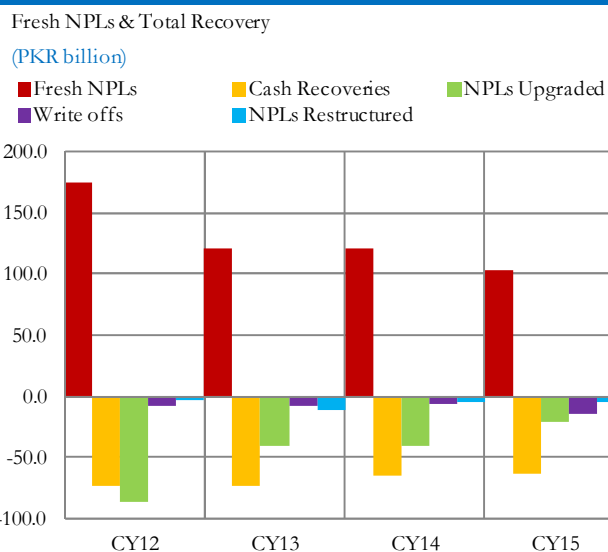
risk monitoring and mitigating mechanisms to ensure non-build up of bad debts in the energy sector.

**Figure 2.3**  
Textile sector has the largest share and highest infection ratio



Source: FSD, SBP

**Figure 2.4**  
Flow of fresh NPLs considerably declined



Source: FSD, SBP

*Receding fresh NPLs and improved provision coverage ratio has increased the resilience of the banking sector...*

The flow of fresh NPLs is decelerating since CY12 on the back of cash recoveries and better recovery efforts

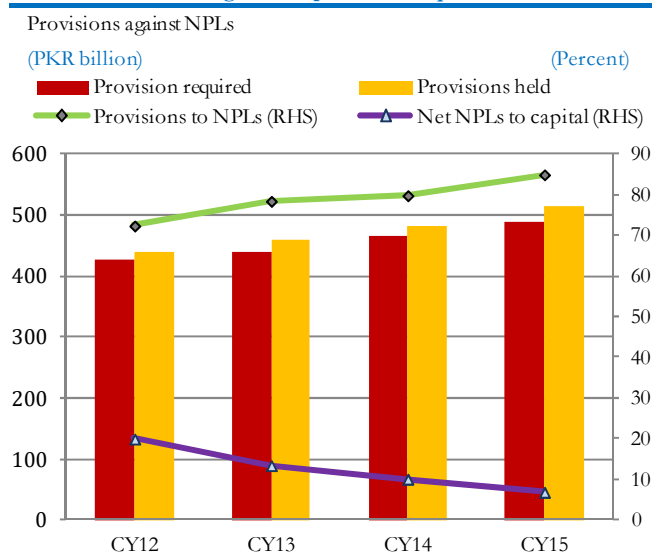
<sup>57</sup> SMEDA, "State of SMEs in Pakistan" (www.smeda.org)

<sup>58</sup> The share of textile sector advances in total advances was 16.7 percent in CY12, 17.3 percent in CY13 and 16.1 percent in CY14.

<sup>59</sup> Anecdotal evidence suggests that circular debt issue remains a concern.

on the part of banks (**Figure 2.4**). In CY15, additions to NPLs amounted to Rs 103 billion which is 41 percent less than the peak of Rs 175 billion in CY12. Moreover, the provision coverage ratio has improved to 85 percent in CY15 from 80 percent in CY14 and 78 percent in CY13 (**Figure 2.5**).

**Figure 2.5**  
Provisions held are higher than provisions required



Source: FSD, SBP

The rise in provisions held by the banking sector against bad debts is due both to the rise in specific provisions which increased by 5.2 percent (YoY) and increase in general provisions which grew by 41 percent (YoY) in CY15<sup>60</sup>. The gradual diminution in the benefit of Forced Sale Value (FSV), allowed earlier by SBP<sup>61</sup>, has induced increase in the stock of specific provisions. Further, the migration from substandard and doubtful categories to loss category also led to an increase in overall provisioning requirements.

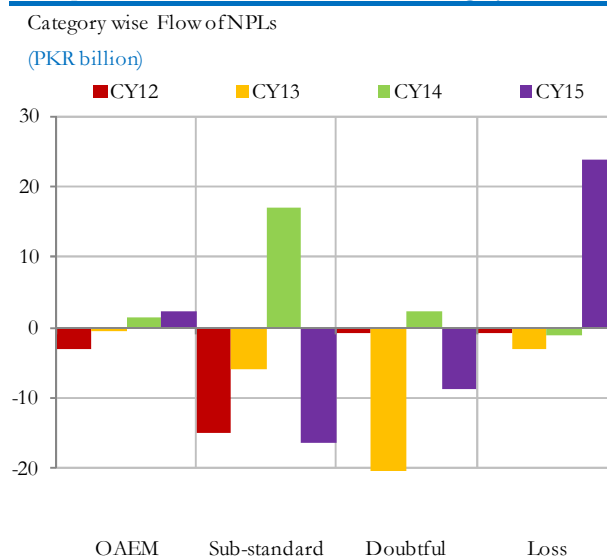
*Rise in bad debts in loss category may increase the cost of lending...*

<sup>60</sup> Total provision exceeds the required provisions as banks 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.

<sup>61</sup> BSD Circular No 1 of 2011

A cause of concern is that the composition of NPLs is tilted towards the loss category which constitutes the bulk (86 percent) of the total bad loans (**Figure 2.6**). In CY15, an additional amount of PKR 24 billion was added to the loss category. However, considering that loss category of advances are, generally, fully provided for (PKR 519 billion), the credit risk tapers down, to some extent. Nevertheless, banks need to ensure that instead of allowing the bad debts to pile up, they need to improve their credit risk evaluation and monitoring processes. Rise in bad debts would increase the cost of lending which would eventually be passed on to the customers.

**Figure 2.6**  
Composition of NPLs is tilted towards loss category



Source: FSD, SBP

*Cash Recovery against NPLs started decelerating after 2013...*

Overall cash recoveries are on a declining path and in CY15 they have declined by 2 percent to reach PKR 63.7 billion (**Figure 2.7**). Recovery to Average NPLs ratio has also decelerated from 12.2 percent in CY13 to 10.5 percent in CY15. Lengthy legal recovery process and lack of efforts on part of some banks to recover bad debts appear to be the major reasons for the slowdown in recoveries. Moreover, persistent higher stock of NPLs in loss category implies slim chances of any further recoveries.

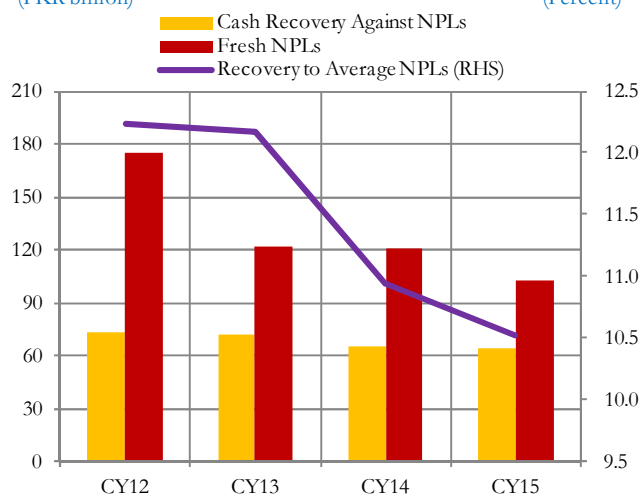
During 2015, LPBs have remained the main contributors to recoveries with 65 percent share in total recoveries followed by specialized banks (SBs) & FBs with a share of 22 and 13 percent, respectively. PSCBs have again been the poorest performers with less than 1 percent share in total recoveries.

**Figure 2.7**

**Cash recovery gradually receding**

Cash Recovery & Flow of Fresh NPLs

(PKR billion) (Percent)



Source: FSD, SBP

*Among different products of Consumer finance, Mortgage loans have the highest infection ratio...*

Except consumer durables, all other consumer financing categories exhibited improvement in infection ratio. The stock of NPLs declined by 15 percent leading to a lower infection ratio of 8.7 percent in CY15 (**Table 2.3**).

Mortgage loans have the highest infection ratio (25 percent) in CY15. However, the share of residential mortgage is less than 1 percent in total bank loans. The highest infection ratio can be attributed to the structural issues faced by banks including weak foreclosure standards, lengthy judicial procedures, non-automation of documentation and non-standardization of procedures amongst various housing schemes.

**Table 2.3**

**NPL Ratio of Consumer Financing**

	CY14		CY15	
	Share	Infection	Share	Infection
	percent			
Credit cards	7.8	10.5	7.4	9.7
Auto loans	24.1	5.1	28.3	2.8
Consumer durable	0.1	20.3	0.1	21.0
Mortgage loans	17.8	27.0	16.2	24.8
Other personal loans	50.2	9.5	48.0	6.5
<b>Total</b>	<b>100.0</b>	<b>11.6</b>	<b>100.0</b>	<b>8.7</b>

Source: FSD, SBP

*Pakistan has the highest NPLs and the highest coverage ratio in the region...*

The regional comparison shows that Pakistan has the highest gross infection ratio (**Table 2.4**). This is largely due to legacy issues<sup>62</sup> as the flow of new NPLs have receded over the years. Due to the legal impediments to writing-off long overdue loans and lengthy litigation process, banks are reluctant to shed off bad loans from their books. A prudent write-offs policy and dedicated efforts to increase recoveries can improve the situation.

**Table 2.4**

**Infection Ratio & Provision Coverage Ratio (percent)**

S.No	Country	CY13	CY14	CY15*	CY13	CY14	CY15*
		Infection Ratio			Coverage Ratio		
		percent					
1	Pakistan	13.0	12.3	12.5	78.0	80.0	82.0
2	Bangladesh	8.6	9.4	9.3**	44.0	42.0	37.0
3	India	4.0	4.4	4.8	47.0	49.0	49.0
4	Indonesia	1.7	2.1	2.6	51.0	51.0	51.0
5	Sri Lanka	5.6	4.2	4.2	40.0	42.0	38.0

\* September 2015 except Bangladesh

\*\* June 2015

Source: FSIs (<http://data.imf.org>)

Pakistan's banking industry, however, maintains adequate level of provisions against NPLs which is the highest in the region (**Table 2.4**). This provides comfort against imminent idiosyncratic and systemic risks.

<sup>62</sup> An aging analysis of NPLs shows that more than 40% of the amount under loss category is older than 5 years with remote chances of recovery

*Results of credit shocks remain satisfactory, though there are some concentration concerns...*

Different hypothetical credit shocks aimed at testing the borrower-wise concentration do not yield encouraging results as around one-third of the banks become non-compliant with the local benchmark of CAR. On the other hand, credit shocks based on historical data do not pose much threat to the asset quality and solvency of the banking sector. Stress tests are discussed in detail in **Chapter 3**.

*Improving macroeconomic conditions suggest lower credit risk in the future...*

Going forward, the improvements in macroeconomic environment signal diluted risks for the buildup of bad debts. The economy is showing signs of recovery; credit to private sector is picking up amid lower interest rates; Large Scale Manufacturing (LSM) is growing; law and order situation is improving and energy shortages are becoming less acute. The decline in oil prices is providing much needed support to the foreign exchange reserves and helping to bring down the production costs. Thus, banks are anticipated to operate in a favorable macroeconomic environment which might alter their risk taking behavior.

Nevertheless, outstanding stock of old NPLs and slower cash recoveries are the areas of concern for credit risk.

### Liquidity Risk

The liquidity profile of the banking sector is characterized by both market developments and the funding position.

*Market liquidity: Calmness prevailed after introduction of SBP target rate ...*

To better manage market liquidity, SBP has introduced changes to its interest rate corridor in May 2015. SBP's main policy rate, which is a target rate<sup>63</sup>, set 50 bps below the ceiling rate has been introduced and the width of the

<sup>63</sup> It is to be noted that this target rate is for money market ONR where SBP manages liquidity (primarily through OMOs) in the market to ensure that ONR remains close to the target rate. <http://www.sbp.org.pk/dmmd/2015/C9.htm>

interest rate corridor has also been reduced to 200 bps<sup>64</sup>. These steps, along with the monetary easing, have resulted in a significant reduction in volatility in the money market liquidity towards the second half of CY15. Not surprisingly, however, OMOs increased both in volume and frequency in order to achieve the aforementioned stability.

The calmness in the money market reduced risks to the day to day liquidity management by the banks. (For details see **Chapter 7**).

*Fund based liquidity remained strong...*

Funding liquidity of the banking sector has also remained healthy during CY15. Though there was increase in non-core liabilities<sup>65</sup>, deposits remained the backbone of the funding mix.

Given the increase in long-term investments in government securities, banks have made efforts to raise fixed deposits in order to match the maturities. Overall, funding liquidity indicators improved during the period under review.

*Core liabilities remained the mainstay of banks' source of funding...*

With a growth of 12.6 percent in CY15 (11 percent in CY14), deposits have been the major contributor towards managing funding requirements (**Figure 2.8**). However, some deceleration in the growth of deposits<sup>66</sup> forced banks to turn to non-core liabilities to fund their asset (advances and investments) growth. This is clearly indicated by a 76.4 percent rise in borrowings during CY15 compared to 38.4 percent in CY14. Overall, the share of non-core liabilities has increased to 20.3 percent in CY15 from 16.6 percent in CY14. Despite this rise, any significant funding risk does not arise as majority of these non-core liabilities consists of secured borrowings.

<sup>64</sup> Besides, SBP also withdrew the penal rate on frequent access (7 times in a quarter) to SBP Reverse Repo and Repo facilities.

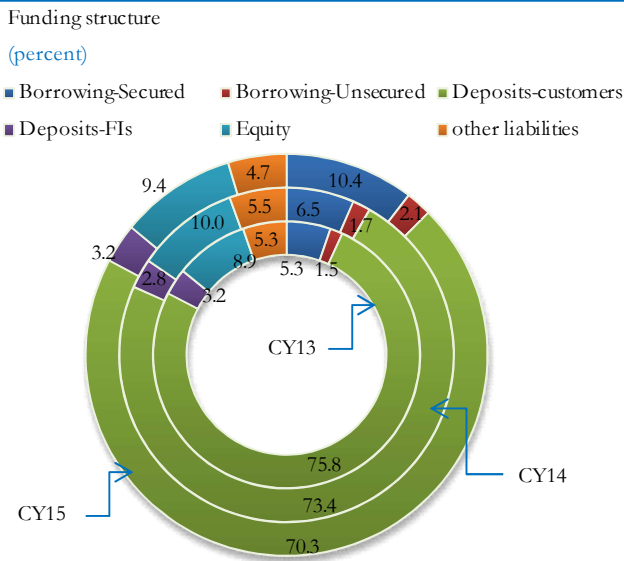
<sup>65</sup> Customer deposits are core liabilities while all other liabilities are referred to as non-core liabilities.

<sup>66</sup> In the preceding two years of CY13 and CY12, YoY growth in deposits was 14% and 17%, respectively.



**Figure 2.8**

**Deposits continued to be the main funding source**



Source: FSD, SBP

...while funding cost of non-core liabilities remained higher

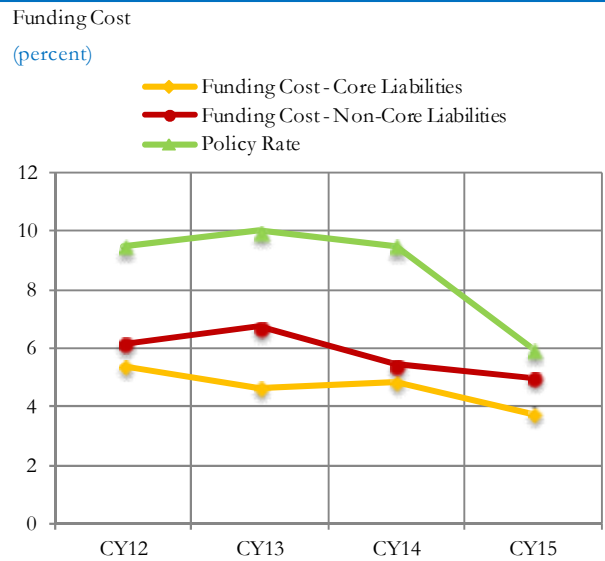
Customer deposits have always been the cheaper source of funds for the banks compared to non-core liabilities which are costlier (Figure 2.9). During CY15, the cost of core liabilities also declined with the continuous fall in interest rates. On the other hand, decline in cost of non-core liabilities was lower due to higher volume of borrowings compared to CY14.

Long term deposits registered consistent growth...

As banks are investing more in long-term securities, they are also making efforts to raise long-term deposits. During CY15 fixed deposits grew by 6.9 percent (YoY). The maturity profile of the deposits also indicates that deposits having maturity longer than three months have increased, while the ones having maturity lesser than three months have decreased (Figure 2.10).

**Figure 2.9**

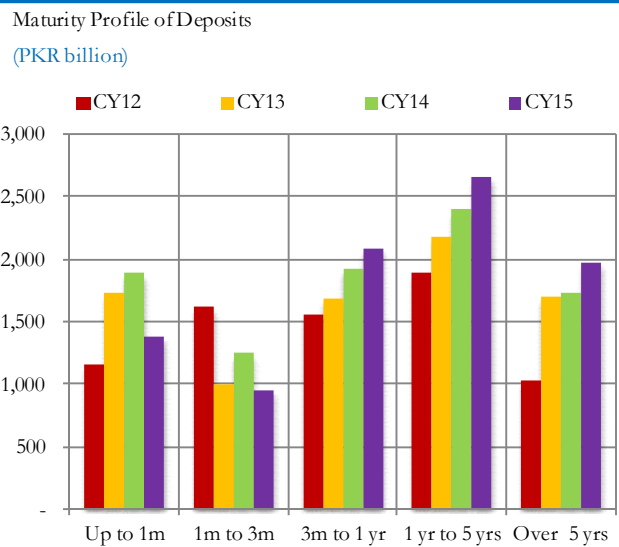
**Funding cost of non-core liabilities remained higher**



Source: FSD, SBP

**Figure 2.10**

**Long term deposits registered consistent growth**



Source: FSD, SBP

The profile of liquid assets has not changed...

The structure of the liquid assets of the banks has not changed as government securities continue to be the major component during CY15 (Figure 2.11). Share of government securities in total liquid assets has increased

to 83.1 percent in CY15 from 80.7 percent in CY14 and 75.1 percent in CY13.

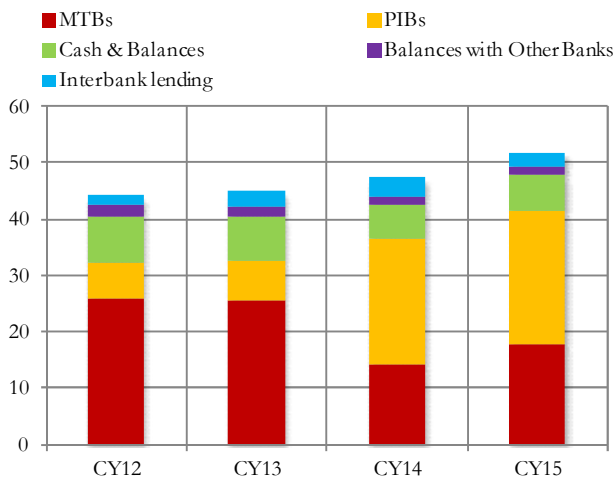
A structural shift towards investment in long-term securities was observed in CY14 owing to the anticipated fall of interest rates at that time. This motivation had led to an increase of 15.4 percentage points in the share of PIBs in total assets during CY14.

On the other hand in CY15, in addition to PIBs, banks have also invested considerably in MTBs owing to uncertainty about future interest rates. Overall, the share of both PIBs and MTBs in investments has increased during CY15.

**Figure 2.11**  
**Fund based liquidity further improved**

Liquid Assets as a percentage of Total Assets

(percent)



Source: FSD, SBP

*...where banks continue to place majority of their risk free government securities in Available for Sale category*

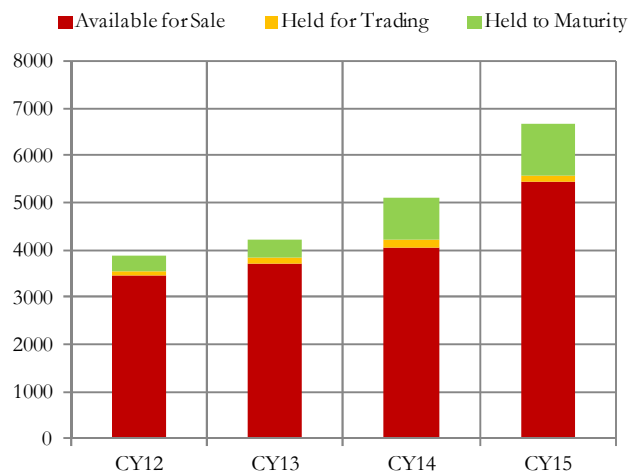
Banks have persisted with their liquidity preference through placement of most of the securities into Available for Sale (AFS) category of investments, which allows banks to efficiently manage their liquidity requirements. Moreover, revaluation gains/losses on AFS securities do not impact the profit and loss statement. In terms of share, 95 percent of MTBs and 71 percent of PIBs are placed in AFS category as of end CY15 (**Figure 2.12**).

In addition to the AFS category, over the last two years, banks have also looked to lock in their income stream from investments by placing some of them in Held to Maturity (HTM)<sup>67</sup> category, majority of which are PIBs. Higher coupon rates and anticipation of decline in interest rates in the future were the reasons behind this diversification.

**Figure 2.12**  
**Banks continued to prefer Available for Sale Category**

Government Securities by Category

(PKR billion)



Source: FSD, SBP

*Small banks exhibited comparatively lower liquidity...*

Comparing liquid assets of the banks with their overall assets reveals that not all banks are equally placed in terms of liquidity during CY15 (**Table 2.5**). Some of the growing banks (including three Islamic banks) belonged to the second quartile (small banks), which continue to have the lowest amount of liquid assets, due to credit growth and branch expansion.

Moreover, lack of high quality Shariah compliant debt instruments and unsophisticated secondary markets for such instruments have also hampered Islamic banks in this regard. On the other hand, large banks had the highest amount of liquid assets. Their ability to attract low cost deposits due to their wider market presence has helped them accumulate higher stock of liquid assets.

<sup>67</sup> Share of HTM in gross investments remained around 17 percent during last two years compared to 9 percent in CY13.



**Table 2.5**

**Liquidity by Bank Size (percent)**

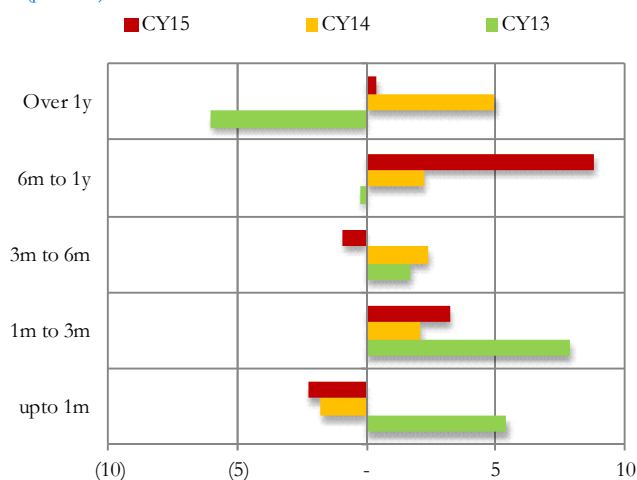
Bank Category	CY12	CY13	CY14	CY15
	Liquid Assets to Total Assets			
percent				
Quartile 4 (Large)	47.2	48.4	51.5	55.4
Quartile 3 (Medium)	45.8	41.9	42.6	51.8
Quartile 2 (Small)	50.6	45.8	45.9	45.7
Quartile 1 (Very Small)	57.0	58.3	48.5	54.1
<b>All banks</b>	<b>47.4</b>	<b>47.3</b>	<b>49.2</b>	<b>53.8</b>

Source: FSD, SBP

**Figure 2.13**

**Gap remained negative over 30-day horizon**

Maturity Gap (Assets-Liabilities) as percent of Assets (percent)



Source: FSD, SBP

*Gap remained negative over 30-day horizon...*

The banking sector presents a mixed picture when it comes to matching the maturity of assets and liabilities. During CY15, banks have fallen short over the 30-day horizon as the deposits maturing within this period have exceeded the assets. In comparison, the Gap for “up to 1m” is also negative in CY14, though it is somewhat lower than CY15. Similarly, the Gap for “3m to 6m” bucket has also turned negative during the period under review (Figure 2.13).

Despite the aforementioned negative Gaps, it has to be kept in mind that maturity Gap analysis does not account for the tradability of the liquid assets. As mentioned before, banks have had a large amount of highly liquid government securities at their disposal, which has contributed to comfortable levels of liquidity throughout the year under review.

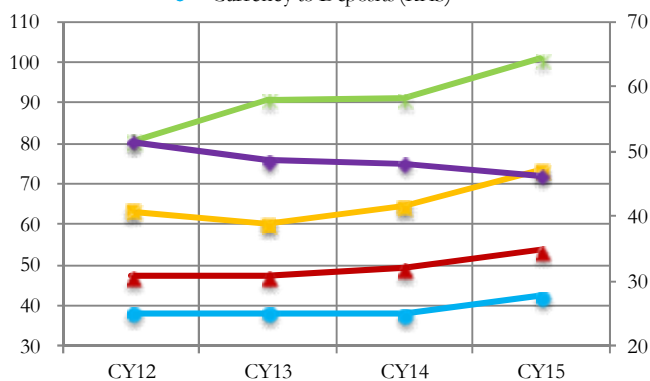
On the positive side, there is improvement in Gap for “1m to 3m” and “6m to 1y” maturities. The latter can be largely attributed to the higher stock of long term securities accumulated by the banks over the last two years.

**Figure 2.14**

**Liquidity Indicators stayed healthy**

Liquidity Indicators

- (percent)
  - Liquid Assets to Total Assets
  - Liquid Assets to Deposits
  - Liquid assets to Short-term liabilities
  - Advances to Deposits (RHS)
  - Currency to Deposits (RHS)



Source: FSD, SBP

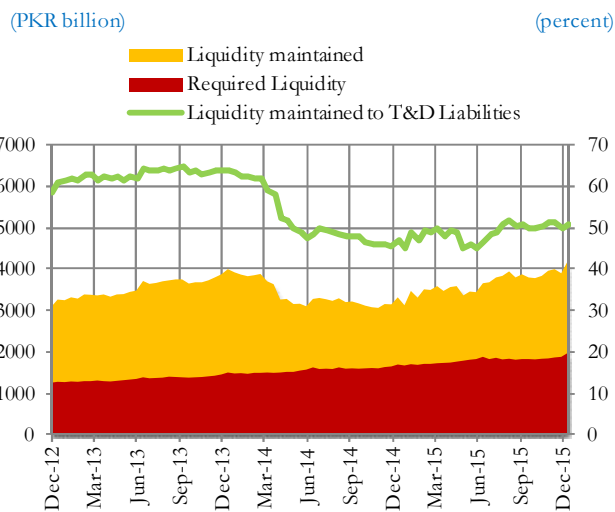
*Liquidity indicators stayed healthy...*

During CY15, more than half of the assets of the banks have fallen in the liquid assets category. As a result, all liquid assets indicators improved (Figure 2.14). Moreover, liquid assets maintained by the banks with SBP as per Statutory Liquidity Requirement (SLR) continue to remain well above the required level of 24 percent (including 5 percent Cash Reserve Requirement) (Figure 2.15). The ratio stood at 50.8 percent at the end of CY15 compared to 46.8 percent last year.

**Figure 2.15**

**Banks maintained surplus liquidity**

Required and Maintained Liquidity by Banks



Source: OSED, SBP

*Rising currency in circulation a risk to deposit growth...*

In an easy monetary policy regime, currency in circulation (CiC) may increase as the overall money supply increases. However, in an efficient intermediation process, the rise in CiC is not prominent. Over the last few years, the currency-in-circulation to deposits ratio (CDR) in Pakistan has exhibited minimal changes.<sup>68</sup> However, the ratio has increased by 4.0 percentage points to reach 32.5 percent as of end December 2015 from 28.5 percent as of end December, 2014.<sup>69</sup>

The rise in CDR points towards depositors' liquidity preference. In a low interest rate environment and higher money supply, savers' opportunity cost of holding cash declines and they either increase consumption or look for better return assets (such as Stocks, CDNS, Property market etc.) rather than keeping deposits in a bank.

However, normally, major part of these funds channel back to the banks' balance sheet in the form of deposits, but it does not seem to be the case during CY15. Some disincentive in the form of withholding tax on banking transactions could be one of the reasons. Rise in CiC

<sup>68</sup> CDR has been hovering around 28.6 percent, as of end December, during the last three years (2012-2015).

<sup>69</sup> CDR has further edged up to 35 percent as of April 8, 2016.

does not bode well for the banking sector and banks need to devise ways to attract depositors, with ample liquidity, in order to have sufficient funds in the future.

*Banks would stand resilient towards various liquidity shocks...*

Banking sector would remain resilient in the face of different liquidity shocks. The results of stress tests on the banking sector reaffirm that system is satisfactorily placed to withstand liquidity shocks under different stress scenarios. For instance, severe liquidity shocks of significant deposit withdrawal for consecutive five days would have negligible effect on the short-term liquidity of the banks. Further, the liquidity coverage ratio (LCR) of the banking system<sup>70</sup>, remained well above the acceptable benchmark of 1, as defined under Basel III. Stress tests are discussed in detail in **Chapter 3**.

**Market Risk**

Market risk refers to the possibility of losses in the on and off-balance sheet positions arising from adverse movements in market prices (interest rates, exchange rates, commodity prices etc.).<sup>71</sup> The market risk of the banking system has remained manageable during CY15.

*Negative short-term rate sensitive Gaps, though within limits, may raise repricing risk in case of increase in interest rates...*

During CY15, the Gap between the rate sensitive assets (RSA) and rate sensitive liabilities (RSL) remained negative for "up to 3m" maturity bucket (**Figure 2.16**). Moreover, the Gap for "3m to 6m" maturities also turned negative compared to positive value for CY14. These negative Gaps may expose banks to repricing risk if the interest rates increase in the future as banks may have to borrow at higher interest rates. On the other hand, banks can benefit in case of further decline in interest rates.

<sup>70</sup> The Liquidity Coverage Ratio will require banks to have sufficient high quality liquid assets to survive a significant stress scenario lasting 30 calendar days.

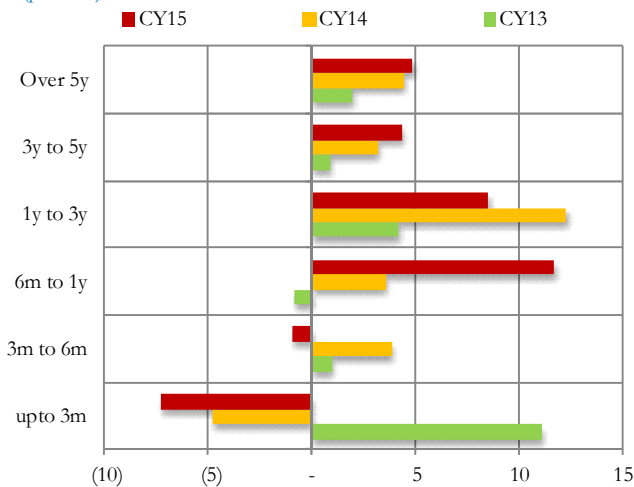
<sup>71</sup> For details see European Banking Authority <https://www.eba.europa.eu/regulation-and-policy/market-risk>

**Figure 2.16**

**Gap (RSA-RSL) remained positive for long term maturities**

Gap (RSA-RSL) as percentage of Assets

(percent)



Source: FSD, SBP

...while positive long-term rate sensitive Gaps may expose banks to revaluation risk in case of rise in interest rates.

Risk sensitive Gap for maturities greater than six months, which was already positive in CY14, has further increased during CY15. This is largely due to the anticipation of further decline in interest rates. Given such high positive Gaps, banks may get exposed to revaluation risk under an increasing interest rate scenario.

*Banks' foreign exchange and equity exposures stayed within limits...*

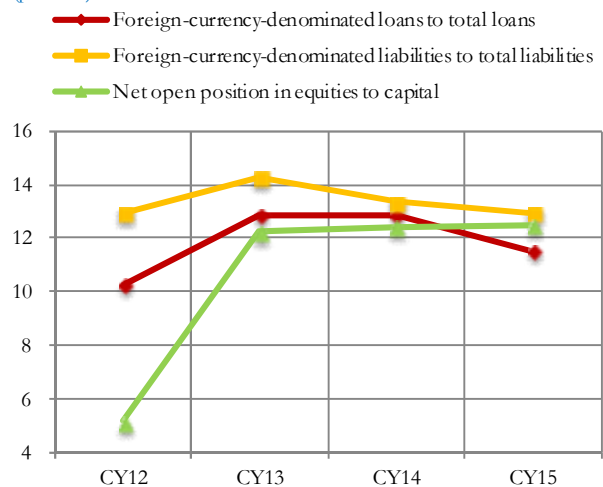
Both foreign exchange assets and liabilities have slightly decreased, while equity exposures have exhibited minimal increase. SBP's prudent policies pertaining to limits on foreign exchange and equity exposures<sup>72</sup> are largely behind the aforementioned trends in market exposures of the banking sector (**Figure 2.17**).

**Figure 2.17**

**Market exposure stayed within limits**

Foreign currency and equity exposures

(percent)



Source: FSD, SBP

<sup>72</sup> Prudential Regulations R-6 and O-5 for Corporate/Commercial banking <http://www.sbp.org.pk/publications/prudential/index.htm>

### Box 2.1: Banking exposure on Textile Sector – a stability perspective

Textile sector has a special significance in the economy of Pakistan due to its backward and forward linkages. This important sector has deep rooted connection with the real sector in many ways i.e. (a) highest share in export volume, (b) more than 40 percent absorption of workforce employment, and (c) significant participation in manufacturing activity with 8.5 percent share in Gross Domestic Product (GDP)<sup>73</sup>. Further, Pakistan is the 4<sup>th</sup> largest producer of cotton<sup>74</sup> with 8.8 percent share in the global production<sup>75</sup>. The spinning industry is the key user of cotton and enables Pakistan to hold around 10.33 percent share in global consumption of cotton.

Textile sector is facing multiple challenges and showing dwindling performance in recent times with decelerating production. Growth in Large Scale Manufacturing (LSM) index of textile sector<sup>76</sup> has reduced to 0.53 percent during FY15 from 1.32 percent during FY14 and 1.6 percent during FY13 (**Table 1**). Recently, during July15-Jan16 (7 months), YoY growth in LSM index has fallen to 0.95 percent compared to 1.05 percent in corresponding period last year.

The textiles' export performance has also been negative. The export of textile & textile articles has touched USD 13.5 billion in FY15 as compared to USD 13.7 billion in FY14 and USD 13.0 billion in FY13 (**Table 2**). In the first eight months (Jul-Feb) of FY16, textile exports have declined by 8.8 percent and were recorded at USD 8.4 billion. The almost stagnant growth in textile export since last few years might have resulted in decline in Pakistan's share in global textile exports in contrast to rising share of peer countries (China, Bangladesh, India etc)<sup>77</sup>.

<sup>73</sup> Source: All Pakistan Textile Mills Association (APTMA)

<sup>74</sup> <http://www.statista.com/statistics/263055/cotton-production-worldwide-by-top-countries/>

<sup>75</sup> Source: "COTISTICS – Annual Cotton Statistics Bulletin", Volume 44, August 2015

<sup>76</sup> Textile sector has around 21 percent weight in LSM index.

<sup>77</sup> Latif, R., Javid, A. Y. (2013), "Determinants for The Demand and Supply of Textile Exports of Pakistan", PIDE Working Paper, 2013:95

**Table 1**  
LSM Growth in Textile Sector

Percent	Weight in LSM	YoY Change		
		FY13	FY14	FY15
<b>Textile</b>	<b>20.91</b>	<b>1.6</b>	<b>1.3</b>	<b>0.5</b>
Yarn	12.96	2.1	1.6	0.5
Cloth	7.19	0.6	0.7	0.1
Jute Goods (Total)	0.33	9.3	-1.1	-7.2
Woollen & carpet yarn	0.33	-7.5	25.6	46.0
Woolen & worsted cloth	0.09	-3.3	-10.0	-11.0
Knitting wool	0.01	8.5	-21.2	0.7
Woolen blankets	0.00	-27.0	-7.3	47.2
<b>Overall LSM Index</b>		<b>4.1</b>	<b>4.1</b>	<b>3.3</b>

Source: Pakistan Bureau of Statistics

Note: FY means here Fiscal Year

**Table 2**  
Export Performance of Textile Sector in Pakistan

	USD billion		
	FY14	FY15	Change
<b>Export - Overall Textile</b>	<b>13,720</b>	<b>13,476</b>	<b>-1.8%</b>
<i>of which</i>			
Cotton Cloth	2,770	2,455	-11.4%
knitwear	2,294	2,417	5.4%
Readymade garments	1,909	2,101	10.0%
Bedwear	2,138	2,096	-2.0%
Cotton yarn	1,997	1,842	-7.8%
Towels	767	781	1.8%
Other Textile Items	1,845	1,784	-3.3%
<b>Total exports</b>	<b>25,110</b>	<b>23,880</b>	<b>-4.9%</b>

Source: Pakistan Bureau of Statistics

Note: FY means here Fiscal Year

Not surprisingly, the financial information of listed textile companies at Karachi (now Pakistan) stock exchange shows a clear decline in profits and meager rise in sales growth in FY15 as compared to the previous year (**Table 3**).

**Table 3**

Performance of Listed Companies - Textile Sector

PKR million	Top-20 listed Companies			Textile Industry*		
	2014	2015	growth	2014	2015	growth
Equity	160,653	185,037	15%	207,114	238,552	15%
Assets	409,041	449,360	10%	574,231	639,794	11%
Sales	350,963	359,471	2%	564,077	581,388	3%
Profit (before Tax)	13,236	11,172	-16%	20,646	12,684	-39%
Profit (after tax)	10,542	7,842	-26%	16,858	8,611	-49%

\* Available information for companies as of Jun-15 is compared with same companies as of Jun-14

Source: Pakistan Stock Exchange

Note: FY means here FY

The current state of textile industry in Pakistan could be attributed to multiple reasons, of which, few are listed below:

- i. The prices of the textile products in the international markets have plummeted in recent past. The international cotton price index has fallen by 24 percent from 90.09 US Cents per pound in Sep-13 to 68.74 US Cents per pound in Sep-15. The decline is even more pronounced (62 percent) if referenced from Jan-11 (**Figure 1**). Sluggish global demand due to consistent recessionary phase in the Euro Zone and slowdown in China is one of the major reasons for the decline in international prices<sup>78</sup>. The steep fall in prices has adversely impacted the export revenues of the textile sector in Pakistan.
- ii. The subdued economic condition in China – one of the key trading partners and buyer of Pakistan’s textile goods- also dented the performance of textile exports. The overall export to china declined during Jul14-Jun15 by 15 percent to reach at USD 2.3 billion<sup>79</sup>.

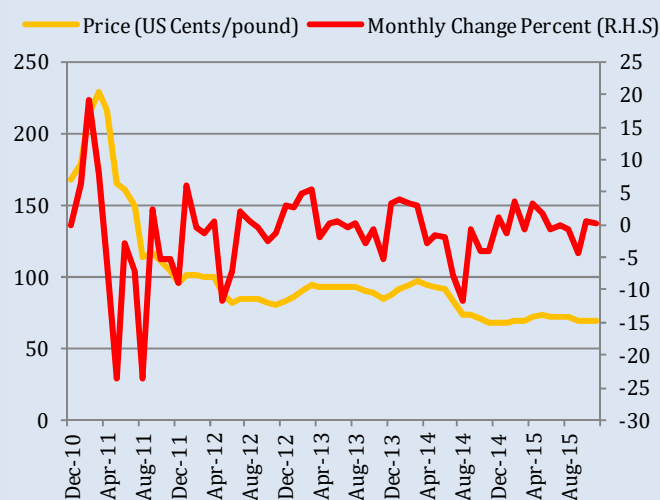
<sup>78</sup> Source: World Bank, “Global Economic Prospects January 2016”

<sup>79</sup> Investigations have revealed that many of the large borrowers have reduced their production due to inability to book orders from China.

**Figure 1**

International cotton prices declined to historical low

International Cotton Price Index - Monthly



Source: IMF

- iii. Domestically, inadequate availability of energy and rising utility prices have compelled the firms to either make expensive alternate arrangements or shutdown the production, in the extreme case. The rising cost of production has resulted in underutilized and/or unutilized productive capacity making it difficult for the firms to survive. The loss making firms to operating firms in textiles have risen from 36 percent as of Jun-14 to 63 percent as of Jun-15.<sup>80</sup>
- iv. The ease of doing business in Pakistan is not up to the mark if compared to the rest of the world (**Table 4**).

<sup>80</sup> Source: Pakistan Stock Exchange.

**Table 4****Country-wise Ranking in Ease of Doing Business for Year 2016**

	Overall Ranking	Starting Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Minority Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
Malaysia	18	14	15	13	38	28	4	31	49	44	45
Thailand	49	96	39	11	57	97	36	70	56	57	49
Turkey	55	94	98	36	52	79	20	61	62	36	124
China	84	136	176	92	43	79	134	132	96	7	55
Philippines	103	165	99	19	112	109	155	126	95	140	53
Sri Lanka	107	98	77	81	153	97	49	158	90	161	78
Iran	118	87	69	88	91	97	150	123	167	62	140
India	130	155	183	70	138	42	8	157	133	178	136
<b>Pakistan</b>	138	122	61	157	137	133	25	171	169	151	94
Bangladesh	174	117	118	189	185	133	88	86	172	188	155
Afghanistan	177	34	185	156	184	97	189	89	174	172	160

Source: World Bank

According to World Bank's survey<sup>81</sup> on "ease of doing business", Pakistan has been ranked at 138 (out of 185 countries) included in the survey. This ranking was assigned considering various components important for doing business e.g. access to energy and credit, registering property, trading across boarder, taxes etc. Importantly, as per the report, Pakistan is one of the lowest ranked countries in terms of getting electricity, paying taxes, and enforcing contract.

- v. The deceleration in textile sector is reflected in the slowdown in LSM growth in yarn and cloth sectors<sup>82</sup>. The LSM growth in yarn and cloth decelerated to 0.5 percent and 0.1 percent during Jul14-Jun15.

#### Why is textile sector important for banking sector?

Textile sector has been one of the core users of the banking services in Pakistan. As of end September, 2015 the overall gross lending of all banks to textile sector was PKR 676 billion or 13.4 percent of the overall gross advances<sup>83</sup>, of which, around PKR 86 billion exposure was non-fund based (off-balance sheet). Under SBP's

<sup>81</sup> <http://www.doingbusiness.org/rankings>

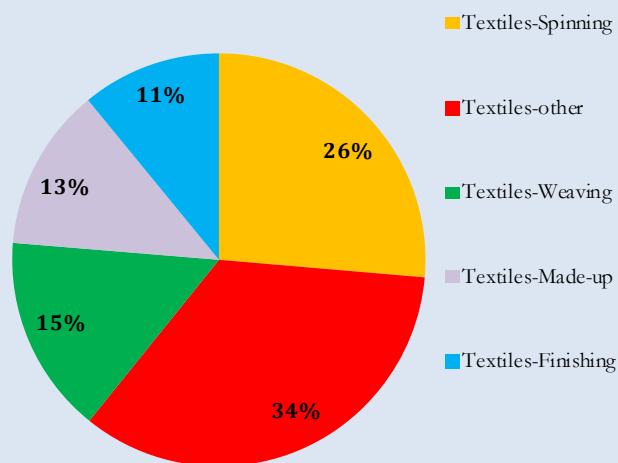
<sup>82</sup> Yarn and cloths carry 13 percent and 7 percent weight, respectively, in LSM index out of 21 percent for textiles.

<sup>83</sup> Due to cyclical movement, the gross lending keeps moving particularly during last two quarters of calendar year.

export financing scheme (EFS), SBP provides short term financing facilities to exporters through banks for exports of all manufactured goods especially value added products. As of end December 2015, textile sector has around 60 percent share in EFS.

**Figure 2****Textile sector exposure is well diversified**

Segment-wise Exposure as of End Sep, 2015 - Textile Sector



Source: FSD, SBP

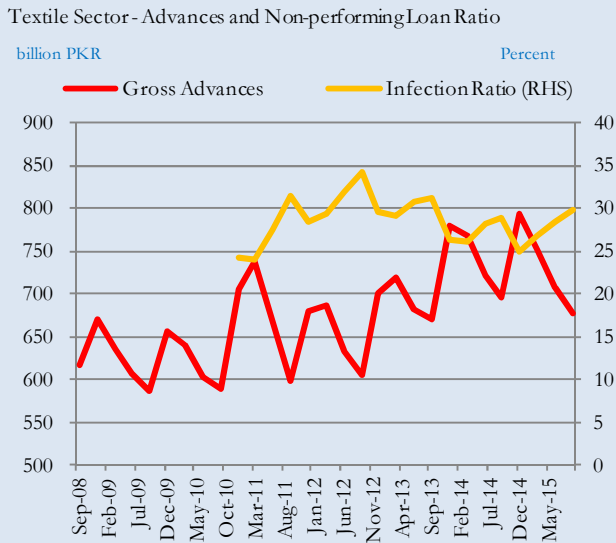
Viewing financing to textile's subsectors, as of end September 2015, highest exposure in textile sector pertains to spinning industry (PKR 138 billion, 26 percent) followed by weaving (PKR 86 billion, 16



percent), textile made ups (PKR 66 billion, 13 percent), and finishing (PKR 57 billion, 11 percent) (Figure 2)<sup>84</sup>.

As the performance of textile sector deteriorated and non-performing loans increased<sup>85</sup>, its demand for credit subsided (Figure 3). This has been more obvious in case of working capital financing<sup>86</sup>; growth remained negative 2.9 percent during Sep14-15 compared to average positive growth of 4.5 percent during Sep10-14 (4 years). However, since CY14, the general decline in interest rates incentivized borrowing firms to enhance their productive capacity (through borrowing for fixed investment) where textile sector is no exception.

**Figure 3**  
Infection ratio declined yet remained high in textile sector



Source: FSD, SBP

The infection ratio of textiles is also at elevated level. As of Sep-15, gross NPLs of the textile sector stood at 29 percent; most of the bad debts were placed in the loss category with significant legacy (showing weak potential of recovery).

The interconnectedness of the textiles and banking sectors entails some risks to the financial stability. Bank's exposure in textiles is concentrated to a few large entities. The outstanding loan disbursement against top-20

<sup>84</sup> Source: e-CIB database, State Bank of Pakistan

<sup>85</sup> Textile sector has the second highest infection ratio in CY15.

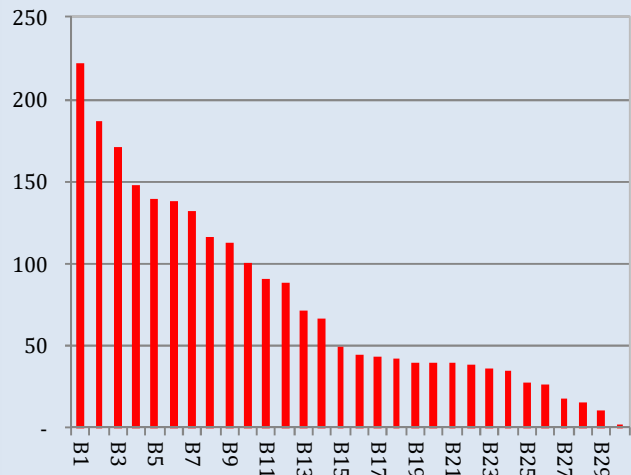
<sup>86</sup> Most of working capital financing pertains to textile sector.

companies stands at PKR 126 billion or around 20 percent of overall funded exposure.

In terms of banks, the exposure to textiles is quite dispersed as twenty nine out of 35 banks are directly serving the industry (Figure 4).

**Figure 4**  
Several banks have high exposure in textile sector

Banks' Exposure in Textile - As percent of Equity (As of End Sep, 2015)



Source: FSD, SBP

However, in terms of equity, exposure of some banks is quite high. Nine (9) banks' exposure in textiles industry is more than 100 percent of their equity; while 13 banks' exposure is more than 50 percent of their equity. Considering entity wise high concentration, few defaults can quickly erode the equity of exposed banks and threaten the stability of the banking sector.

Interestingly, however, the five (5) largest banks of the banking sector, though, have high exposure in absolute terms; the concentration in terms of their equity is moderate hovering around 20-30 percent due to their relatively larger equity base.

**Stress Assessment:**

Given the current state of textiles, any further worsening in the future would have consequences for the stability of the banking system. In the hypothetical scenarios of additional 5 percent, 10 percent, and 20 percent defaults,

the Capital Adequacy Ratio (CAR) of the banking sector reduces to 16.18 percent, 15.63 percent, and 14.55 percent respectively, still well above the minimum required level of 10.25 percent (**Table 5**). However, solvency of banks with high concentration may come under pressure on default in textile exposure<sup>87</sup>.

**Table 5**

Stress Test - Impact on Solvency with increase in NPLs in Textile Sector

PKR billion	Existing as of end Sep, 2015	If 5% advances become NPLs	If 10% advances become NPLs	If 20% advances become NPLs
Advances - Textile Sector	673	673	673	673
Overall Risk Weighted	6210	6210	6210	6210
Total Eligible Capital	1038	1005	971	904
<b>CAR (in Percent)</b>	<b>16.72</b>	<b>16.18</b>	<b>15.63</b>	<b>14.55</b>
Decline in CAR		-0.54	-1.09	-2.17
No of CAR non-compliant banks	2	2	3	6

Source: SBP

### Future outlook:

In addition to sluggish global demand, the prime bottleneck hindering the textile sector's growth appears to be inadequate and high priced energy supply. The use of alternates (furnace oil, self-generation of power etc) may be feasible for few blue-chip corporates in short-term but may not be appropriate for majority of the firms. The materialization of government efforts to resolve energy issue through bringing more power into the system or tax incentives<sup>88</sup> in favor of textile sector are positive signs for the sector.

Further, the successful conclusion of dialogue between APTMA and government on textile package<sup>89</sup> may also have some positive impact on textile production and

<sup>87</sup> It has been observed in 2011 that default of few large borrowing groups raised the infection ratio of the banking industry.

<sup>88</sup> Recently, FBR has continued to keep its zero rating policy (i.e. zero sales tax on use of gas and electricity) to textile, surgical, lather, carpets, and sports goods to spur exports.

<sup>89</sup> APTMA has been requesting the government to withdraw three percent duty on import of cotton, remove surcharge of Rs3.60/unit of electricity, and do away with Gas Infrastructure Development Cess. Besides, the association is asking to release sales tax refunds pending for years.

financing from banks. The World Bank's forecast on global oil price is on downside due to excess supply. The spillover effect in terms of reduced oil prices in Pakistan may continue to provide partial support to textile industry.

As per World Bank survey, consistently low cotton prices are expected to bottom out with signs of mild recovery in coming years of 2016 and 2017<sup>90</sup>. This will help Pakistan's textile exports to grow with expected pick up in textile financing given other domestic bottlenecks are removed.

Besides, the performance of textile sector will also depend upon other important factors including stability of exchange rate, international and local regulations, political stability and law and order conditions in the country. Importantly, the GSP plus status awarded to Pakistan by EU is subject to fulfillment of various conditions<sup>91</sup>. In case GSP plus status is withdrawn due to failing of one or few conditions, it may negatively impact the textile sector exports.

<sup>90</sup> Source: World Bank, "Commodity Market Outlook", October 2015.

<sup>91</sup> Including signing and implementation of 27 core International Conventions pertaining to; Human Rights, Labor Rights, Environment, Narcotics Control and Corruption besides vulnerability criteria ([https://www.tdap.gov.pk/eu-atp-assets/EU\\_GSP\\_Plus\\_FAQ.pdf](https://www.tdap.gov.pk/eu-atp-assets/EU_GSP_Plus_FAQ.pdf))

## Box 2.2: Sugar Sector and Banking Sector Stability<sup>92</sup>

The second largest agro-industry of the country, Pakistan's sugar industry stands as the World's eighth largest producer and the fifth largest in terms of sugarcane production<sup>93</sup>. Sugarcane crops cover 1.17 million hectares of cultivated land and provides raw material to 89 sugar mills, playing a crucial role in creating economic activity in the country.

**Table 1**  
Pakistan Sugar Industry Facts

Year	Refined Sugar Produced (Million Tones)	Carryover Stock (Million Tones)	Sugar Cane Support Price (Punjab-Sindh) (Rs per 40 Kg)	Average Retail Price of Sugar (Rs per Kg)	Area under Sugarcane Cultivation (Million Hectares)	Sugarcane Produced (Million Tones)
2009-10	3.14	0.87	100-102	63.41	0.94	49.37
2010-11	4.17	1.03	125-127	73.65	0.99	55.44
2011-12	4.65	1.11	150	57.16	1.04	58.04
2012-13	5.06	1.39	170-172	53.41	1.13	63.72
2013-14	5.62	0.84	170-172	54.8	1.17	67.43
2014-15	5.13	1.197	180-182	59	1.13	64

Source: Pakistan Sugar Mills Association (PSMA) Annual Reports/Reviews

Geographically, 45 sugar mills are located in Punjab, 7 in KPK and 37 in Sindh. Over the last five years, problems like high cost of production, narrow profit margins<sup>94</sup>, serious productivity growth problems and province-wise support price differential have hurt the sector and limited the mills ability to meet their financial liabilities<sup>95</sup>.

An analysis of the last six years revealed that sugar industry is facing issues of surplus stock and lower sugar prices. The persistent higher sugarcane support prices since 2009-10 have led to the increase in area under sugarcane cultivation and consequently higher availability of sugarcane. Farmers got better income but cost of production rose for the mills. Carryover stocks and bumper sugarcane crops created a glut in the domestic sugar market which subdued the prices in 2011-2012 and onwards making it difficult for the mills to cover the cost of production. From 2010-11 onwards, surplus sugar stock along with suppressed sugar prices can also be observed in the international markets<sup>96</sup>.

<sup>92</sup> The financial year of sugar mills end in September of every year. Therefore, end September data is used for analysis in this box.

<sup>93</sup> Pakistan Sugar Mills Association (PSMA) Annual Report 2014.

<sup>94</sup> For further details, see **Table 2**.

<sup>95</sup> Overview of sugar industry in Pakistan, June 2013, Lahore Chamber of Commerce and Industry.

<sup>96</sup> ISO Quarterly Market Outlook Aug 2014.

The government has allowed export of sugar since 2011. However, due to non-competitiveness of domestic sugar prices as compared to international prices, higher quantities could not be exported. Government also permitted subsidy on sugar exports, but it was not enough to cover the price differential between domestic and international sugar prices and sugar mills failed to meet the export quotas. In order to support domestic sugar prices, Government has also imposed 20 percent regulatory duty on import of cheap raw and refined sugar in November 2014 which was subsequently increased to 40 percent in August 2015.

**Table 2**  
Key Performance Indicators of Sugar Industry

Financial Ratios	FY10	FY11	FY12	FY13	FY14	FY15*
Current Ratio	0.7	0.9	0.8	0.8	0.8	0.8
Cost of goods sold to sales %	89.2	88.2	90.8	92.1	92.4	89.6
Debt Equity Ratio	2.3	2.8	2.7	2.3	2.5	2.2
Net profit margin before tax %	3.3	3.4	1.3	1.6	0.7	3.2
Return on Assets before tax	4.6	4.5	1.5	2.0	0.8	2.9
Return on Equity before tax	17.3	16.2	5.5	6.9	2.5	9.2

Source: Statistics & DWH Department, SBP 2015. Data represents financial results of 31 listed sugar mills.

\* Data is based on audited financials of 15 listed sugar mills. The selection of sugar mills is based on the availability of financials for the year 2015.

The financial condition of sugar industry reveals rising cost of production with narrow profit margins (**Table 2**). Return on Assets (ROA) and Return on equity (ROE) has declined to historically low levels at 0.75 percent and 2.54 percent, respectively in 2013-14. However, financial results for 2015 suggest encouraging picture for sugar industry.

## Banking Sector Exposure on Sugar Industry

The banking sector's total advances in Pakistan reached to their historic high of PKR 5.051 trillion as of 30-09-2015 with sugar sector financing<sup>97</sup> of around PKR

<sup>97</sup> Sugar sector financing comprises of two parts; commodity financing extended for trading of sugar and sugar financing extended to sugar mills for manufacturing.

184.475 billion (3.65 percent of total banking advances). The last five years statistics show that, on average, the share of sugar sector in total banks' advances accounts for a notable 4.0 percent, with commodity financing share of 1.0 percent and sugar financing share of 3.0 percent (Table 3). Private sector stood as the major contributor of sugar sector financing with 2.95 percent share, followed by the public sector with an average share of 1.10 percent.

**Table 3**

**Sugar Industry Exposure Bifurcation (PKR Billions)**

Years	Commodity Financing	Sugar Financing	Total Sugar Industry Exposure
FY11	39.0	95.0	133.9
FY12	44.2	97.9	142.1
FY13	38.6	108.0	146.6
FY14	43.7	139.2	182.9
FY15	48.8	135.6	184.5

Source: FSD, SBP

**Infection Ratio Analysis of Sugar Industry**

During the last five years, the average infection ratio of sugar sector financing stood at 5.26 percent, in comparison to the overall banking sector's infection ratio of 14.15 percent. Further, the ratio gradually came down after touching the peak of 11.2 percent in Dec 2011 to as low as 2.63 percent in Mar 2015 (Figure 1). Afterwards, there is an uptick in bad debts in sugar sector and the infection ratio, as of 30<sup>th</sup> September 2015 stands at 5.08 percent.

Following the same trend of overall sugar financing, the infection ratio exhibits high average for private sector in comparison to public sector. Public sector infection ratio was essentially nil (due to the exposure being backed by government guarantees) as compared to private sector's NPL ratio of 7.49 percent on average over the last five years. Hence, the trend in infection ratio in sugar industry is entirely driven by the private sector.

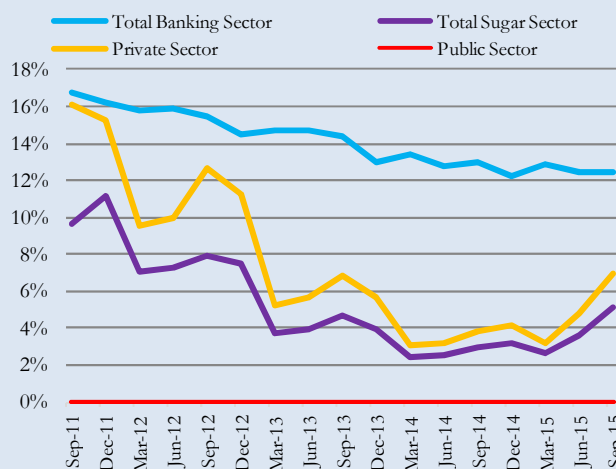
The main drivers behind the infection ratio of sugar financing could be the rising production costs due to

higher sugarcane support prices; lower sale prices due to excess supply resulting from higher than expected sugarcane crops during the last five years along with carryover stocks of sugar; and lower than domestic sugar prices in the international market<sup>98</sup>.

**Figure 1**

**After Mar 2015, upward trend in infection ratio**

Infection Ratio of Sugar Industry (PKR billion)



Source: FSD, SBP

A granular analysis of sugar financing as reported in e-CIB (30-09-2015) highlights the following facts:

- Sugar exposure is significantly concentrated in top 5 banks which constitute around 54 percent of total sugar financing.
- Approximately 44 percent of the funded exposure is concentrated in top 10 borrowers.
- Among top 20 borrowers, only one borrower was reported as defaulter.

**Future Outlook**

The International Sugar Organization (ISO) in its report for August 2015 has reported world production for 2015 at 170.911 million tons against the consumption of 173.398 million thus creating a deficit of 2.487 million tons. As such it may have some impact on price of sugar in international market. Also the World Bank Commodity Markets outlook 2015 predicts that, nominal

<sup>98</sup> For further details, See table 1

annual sugar prices (\$/kg) is expected to show an increasing trend in 2016 and onwards due to decrease in world sugar production. Moreover, domestic average retail sugar prices have registered a rise of Rs 4/kg in 2014-15 after announcement of sugar export quota by the government<sup>99</sup>. The expected rise in sugar prices may bring some respite to the industry.

Moreover, the improving financial results for 2015 also bode well for sugar industry. The government, in addition to the measures already taken, may also look at the incentives given by neighboring countries to support their sugar industry.

All in all, the outlook of sugar industry is positive and its impact on banking sector is likely to be less risky.

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<sup>99</sup> *Pakistan Sugar Mills Association, Statistics National*

