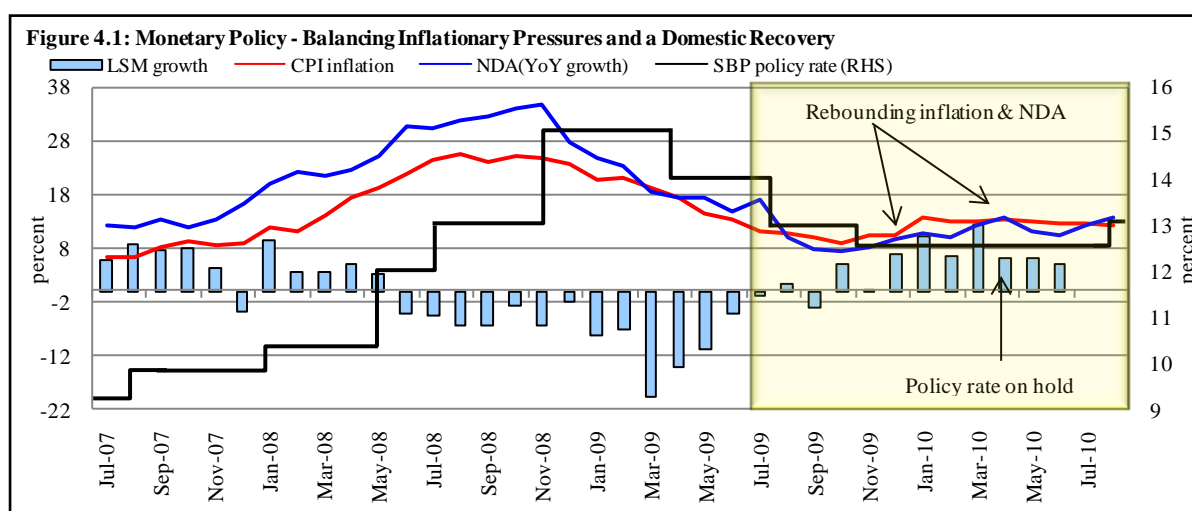


# 4 Money and Banking

## 4.1 Monetary Policy

The SBP's monetary policy stance over FY10 reflects its efforts to strike a balance between supporting the domestic recovery and arresting inflationary pressures. At the start of the fiscal year, the central bank continued lowering its policy rate as inflation declined to less than half its FY09 peak, and the country's macroeconomic situation gradually improved. The policy rate was reduced by a cumulative 150 bps during H1-FY10. However, further easing was put on hold for the remainder of the fiscal year due to resurfacing risks to price stability from an uncertain fiscal position – amid delays in external financing – and pressures from adjustment in administered prices.

Although the policy rate remained flat during most of the year, the SBP took a number of steps in other dimensions of the monetary policy framework to enhance its transmission mechanism and foster transparency in the decision making process (see **Box 4.1**).



### *Continued Improvement in the Macroeconomic Environment and Further Easing: H1-FY10*

As the macroeconomic picture continued to improve, and particularly as inflation fell to 11.2 percent by July FY10 from 24.3 percent a year earlier, the SBP further loosened its monetary stance. The considerable reduction in inflationary pressures and declining external imbalances provided monetary policy with the necessary room to support the domestic recovery. Subsequently, the SBP cut its policy rate by 100 bps taking it to 13 percent on 17<sup>th</sup> August 2009 (see **Figure 4.1**).

However, the SBP remained cognizant of the medium-term challenges posed by domestic supply-side constraints (as a result of the energy shortages, socio-political and security situation in the country), possible slippages in the fiscal deficit target as well as vulnerability of the fiscal position to timely disbursements of pledged official foreign inflows. While IMF inflows bolstered the external position, concerns over the fiscal position continued to mount.<sup>1</sup> From a monetary policy perspective this situation was complicated by concerns over subdued credit to the private sector and its implications for a recovery in the real sector; as well risks to domestic inflation from the planned rationalization of administered prices (notably power tariffs). This mixed situation called for a response that protected

<sup>1</sup> It may be noted that in the face of delays in pledged official foreign inflows, the IMF provided bridge financing for budgetary support, in addition to balance of payments support.

the gains from previous stabilization efforts, without stifling the nascent recovery. This outlook prompted the SBP to leave its policy rate unchanged at 13 percent in its second policy decision on 29<sup>th</sup> September 2009.

A pause in easing and adherence by the government to the IMF's quarterly ceilings on deficit monetization during H1-FY10 along with a sharp decline in international commodity prices helped inflation coming down to single digit by October 2009. This decline in inflation was made more encouraging as large scale manufacturing (LSM) showed signs of recovery after a prolonged period of decline (see **Figure 4.1**). However, looking forward and incorporating the effects of forthcoming increases in electricity tariff the SBP's projection for inflation increased to 11 – 11.5 percent for the fiscal year 2010.

Moreover, notwithstanding the improvements in the real sector, concerns over the financing of the deficit continued to grow as budgeted foreign inflows remained lower than expected. This risk to the fiscal position carried the potential to spill over to the real sector. Specifically, banks' risk aversion due to rising Non-Performing Loans (NPLs), amid increased government demand for credit provided them an attractive risk-free investment avenue. However, this exerted further pressure on banks' liquidity; already constrained due to a record increase in quasi-fiscal factors; including lower than expected retirements from financing for commodity operations and considerable public borrowing for PSEs. This raised concerns that fiscal and quasi-fiscal operations could crowd out private sector activities stifling emerging pick-up in private sector credit and jeopardizing the real sector recovery. Therefore, despite continued concerns over inflation, in an effort to maintain financial stability, the SBP decided to make another downward adjustment of 50 bps in its policy rate; taking it to 12.5 percent on 24<sup>th</sup> November 2009.

#### **Box 4.1: Key Changes to the Monetary Policy Framework during FY10**

- Re-constitution of the Monetary Policy Committee (MPC): The committee now includes two external experts as members, in addition to SBP representatives, in order to foster greater transparency and credibility of the monetary policy decision-making process. Minutes of the MPC meetings are also being disclosed with a lag of two months.
- Liquidity Management: In order to enhance the monetary policy transmission mechanism, in line with international best practices, the SBP set up an interest rate corridor. This corridor operates with the central bank's policy rate as its ceiling, and a floor rate, which is set 300 bps below the ceiling rate. The interest rate corridor was introduced to limit volatility in the overnight rate; the SBP's operational monetary policy target. This new framework includes the introduction of an overnight standing deposit facility, or SBP Overnight Repo Facility. The facility provides banks an avenue for overnight placement of surplus funds at the floor rate with the central bank at the end of the day, and discourages banks from lending excess funds in the interbank market below the floor rate; thereby limiting volatility. (see section 4.4 Money Market).
- Increase in frequency of monetary policy decisions: the number of monetary policy decisions has been increased from four to six times a year. While the January and July policy decisions are accompanied by a complete Monetary Policy Statements (MPSs) and press conferences, the other four are conveyed through a brief press statement.

For details on these developments, see **Monetary Policy Statement (Jul-Sep 09)**.

#### ***Resurfacing Risks to Price Stability and the Holding Phase: H2-FY10***

After falling for eight consecutive months, inflation began to rebound in November 2009; largely due to increases in electricity tariffs and adjustment in administered prices e.g. wheat<sup>2</sup> (see **Figure 4.1**). In this environment striking a balance between arresting inflationary pressures and supporting growth became increasingly difficult. With price stability the main goal of monetary policy, emerging risks from the second-round impact of these price adjustments, the difficulty in predicting the extent to which their effect would permeate to other prices in the economy, and their impact on agents' expectations, the SBP could not risk loosening its stance further. Moreover, in the face of slippages in

<sup>2</sup> CPI inflation rose to 13.7 percent in January 2010.

the fiscal deficit, rising uncertainty over budgeted FoDP inflows and an ambitious tax collection target, greater reliance of the government on domestic sources – mainly the banking system –for deficit financing became increasingly likely.<sup>3</sup>

While cognizant of the risks to monetary stability from this weak fiscal position, the SBP was inclined to utilize any room to support private sector growth, and postpone tightening in response to these concerns. As a result, it decided to keep its policy rate on hold at 12.5 percent in its meeting in January 2010. This marked the start of a holding phase that would last for the remainder of the fiscal year. In view of the considerable uncertainty in predicting events that influence monetary policy considerations and therefore monitor the situation, the SBP left its policy rate unchanged on its subsequent policy decisions for the fiscal year; on 27<sup>th</sup> March and 24<sup>th</sup> May 2010. However, the minutes and the voting pattern of the Monetary Policy Committee (MPC) show that concerns over inflation and macroeconomic stability continued to mount. In the last two meetings of the MPC, the decision to hold was supported by a shrinking majority.

In retrospect a timely pause in easing, and price stability concerns appear justified; average inflation for FY10 stood at 11.7 percent – 2.7 percentage points higher than target. In line with expectations, as the year progressed, government credit led growth in Net Domestic Assets (NDA) of the banking system picked up considerably. In fact, the government breached both quarterly limits for incremental SBP borrowing agreed with the IMF in H2-FY10, while domestic inflation exhibited persistence due to cost pressures from adjustment in administered prices, as well as the demand pull from the rising fiscal deficit.

#### ***Inflation Persistence, Risks to Macroeconomic Stability and Tightening: Beginning FY11***

As the new fiscal year began, fiscal developments of the previous year, proved inconsistent with price stability; inflation stood at 12.3 in July 10, compared with 11.7 percent for FY10. The inflation outlook for the year was plagued by imminent pressures from further upward revisions in power tariffs and the revised General Sales Tax (GST), and their impact on agents' inflation expectations. These pressures were expected to be exacerbated by an impetus to domestic demand from an increase in public sector wages. Further, another ambitious fiscal deficit target called for additional caution in assessing risks to price stability

In addition to the price level, this situation carried risks to broader macroeconomic stability. While the previous year's experience of reliance on external inflows for deficit financing proved untenable for the fiscal position, it now carried risks to sustainability of the external accounts as well. In particular, as the pickup in domestic demand amid forecasts for higher international commodity prices would increase the import bill, the impact of any resulting deterioration in the current account on the country's overall external position would depend on timely realization of official foreign flows. In this backdrop, the SBP moved to contain aggregate demand induced risks to macroeconomic stability by raising its policy rate by 50 bps to 13 percent on 2<sup>nd</sup> August 2010.

However, soon after the SBP's rate decision, the country experienced an exogenous supply shock from flooding triggered by exceptional monsoon rains. While assessments of the scale of the devastation and its implications on various sectors of the economy are ongoing, based on current estimates the SBP has revised upward its inflation forecast for FY11 to 13.5 – 14.5 percent.<sup>4</sup> It is pertinent to note however, that inflation forecasting in this situation depends on the inter-play of a

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<sup>3</sup> The government already had experienced a slippage in the fiscal deficit target by 0.3 percent of GDP by Q1-FY10.

<sup>4</sup> See Chapter 3 on Prices

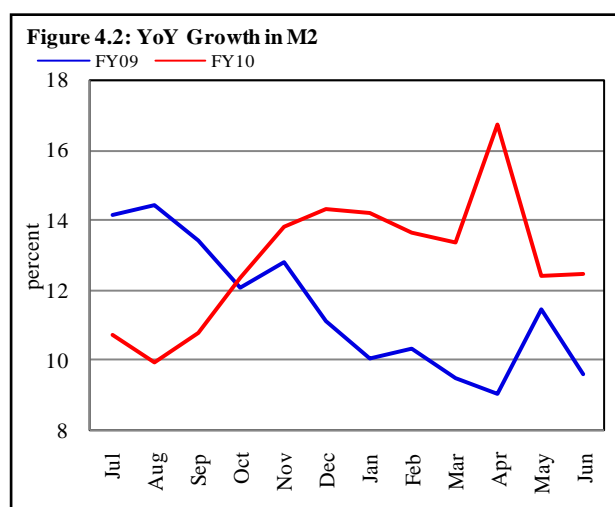
host of uncertain factors, not least the extent of the impact on the fiscal deficit, its financing and monetary implications.<sup>5</sup>

## 4.2 Development in Monetary

### Aggregates

Broad money (M2) grew by 12.5 percent during FY10 compared with 9.6 percent growth in the last fiscal last year FY09. This acceleration in M2 growth was due to expansion in both, the Net Domestic Assets (NDA), and Net Foreign Assets (NFA) of the banking system.

A disaggregated analysis shows that YoY growth in M2 picked up considerably after September 2009, and subsequently remained higher than the previous year throughout FY10. (see **Figure 4.2**). The steep rise seen Sep-Dec 09 mainly reflects strong growth in private sector credit.



The developments in broad money indicators were generally in line with the program parameters agreed under the SBA with the IMF. The central bank remained successful in meeting its NDA and NFA targets. However, mounting fiscal pressures ultimately resulted in a breach of IMF ceilings on

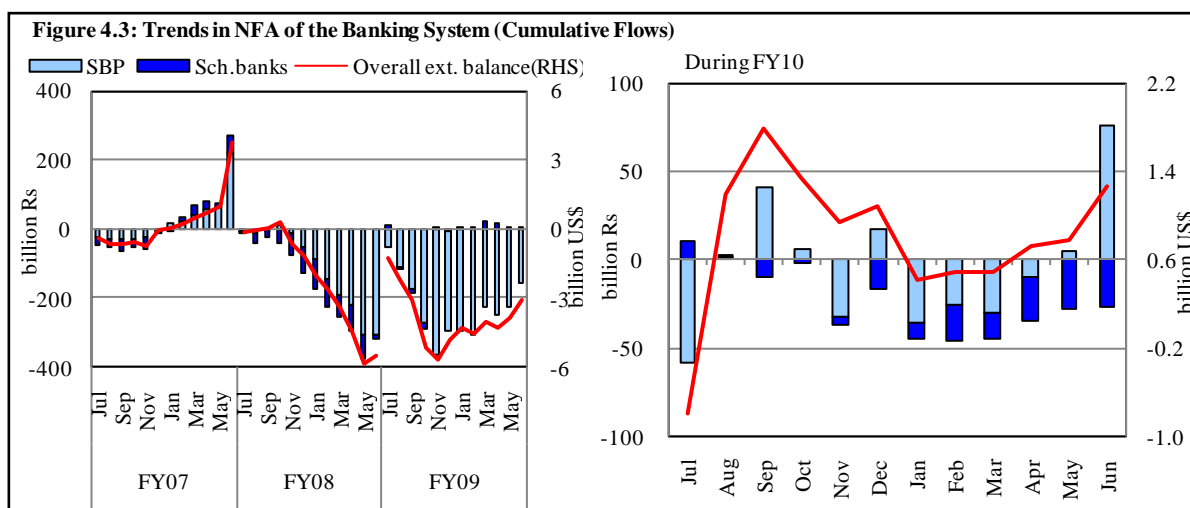
**Table 4.1: Monetary Aggregates**

flows in billion Rupees, growth in percent

	Flows				Growth	
	FY09	FY10	Jan-Jun		FY09	FY10
			FY09	FY10		
Broad money (M2)	448.1	640.0	345.3	300.4	9.6	12.5
NFA	-171.7	49.6	120.2	47.7	-25.7	10.0
SBP	-177.3	76.0	116.6	58.0	-36.9	25.1
Scheduled banks	5.6	-26.4	3.6	-10.2	3.0	-13.7
NDA	619.7	590.4	225.1	252.6	15.4	12.7
SBP	128.4	86.2	-85.5	-24.8	16.6	9.6
Scheduled banks	491.4	504.2	310.6	277.4	15.1	13.5
<i>of which</i>						
Government borrowing	525.8	406.6	300.1	285.2	34.9	20.0
For budgetary support	316.4	330.4	106.1	199.6	23.2	19.7
SBP	130.9	44	-91.9	106.6	12.7	3.8
Scheduled banks	185.5	286.4	198	93	56.1	55.5
Commodity operations	210.8	77.0	193.7	85.0	168.1	22.9
Non government sector	170.1	198.8	-88.1	-18.0	5.6	6.2
Credit to private sector	17.1	112.9	-179.9	-11.7	0.6	3.9
Credit to PSEs	152.6	85.0	91.3	-8.0	134.3	31.9
Other items net	-76.1	-15.0	13.1	-14.5	15.0	2.6

the budget deficit and net government borrowings from the SBP.

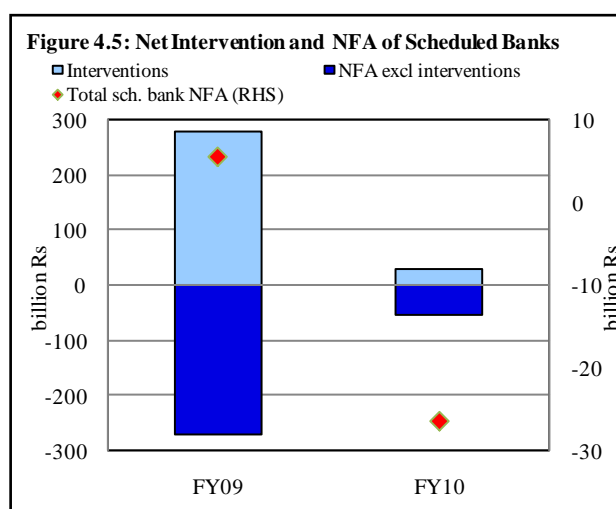
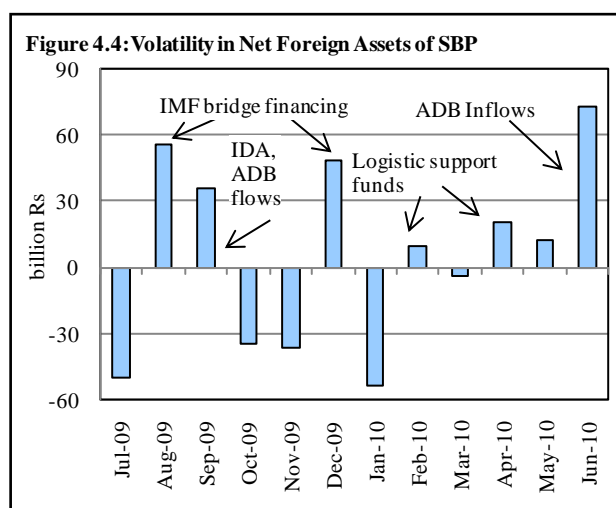
<sup>5</sup> In its second monetary policy announced on 29<sup>th</sup> September 2010, the SBP has raised the policy rate to 13.5 percent keeping in view pressure on aggregate demand and inflationary expectations during the subsequent months of FY11.



#### 4.2.1 Net Foreign Assets (NFA)

The stock of net foreign assets (NFA) of the banking sector showed some signs of improvement in FY10, mainly due to a surplus in country's external balance. This expansion was driven by surplus in the financial account, supported by various institutional inflows that more than offset the current account deficit during the year. This is in stark contrast with the previous two years when a sharp widening in the current account deficit overshadowed the surplus in financial account (see **Figure 4.3**). However, this improvement in NFA would be sustainable only if the composition of external inflows is tilted towards non-debt creating financial inflows, non-quid pro quo current flows (e.g. workers' remittances and grants) and exports earnings (for details on composition of external balance see **Chapter 6**).

Despite improvements in net foreign assets, market flows were weak, as most of the increase in reserves was due to (a) end of SBP market support, and (b) flows came directly to the government. IMF loans for bridge financing,<sup>6</sup> as well as logistic support funds and other foreign grants formed the bulk of external inflows during FY10. (see **Figure 4.4**).



NFA of scheduled banks remained under pressure due to complete shifting of oil import payments to them after December 2009. In addition, limited forex selling in the market by the SBP also hampered the scheduled banks' NFA (see **Figure 4.5**). Moreover, expectations of rupee depreciation also had a

<sup>6</sup> All three tranches of IMF bridge financing amounting to US \$ 1.1 billion materialized.

self-fulfilling impact on commercial banks' NFA, as a major portion of the rise in FE-25 deposits was used to finance domestic activities. The depletion in nostro balance was another factor responsible for weaknesses in NFA of schedule banks during FY10.

#### 4.2.2 Net Domestic Assets

Growth in net domestic assets of the banking sector declined slightly to 12.7 percent in FY10 compared to 14.9 percent in FY09. With the exception of private sector credit, the contribution by all other components of NDA declined in FY10. While the contribution of budgetary borrowings in NDA growth declined during the year, it still had the largest share. The contributions by financing for commodity operations and credit to public sector enterprises (PSEs) decreased, and explain the lower expansion in NDA during FY10 (see **Table 4.2**).

##### *Government borrowings for budgetary support*

Government borrowing for budgetary support increased to Rs 330.4 billion in FY10, compared with Rs 316.4 billion during FY09. This reflects constraints in securing funds from other sources including domestic non-bank as well as external sectors.

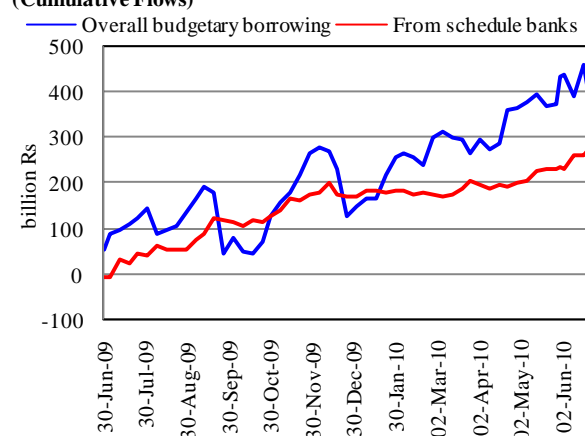
A sizeable fiscal deficit, coupled with lower than targeted external finance left no choice with the government, but to borrow from domestic sources. Within the banking system, the government relied heavily on commercial banks for its deficit financing, mainly to comply with the quantitative ceilings under SBA program (see **Figure 4.6**). As a result, the government was able to raise Rs 286.4 billion from commercial banks in FY10. From a supply-side perspective, banks' interest in risk-free government securities is reflected in their highest ever offer amounts in FY10. An amount of Rs 1,573.5 billion was realized during the year against a pre-auction target of Rs1,360 billion.

Despite heavy reliance on scheduled banks, the government missed IMF program ceiling targets on borrowing from the SBP in last two quarters of FY10 (see **Figure 4.7**). The breach of these targets was the result of a continuous rise in fiscal spending, as well as non-materialization of expected external flows. Resultantly borrowings from the central bank reached Rs 106.6 billion in the second half of FY10, compared with a net retirement of Rs 62.6 billion in H1-FY10.

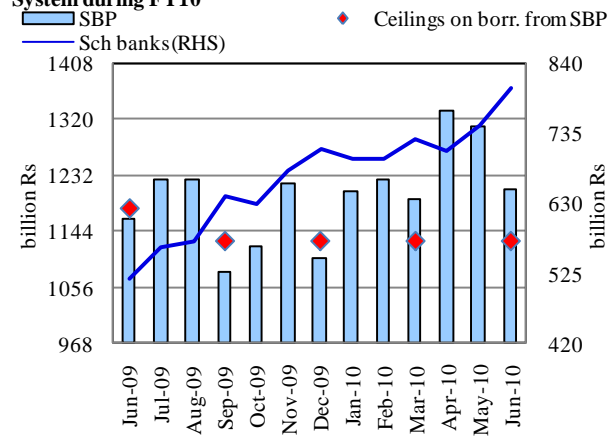
**Table 4.2: Contribution in NDA Growth**

	FY08	FY09	FY10
NDA growth	30.6	15.4	12.7
Budgetary borrowing	18.0	7.9	7.1
Commodity operations	0.9	5.2	1.7
PSC	13.3	0.4	2.4
PSEs	1.1	3.8	1.8
OIN	-2.7	-1.9	-0.3

**Figure 4.6: Budgetary Financing from Scheduled Banks (Cumulative Flows)**



**Figure 4.7: Stock of Net Budgetary Borrowing from Banking System during FY10**



### Commodity Operations

The outstanding stock of commodity finance expanded by Rs 77.0 billion, compared to a rise of 209.0 billion in FY09. Most of the contribution in this lower expansion of commodity operations came from lower disbursements made under wheat advances. Despite this, outstanding stocks of procurement loans reached at Rs 414.2 billion at 30<sup>th</sup> Jun 2010.

Procurement authorities could not reduce this huge debt on their own, mainly due to the non-materialization of price differential subsidies from the government. In particular, most of the burden accumulated by provincial food departments was due only to wheat transactions (see **Table 4.3**).

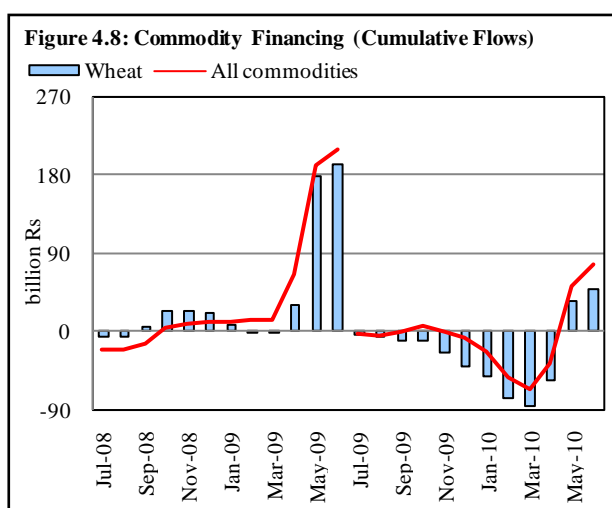
**Table 4.3: Outstanding Amount of Commodity Finance against Provincial Food Dept. & Govt. Agencies**

flows in billion Rs

	Punjab	Sind	PASSCO		TCP		
	Wheat	Wheat	Wheat	Rice	Wheat	Fertilizer	Sugar
FY05	25.8	5.5	13.7	0.0	6.4	6.7	5.9
FY06	43.8	6.6	17.5	0.1	3.4	6.3	17.3
FY07	32.6	6.1	18.8	0.0	3.6	5.9	24.8
FY08	39.8	1.8	14.0	0.0	26.8	7.0	29.8
FY09	149.0	27.7	51.7	21.1	48.3	15.0	20.1
FY10	191.0	41.3	58.5	20.4	26.7	35.0	30.3

Weak repayment capacities of procurement agencies exerted pressure on banking liquidity; and banks were cautious while lending for fresh wheat procurement (see **Figure 4.8**). In addition, the share of the largest five banks in the wheat business also declined, suggesting their reluctance to increase exposure. As a result, the government was forced to revise its wheat procurement target to 7.5 million tons in FY10 from 9.5 million tons in FY09. Consequently, actual wheat financing was Rs 48.4 billion; four times lower than Rs 192 billion in FY09.

In the case of rice, outstanding stocks remained at Rs 22.7 billion – almost the same level as in FY09<sup>7</sup>. The federal procurement agency delayed repayments, as it could not offload procured stocks in the market due to the lower prevailing prices.



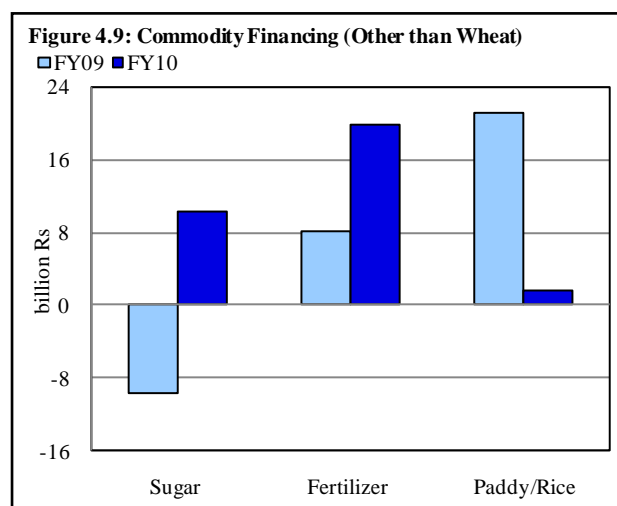
<sup>7</sup> The loans for procurement of rice gathered momentum in last year as government decided to support the paddy growers with support prices higher than the market prices



Besides domestic procurements, bank financing also made possible the timely imports of fertilizer and sugar from the international market.<sup>8</sup> For fertilizer, Trading Corporation of Pakistan (TCP) borrowed Rs 20 billion in FY10 for the import of 1.24 million tons.<sup>9</sup> Simultaneously, to curtail potential domestic sugar shortages, banking finance of Rs 10.2 billion was availed for import of an additional 0.45 million tons of sugar. (see **Figure 4.9**)

### **Credit to Public Sector Enterprises**

The public sector enterprises' (PSEs) borrowing from commercial banks increased moderately by Rs 85.0 billion during FY10 compared with a substantial rise of Rs 152.6 billion last year. Despite the sizeable reduction in cumulative flows, outstanding stock remains at considerably high level of Rs 371.5 billion.

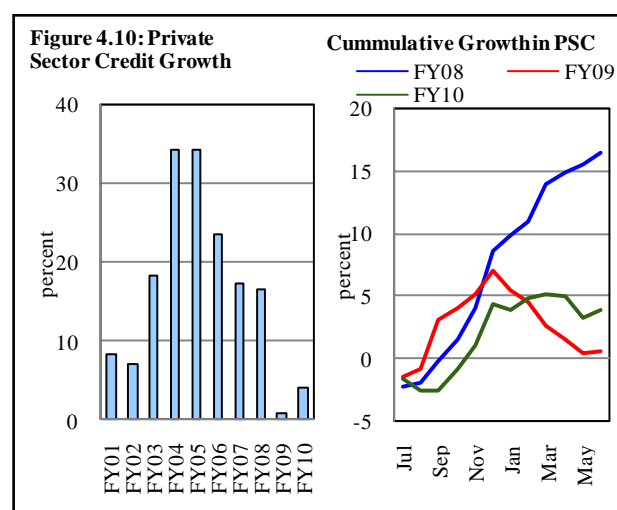


Non-settlement of the circular debt issue in the energy sector remained one of the serious concerns, and major stocks of PSEs loans are still mounting against energy related PSEs. Though the government established a power holding company and transferred majority of banks' claims to this entity, even so the issue could not be completely resolved, and a few PSEs and private entities still depend on bank advances to finance their cash flow needs.<sup>10</sup>

### **Private Sector Credit (net)**

Credit to the private sector staged a recovery in nominal terms, with the onset of revival in large-scale manufacturing in FY10 compared to the dismal performance last year (see **Figure 4.10**). However, in real terms, private sector credit witnessed a contraction during FY10

Nominal private sector credit posted a growth of 3.5 percent in FY10 compared with 0.5 percent rise in FY09; however in real terms, credit to the private sector declined by 13.9 percent, compared with growth of 1.3 percent last year. Higher nominal growth can be explained by a number of developments including (a) an increment of 9 percentage points in growth of LSM over the previous year, (b) increase in seasonal financing requirements for cotton and other raw materials, and (c) a 2.9 percent rise in the volume of external trade.



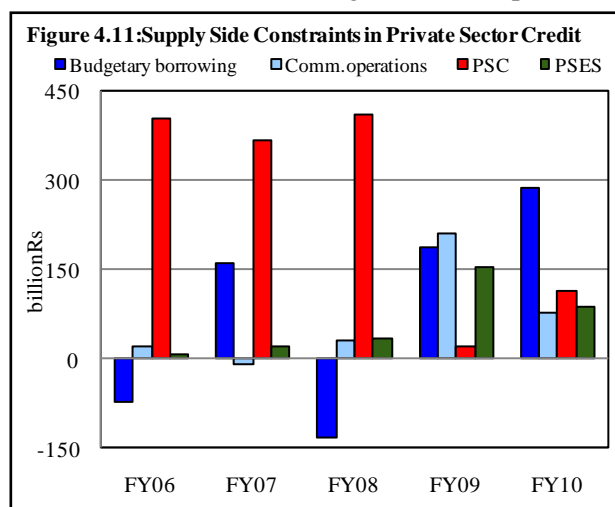
<sup>8</sup> Trading corporation of Pakistan (TCP) is the only procurement agency, engaged in imports of different commodities, such as wheat, fertilizer and sugar.

<sup>9</sup> ECC approved import of 0.6 million tons of urea in Sep 09 to facilitate the maximum wheat production in Rabbi season of FY10.

<sup>10</sup> For details see Chapter 4 on Money and Banking of SBP Annual Report FY09.



Commercial banks, on the other hand, appeared more comfortable in advancing loans to the private sector with an ease on asset quality concerns due to a diligent monitoring of loans; despite a demonstrated preference for risk-free assets. It is pertinent to note that the growing exposure of the banking system to risk free avenues of budgetary support, commodity operations and PSEs, reduced the funding availability for the private sector credit. However, the crowding out of private sector credit, which was quite apparent last year, eased a bit in FY10 largely due to the lesser credit flows in commodity operations and PSEs (see **Figure 4.11**).



A regional distribution of the overall credit shows that more than 90 percent of the credit is disbursed in the provinces of Punjab and Sindh, the two provinces with dominant share of all the three categories of economic activities, viz. agriculture, industry and services. The other areas including Baluchistan, KP, and Islamabad have a less than ten percent share in overall credit allocation.

Credit off-take by the Punjab province was Rs 119 billion during CY09, with a YoY growth in outstanding stock of 8.2 percent – considerably lower than average growth of 22.1 percent in the last five years; in line with the trend in total credit. Similarly, credit extended in Sindh was Rs 48.8 billion during CY09 with a stock amount increased by 3.8 percent compared with an average growth of 23.7 percent in the preceding five years span (see **Table 4.4**).

In retrospect, credit off take showed no signs of improvement in the first quarter of FY10. It was after Sep 09 that credit growth gathered pace, mainly, to finance the seasonal procurement needs of certain sectors. The repayment capacities of these sectors remained reasonable and most of the seasonal financing availed during second quarter was retired earlier as compared to their usual retirement cycle. Accordingly, deceleration was seen in credit growth during the second half of FY10.

**Table 4.4: Province Wise Share in Overall Credit Off-take**  
percent

	Punjab	Sindh	KP	Baluchistan	Islamabad	All Others
Dec 05	47.9	42.3	2.6	0.9	6.0	0.4
Dec 06	49.3	41.3	2.9	0.8	5.1	0.5
Dec 07	47.4	43.6	2.0	0.6	6.1	0.3
Dec 08	47.6	41.9	1.9	0.5	7.8	0.3
Dec 09	49.3	41.7	1.6	0.4	6.7	0.3

Within private sector credit, growth in fixed investment loans decelerated sharply from 25.3 percent in FY09 to 8.4 percent in FY10, mainly due to completion of certain capacity expansion projects undertaken last year in the cement, refineries and fertilizer sectors. In contrast, demand for working capital as well as trade related loans showed resilience and posted higher growth in FY10 compared to the last fiscal year. Seasonal financing as well as higher export volumes partly explain this credit pick-up in working capital and trade related loans during FY10.

A bank wise analysis indicates broad based credit expansion, and participation by a larger number of banks during FY10 compared with the last year. However, most of the credit expansion was not by the four largest private banks (see **Figure 4.12**).

Although lending activity by the largest four private banks improved somewhat from last year, the contribution of these banks to overall credit growth remained subdued in FY10. This was largely due to the cautious lending behavior of two of these banks, in response to large NPLs accumulated last year. These banks not only held back on fresh lending, but also diligently monitored recoveries of their outstanding advances.

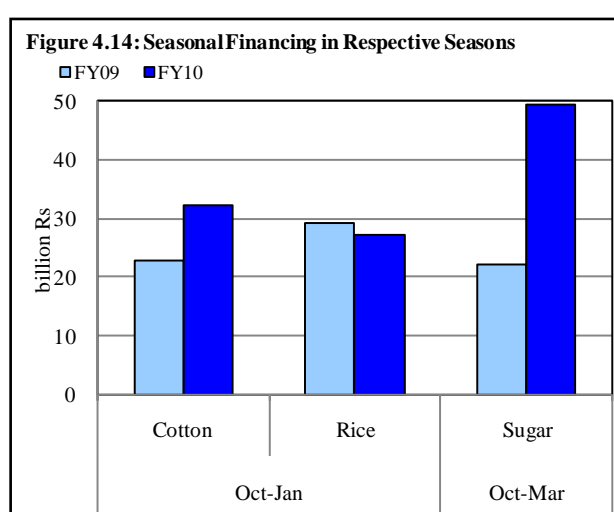
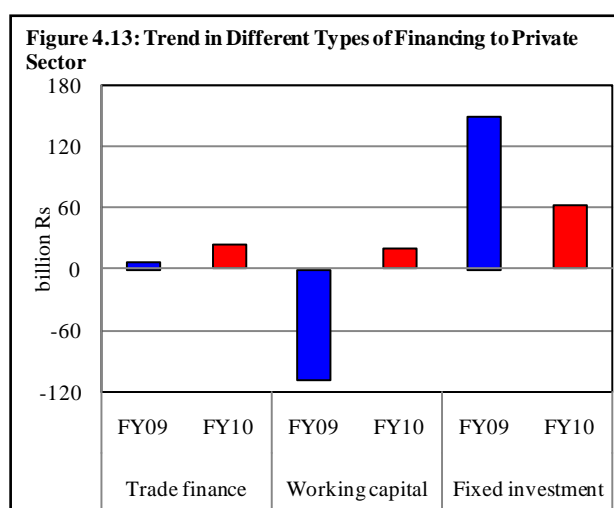
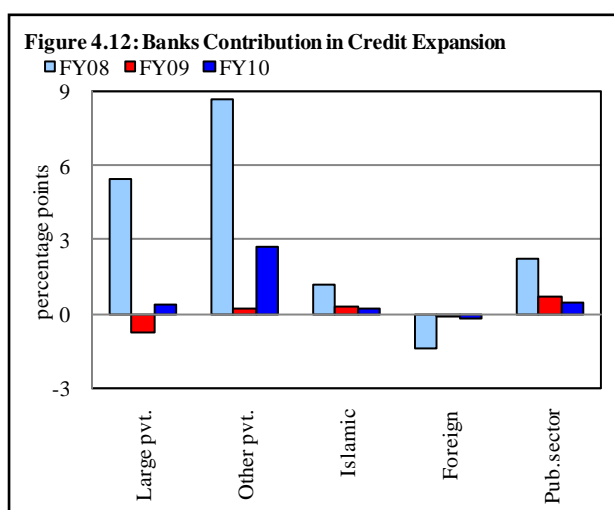
Lastly, while credit growth in the public sector banks shows a decline in FY10, this was mainly due to earlier than expected seasonal retirement of certain commodities and conversion of some power related loans to Term Finance Certificates (TFCs) in one of the largest public sector banks; rather than their lower disbursements.

### Sectoral Analysis

In response to the overall economic upturn, private sector advances posted growth of 2.7 percent in FY10. However, in contrast, consumer loans recorded a fall of 11.7 percent in FY10. On the other hand, business sector advances gathered some momentum from last year, but remained well below FY08 levels.

Purpose wise analysis shows a sharp deceleration in demand for fixed investment loans; whereas working capital and trade related loans showed resilience in FY10 (see **Figure 4.13**). More specifically, activities under working capital advances picked momentum in Sep-Jan FY10, when banks funded Rs 135.3 billion for the seasonal procurement demand against certain commodities, such as sugar, rice and cotton (see **Figure 4.14**). Trade financing on the other hand, grew by 7.2 percent, significantly higher compared with 2.5 percent achieved in FY09. The acceleration in trade financing is mainly explained by increased flows in import finance for cement, power and commerce and trade. In contrast, export financing scheme loans decelerated sharply in FY10 mainly due to subdued demand of textile sector.

Within trade loans, currency wise analysis, however, shows that in line with a sharp depreciation of rupee against US dollar in first half of FY10, traders retired their costlier foreign currency loans and



substituted them with subsidized EFS rupee loans. In contrast during H2–FY10, a relatively stable exchange rate along with the continuous rise in EFS rate<sup>11</sup> made foreign currency loans more attractive for traders. Consequently demand for the foreign currency loans rebounded during second half of the year (see **Figure 4.15**).

#### Manufacturing

Advances to the manufacturing sector rose 2.6 percent in FY10; slightly higher than seven year low seen in FY09.

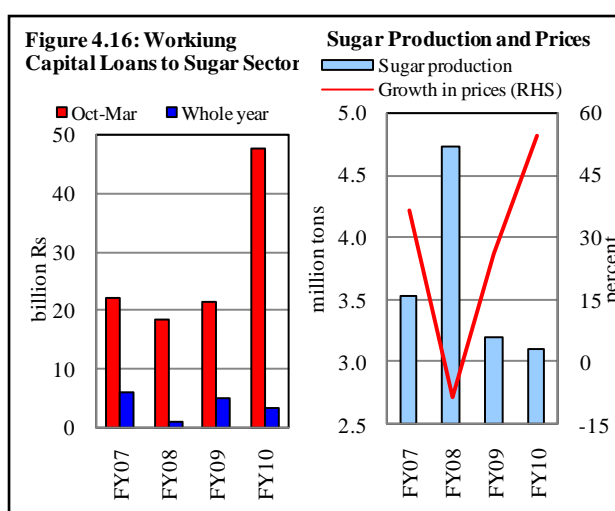
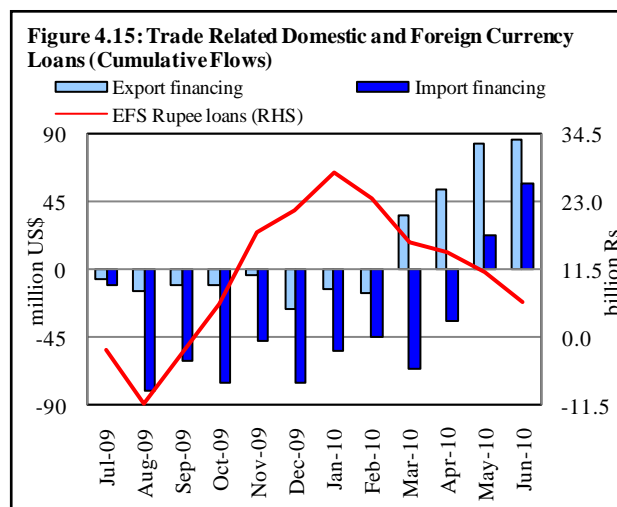
Further, a division of manufacturing sector advances illustrates that the increase in credit off-take during FY10 came from trade finance followed by fixed investment category. Specifically both these categories encompass 88.2 percent of the total rise in credit in FY10 with almost equivalent contributions. Working capital loans recovered somewhat and posting positive growth during FY10 compared to a significant fall of 7.5 percent in FY09.

#### Food and beverages

Advances to the food and beverages sector increased by 5.3 percent in FY10, slightly lower than growth of 5.9 percent in the previous year. This was driven exclusively by working capital and trade related loans to meet the financing needs of the sugar and beverages sectors. In contrast, fixed investment credit fell in almost all major categories within the food and beverages sectors with the largest fall was seen in the oil and ghee sectors.

Growth in credit to the sugar sector also decelerated during FY10 as: (a) most of the sugar mills operated below their optimum level of capacity utilization in response to the lower availability of sugarcane. Reduced operation activities lowered the demand for fixed investment loans; (b) during the crushing season of Oct–Mar FY10; a sharp rise was seen under the working capital loans, mainly acquired to finance costly sugar cane procurement. However, anecdotal evidence suggests that better market prices encouraged sugar mills to retire most of their loans borrowed in FY10. This seems to be reflected in the reduced expansion in working capital loans in FY10 compared to the previous year (see **Figure 4.16**).

Similarly, advances to the edible oil and ghee sectors fell for yet another year in FY10, fixed investment loans contributed to most of the fall in overall advances, whereas demand for working capital as well as trade loans remained muted.



<sup>11</sup> To comply with IMF conditionality, SBP gradually increased the lending rate on subsidized loans of export financing scheme (EFS).

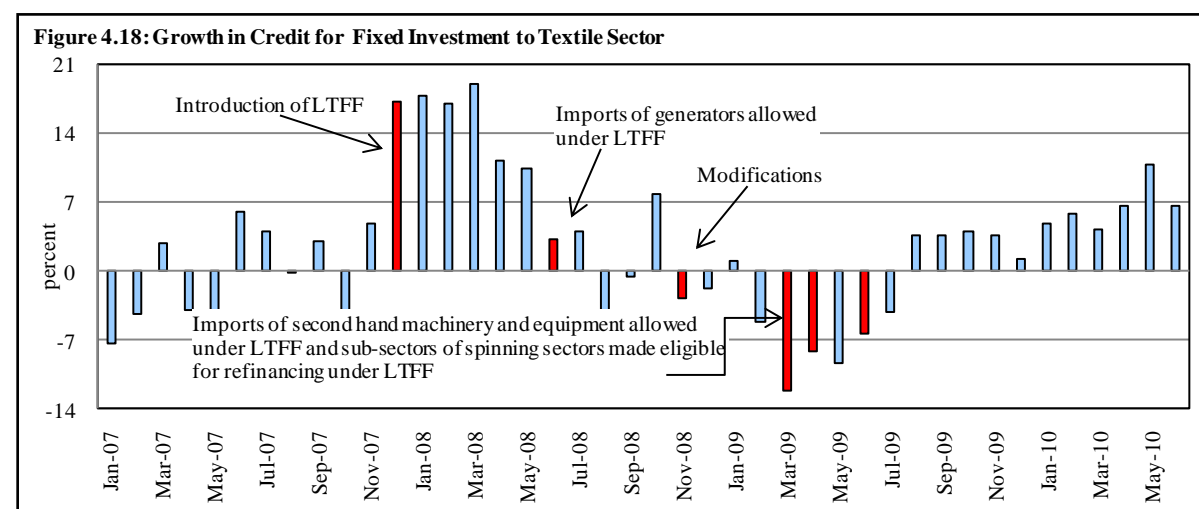
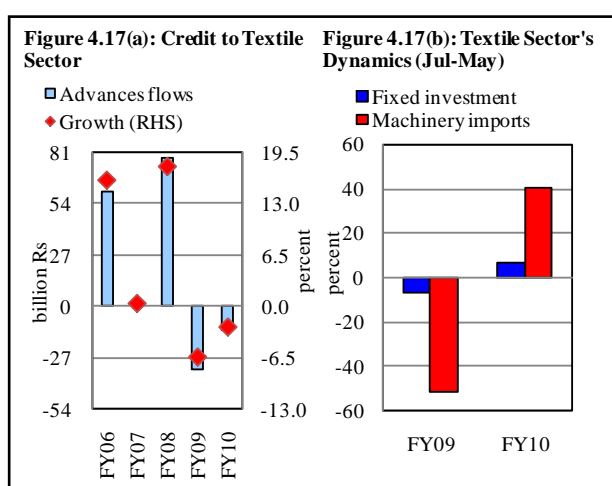
In contrast, advances to the beverages sector rose sharply recording growth of 57.4 percent in FY10. The bulk of the impetus came from working capital loans, whereas trade financing as well as fixed investment also contribute positively.

### Textiles

The contraction in credit demand (which began in H2-FY09) by textile manufacturers eased somewhat during FY10; although advances to the textile sector witnessed net retirements in each month of FY10.<sup>12</sup> This moderation of the negative trend in textile sector credit flows was due to re-emergence of investment in textile sector on account of SBP's long term financing facility (LTFF)<sup>13</sup> (see **Figure 4.17 & 4.18**). Trade financing also contributed to this moderation during the review period.

A detailed analysis reveals that unlike FY09 when all sub-sectors of the textile industry witnessed net retirements, spinning sector accounted for a major portion of these retirements during H2-FY10 (see **Figure 4.19**). This is consistent with the seasonal trend witnessed in textile industry and it was more pronounced during the current season due to improved profitability from higher exports of yarn.

It is important to mention here that demand for credit from the spinning sector also increased due to higher domestic prices of cotton and increased production.<sup>14</sup> Specifically, during Q2-FY10 credit to



the spinning sector increased by 18.6 percent as compared to 11.6 percent in the corresponding season last year. Purpose wise data shows that almost all of the increase in credit off-take was explained by working capital needs during Q2-FY10.

<sup>12</sup> Monthly Analysis shows that advances to textile sector were falling from consecutive 16 months.

<sup>13</sup> The SBP has extended refinancing facility for the import of used textile machinery up to June 2010 (SMEFD circular letter no. 03, 2010)

<sup>14</sup> Production of cotton crop is estimated at 12.7 million bales during FY10 as compared to the 11.8 million bales in FY09.

In contrast to the credit availed by spinning sector, large scale production of cotton yarn during FY10 fell by 3.4 percent despite phenomenal growth in cotton yarn exports. This apparent contradiction between production and exports is the result of the LSM index coverage issue as small scale manufacturers might have played a significant role in exports due to favorable movement in international prices of cotton on the back of global shortage of the commodity.

Retirements after procurement season (Q2) also gathered pace in the subsequent quarters possibly due to higher credit off-take during Q2-FY10 supported by better margins of spinners that enabled them to retire their running finance loans (see **Figure 4.20**).

#### Fertilizer

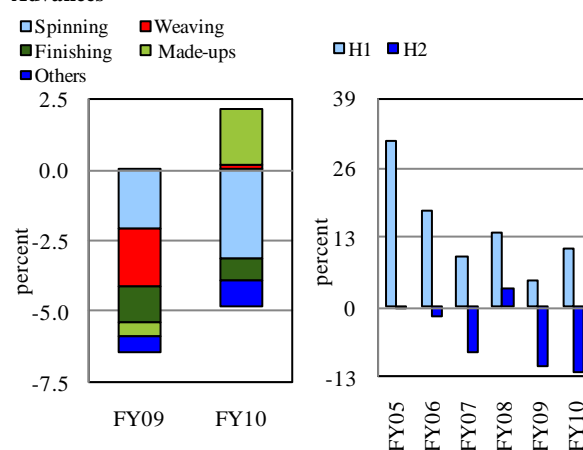
Growth in advances to the fertilizer industry during FY10 (26.5 percent) was led by increased demand for running finance as well as import requirements (see **Figure 4.21**). However, this growth was lower than that in FY09 on the back of lower fixed investment requirements as two new plants are in the final stages of their completion.<sup>15</sup>

However, the rise in import demand originated from slowdown in domestic production and inadequate domestic stock of DAP. Anecdotal evidence suggests that some importers built up inventories to take advantage of an anticipated increase in international prices.

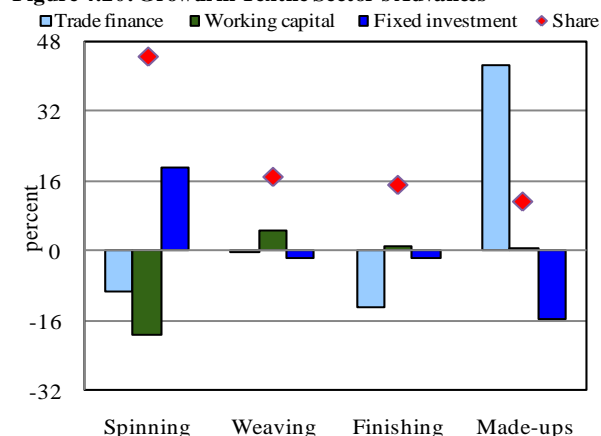
#### Cement

Advances to cement industry slowed considerably during FY10, growing by 1.1 percent compared to 11.3 percent in FY09. This sharp deceleration in advances stood in contrast to the production of cement which grew by 9.6 percent during Jul-May FY10.

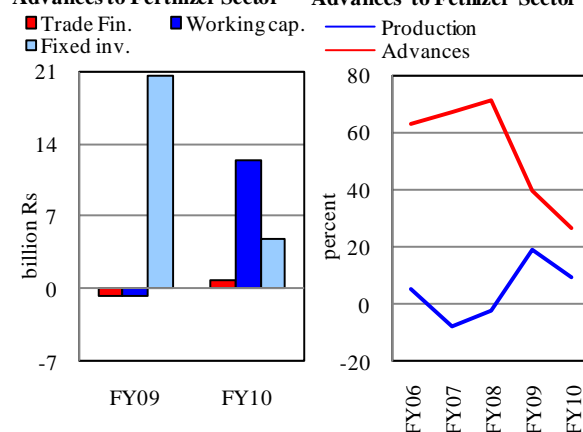
**Figure 4.19: Contribution in Growth of Textile Sector's Advances**



**Figure 4.20: Growth in Textile Sector's Advances**

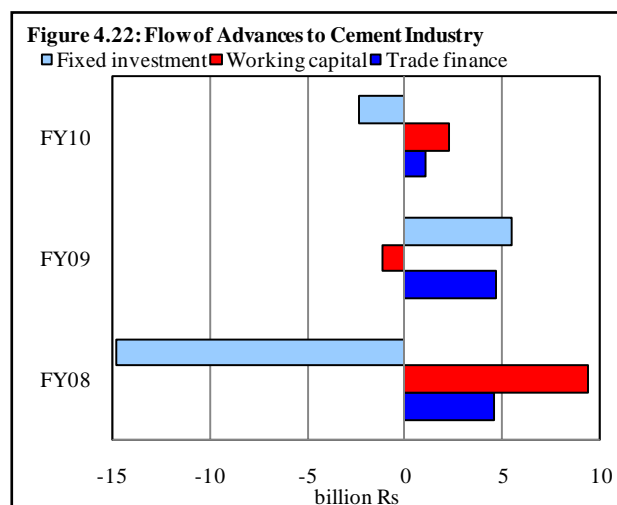


**Figure 4.21: Change in Advances to Fertilizer Sector**



<sup>15</sup> Long term financing to fertilizer industry decelerated sharply in FY10 as one of the fertilizer company became operational in March 2010. Going forward the fixed investment in fertilizer sector is expected to fall as additional capacity will be operational by end October 2010.

A purpose-wise breakup of advances to the cement industry suggests working capital loans were availed to meet the domestic demand in the face of a revival in construction activities during FY10.<sup>16</sup> Although cement exports experienced a fall of 17.6 percent, cement manufacturers availed concessional financing under the EFS to meet international demand as well.<sup>17</sup> However, the international demand for Pakistani cement slowed down sharply due to (a) a slowdown in construction activity in UAE, and (b) lifting of a ban on cement exports by Saudi Arabia. The decline in fixed investment loans to cement industry during FY10 was also an outcome of a one-off capacity enhancement project undertaken during FY09 (see **Figure 4.22**).



### Basic Metals

Advances to the metals industry continued to slow down for a second consecutive year during FY10. Purpose wise data suggests that the metals industry generally availed loans in trade and investment categories. During FY10 import financing increased marginally compared to the net retirements of Rs 1.2 billion in FY09. This is in contrast to the revival in construction activity where iron and steel are used as a primary inputs, while large scale production of these commodities also witnessed decline during Jul-May FY10. The demand for the raw material was probably met through the ship breaking industry where the import of ships more than doubled during Jul-Mar FY10 compared with the same period last year.<sup>18</sup>

### Transport, Storage and Communication

Credit demand for this sector recovered marginally during FY10 growing 9.2 percent after decelerating sharply in FY09. This improvement was primarily an outcome of the financing availed by the telecom sector. The telecoms industry alone explained 87.2 percent of the total increase in credit to *transport, storage and communication sector*.

Category-wise data shows a sharp deceleration in the fixed investment category which might be the result of saturation in the telecoms sector as indicated by a rise in the tele-density to 63.5 percent by end December 2009.<sup>19</sup> Furthermore, tax structure also hit the profitability of telecom operators which in turn kept them unable to expand their networks<sup>20</sup>. However, the telecoms industry availed financing under working capital category during H2-FY10 for day to day expenditures possibly due to the squeezing margins of the industry.

### Commerce & Trade

The recovery in industrial activity coupled with improvement in trade volumes led to some pick-up in credit demand by the commerce and trade sectors. Although financing availed by this sector witnessed

<sup>16</sup> Construction activity posted a healthy growth rate of 15.3 percent in FY10 after witnessing the decline in last couple of years. During FY10, domestic dispatches increased by 14.6 percent, (source: APCMA).

<sup>17</sup> Cement exports increased by 2.6 percent in quantum terms, however due to huge fall in unit values cement exports fell by 17.6 percent in FY10.

<sup>18</sup> According to trade data, number of imported ships was 100 during Jul-Mar FY10 as compared to 42 in the same period of FY09.

<sup>19</sup> [www.pta.gov.pk](http://www.pta.gov.pk)

<sup>20</sup> Two major cellular operators dropped their cellular numbers due to some definitional charges (source: PTA)



a fall of 1.7 percent during FY10; retail trade recorded an 8.8 percent increase which is consistent with the demand led recovery in the economy.

### Construction

Despite considerable growth in construction activities, advances to this sector could not keep pace and experienced a fall of 5.5 percent in FY10. Higher growth in construction activities without sound financial support from banking system is explained by the increased FDI inflows to the sector that rose 9.8 percent in FY10, compared with 4.6 percent growth last year. Moreover, anecdotal evidence suggests that banks remained cautious while providing financing for riskier residential projects in the wake of lower values of pledged collateral.

### Power

Though the increased credit exposure in other sectors reduced the share of advances to the electricity and related industries; it still constitutes a large portion of total advances. Similar to the last year, growth in advances to the power sector remained robust and most of the contribution came from the committed long term project financing under power policy 2002.

### Refineries

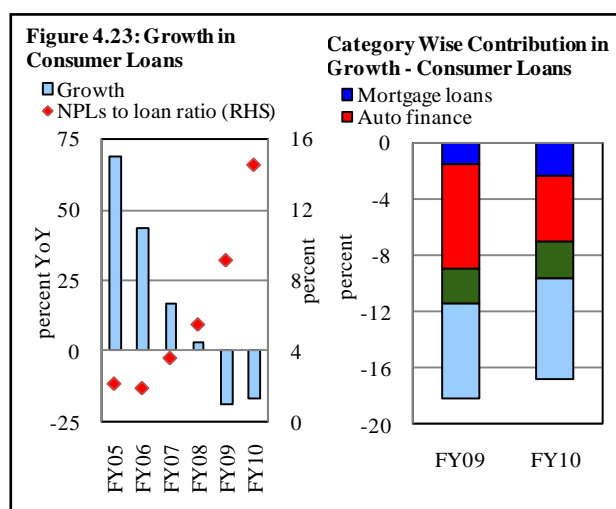
Advances to refineries increased by 23.0 percent during FY10, and most of the rise came from the working capital loans, while fixed investments decelerated sharply. This acceleration in advances is despite the dismal performance of refineries, where most of them worked under their optimum throughout during FY10. Liquidity constraints faced by refineries due to the circular debt coupled with depressed refining margins prevailing worldwide all explain the lower fixed investment throughout in the industry. As mentioned earlier, despite the decline in fixed investment loans, demand for working capital loans picked up due to the unresolved circular debt issue.

### Domestic Durables

After a dismal performance in FY09, the domestic durables industry showed a revival in FY10. During the year, an improvement in consumer purchasing power amplified the demand for the domestic durables, and the industry grew by 17.8 percent compared with a fall of 23.1 percent last year. Consequently, the demand for the bank finance experienced growth of 16.6 percent in FY10 compared to a fall of 21.4 percent in FY09. Most of this borrowing continues to finance expansion projects in the domestic durables industry; though the pace has decelerated in FY10. In addition, trade advances also picked up in FY10.

### Consumer Credit

Consumer loans continued to fall for second consecutive year witnessing a decline of 16.9 percent during FY10 (see **Figure 4.23**). Similar to FY09, the decline in consumer credit off-take stemmed from inflationary pressures which reduced the real income of the consumers. On the supply side, the banking sector also remained cautious while lending to the riskier areas of consumer financing due to rising NPLs in the last few years (see **section on NPLs**).





Increased prices of cars due to rising manufacturing costs<sup>21</sup> restrained demand for auto finance during FY10. The decline in demand for mortgage loans was also explained by the rising interest rates and inflation

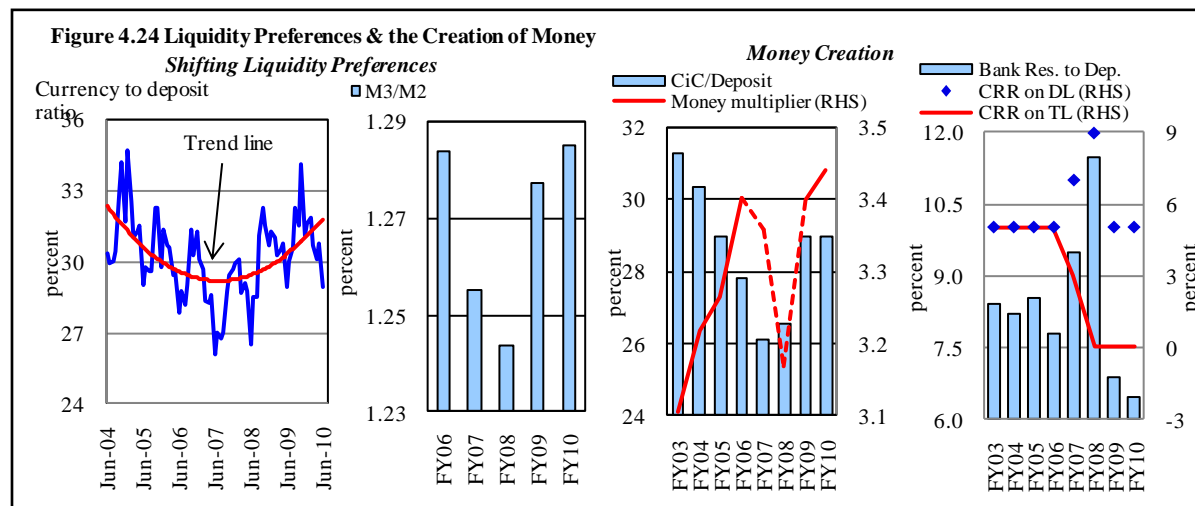
### 4.3 Monetary and Banking Indicators

#### 4.3.1 Monetary Indicators

##### *Financial deepening and the role of agents' liquidity preferences*

The broad money (M2) to gross domestic product (GDP) ratio is widely seen as an indicator of the depth of the financial system – measuring the size of financial assets relative to the real sector of the economy. A rising M2 to GDP ratio provides some indication of the level of development of the financial system, and hence the extent of intermediation in the economy. The trend decline in this measure of monetary depth continued in FY10. While the pace of the decline appears to have moderated, this was due to an exaggerated fall last year. In particular, in FY09 the sharp decline was not surprising, given (a) a slowdown in M2 growth as a result of IMF conditionalities upon entering Stand-by Arrangement (SBA) and the SBP's tight monetary stance, and (b) inflated level of nominal GDP.<sup>22</sup> However, the contraction in the current fiscal year was despite a considerable decline in inflation and easing in the SBP's policy rate. Further this declining trend in monetary depth over the past couple of years appears to be accompanied by a shift in components of monetary liabilities away from bank deposits (see **Figure 4.24**).<sup>23</sup>

A regional comparison highlights that Pakistan has one of the highest and (rising) holdings of currency to M2. This is in stark contrast to regional peers where monetary deepening has been aided by a preference to hold monetary assets in the form of deposits; and the role of currency appears to be falling (see **Table 4.5**).



In Pakistan however, the rising costs associated with the use of the banking system e.g. negative real returns on deposits and the rising burden of the financial transactions tax appear to have discouraged

<sup>21</sup> Manufacturing costs increased on account of depreciation of Pak Rupee against Japanese Yen by 12 percent during FY10.

<sup>22</sup> The SBP increased its policy rate by a cumulative 300 bps during first three quarters of FY09. The monetary easing cycle began on 21<sup>st</sup> Apr 09, with a reduction of 100 bps in the policy rate.

<sup>23</sup> The SBP reduced its policy rate by a cumulative 150 bps during FY10; 100 bps on 17<sup>th</sup> Aug 09, and another 50 bps on 25<sup>th</sup> Nov 09. However the policy rate was left unchanged at 12.5 percent for the remaining three rate decisions in FY10.

the use of the banking system.<sup>24</sup> In addition, banks appear to face increasing competition in deposit mobilization from non-bank sources, as evident from the rising M3<sup>25</sup> to M2 ratio— notably National Saving Schemes (NSS).

As a result the currency to deposit ratio shows an upward trend since FY07 (see **Figure 4.24**). The lower proportion of monetary assets held as bank deposits constrains banks' credit creation and appears to be a key factor explaining the lower money multiplier<sup>26</sup> compared with regional countries.

In FY09, banks experienced significant deposits withdrawals. Responding to the subsequent liquidity crisis of Sep-Oct 08, the SBP reduced the Cash Reserve Requirement (CRR) by a cumulative 400 bps.<sup>27</sup> As a result banks were required to maintain a lower proportion of their deposits as reserves, and the money multiplier rose sharply. However, despite a subsequent recovery in banks' deposit

**Table 4.5: Regional Monetary Indicators**

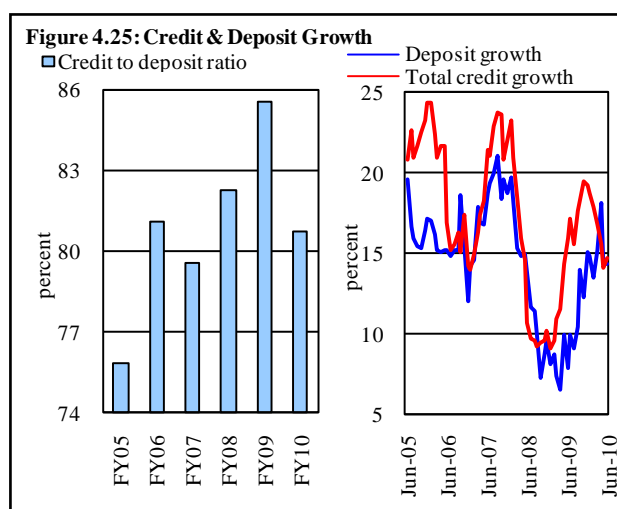
percent	M2 to GDP			Currency to M2			Money Multiplier		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Bangladesh <sup>1</sup>	48.8	49.8	53.4	15.2	14.8	13.5	4.5	4.5	4.7
Malaysia	124.6	122.3	146.7	5.3	5.3	5.2	12.5	13.2	18.0
Pakistan <sup>2</sup>	45.8	40.3	39.4	20.9	22.4	22.4	3.2	3.4	3.4
Singapore	115.1	125.2	144.1	5.6	5.7	5.4	10.6	9.8	10.2
Sri Lanka	32.1	29.1	31.8	12.8	12.1	11.8	4.3	4.8	5.1
Turkey	40.8	45.9	51.7	8.0	7.3	7.8	5.2	5.1	5.8

Source: IMF International Financial Statistics (IFS) and Central Bank Websites

<sup>1</sup> Fiscal Year end June, <sup>2</sup> Figures correspond to end-June FY 08, 09 and 10

base during FY10, the currency to deposit ratio at end-June FY10 remained unchanged over the previous year. While the money multiplier edged up marginally, this appears to be mainly due to a reduction in the proportion of bank deposits kept as reserves.

From a liquidity perspective, while banks' credit to deposit ratio eased compared to FY09, this was expected as the bulk of bank credit was extended to the government for deficit financing.<sup>28</sup> Including government lending by banks, total credit growth continued to outpace deposit growth during FY10 (see **Figure 4.25**).



<sup>24</sup> The withholding tax on cash withdrawals at 0.1 percent on 1<sup>st</sup> Jul 05 has been subsequently increased to 0.2 percent on 27<sup>th</sup> Jun 08 and 0.3 percent on 27<sup>th</sup> Aug 09. The scope of the tax for FY11 has been extended to include all bearer instruments.

<sup>25</sup> M3, a broader measure of money supply includes components of M2, as well as National Savings Schemes (NSS) and Post Office deposits.

<sup>26</sup> The money multiplier is defined as the ratio of broad money (M2) to reserve money.

<sup>27</sup> The SBP increased the Cash Reserve Requirement (CRR) by a cumulative 400 bps during FY07-08. It then reduced the CRR on demand liabilities by 100 bps on 11<sup>th</sup> Oct 08, 200 bps on 18<sup>th</sup> Oct 08 and another 100 bps on 1<sup>st</sup> Nov 09. It may be noted that CRR on time liabilities was eliminated on 10<sup>th</sup> Aug 07.

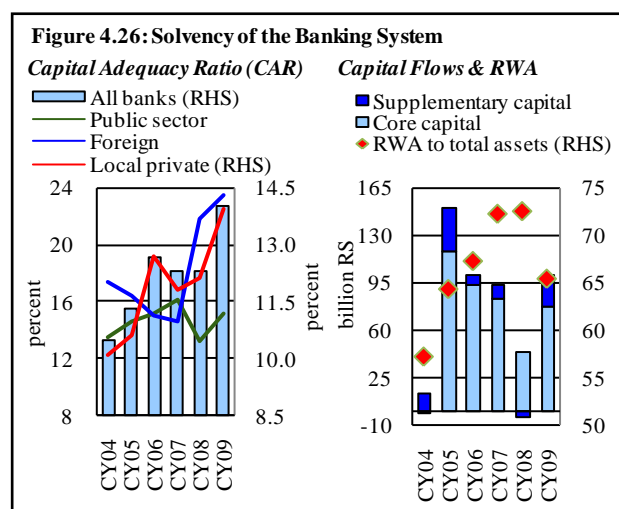
<sup>28</sup> Credit in this context includes all bank credit excluding credit extended to the government for budgetary borrowings. Deposits include all customer deposits including government deposits.

### 4.3.2 Banking Indicators<sup>29</sup>

The performance of the banking sector over CY09 largely reflects the shift in banks' risk preferences, strong government demand for bank finance and amendments in regulations by the SBP - rather than real sector activity. While robust government demand for credit, accompanied by banks' risk aversion and higher capital requirements improved the solvency of the banking system, banking profitability improved largely as a result of amendments in prudential regulations.

#### *Risk-aversion: shift in banks' preferences and improvement in solvency*

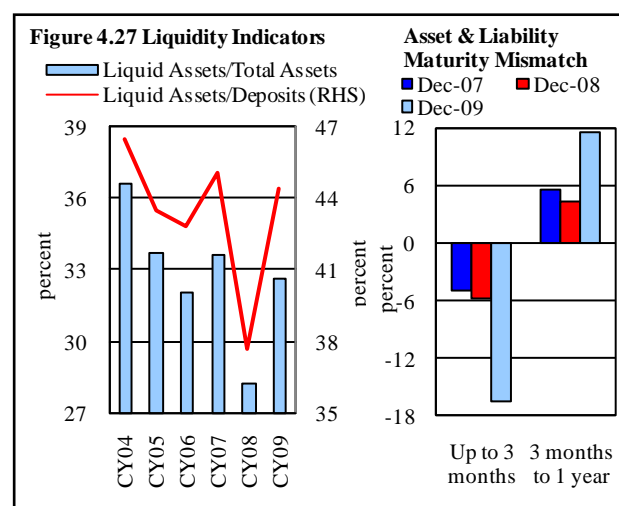
Solvency of the sector improved significantly during CY09 – based on both; eligible capital as well as risk-based capital adequacy measures. In particular, banks' risk-averse asset allocation as well as capital injections in compliance with the SBP's Minimum Capital Requirements (MCR)<sup>30</sup> bolstered the solvency profile of the system. As a result the Capital Adequacy Ratio<sup>31</sup> (CAR) improved by 180 bps to 14 percent - well above the 10 percent regulatory requirement<sup>32</sup> (see **Figure 4.26**).



Banks' aversion to risky lending in the face of rising Non-Performing Loans (NPLs), subdued demand for credit by the private sector and rising demand for credit by the public sector resulted in a significant shift in asset allocation towards lower risk weighted assets. In particular, as a result of a sharp increase in banks' investments in government securities, risk-weighted assets to total assets fell considerably during CY09. At the same time, as banks channeled improved profitability into reserves, total eligible capital increased; with the bulk of the increase in core capital (see **Figure 4.26**).

#### *Maturity mismatch but improved liquidity profile*

The shift in banks' preferences towards less risky assets was accompanied by a shift in the maturity profile of both, investments, as well as deposits. This had a significant impact on the banking systems' liquidity as well as maturity profile. Heavy investment in government securities improved the liquidity profile of the system, reflecting a strong recovery from the liquidity crisis of CY08. In particular, the share of liquid assets rose close to pre-crisis levels (see **Figure 4.27**).



<sup>29</sup> The analysis presented in this section is based on banks' annual audited balance sheet data, unless otherwise stated.

<sup>30</sup> The Minimum Capital Requirement (MCR) for banks was increased from Rs 5 billion for CY08 to Rs 6 billion for CY09 vide BSD Circular No. 7 of 2009.

<sup>31</sup> The Capital Adequacy Ratio for banks was increased from 9 to 10 percent for CY09 vide BSD Circular No. 30 of 2008.

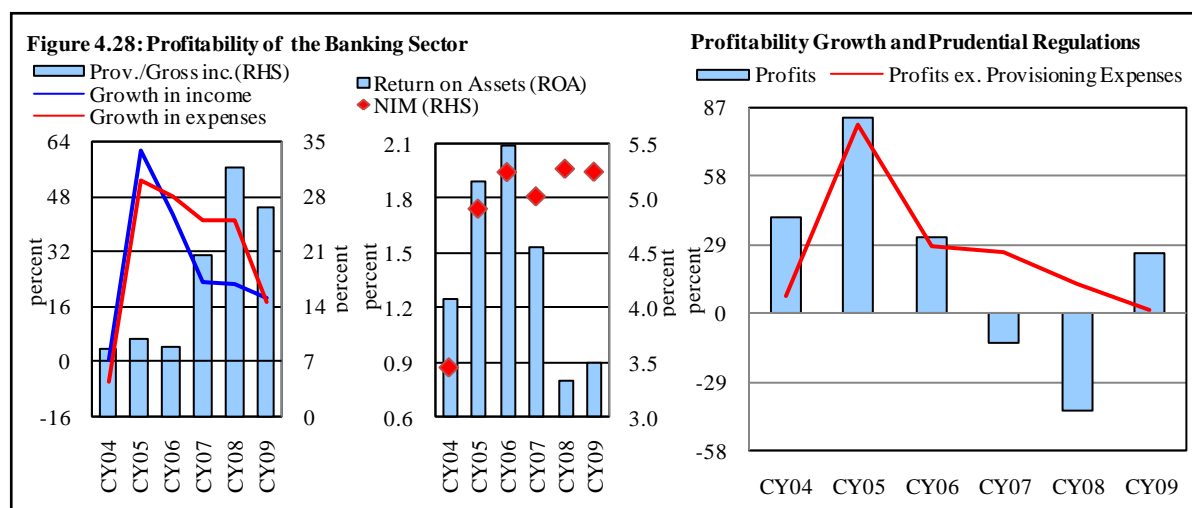
<sup>32</sup> The Capital Adequacy Ratio (CAR) stood at 12.3 and 12.2 percent in CY 07 and 08 respectively.

However, as market expectations regarding the policy rate peaked and the monetary easing cycle began,<sup>33</sup> banks' preferences shifted towards longer-tenor treasury bills – mainly in the 6-month and 12-month maturities. At the same time, banks increased the share of shorter-tenor deposits in their total deposit base. This shift in asset and deposit maturity resulted in a considerable widening of the maturity gaps.<sup>34</sup>

While widening maturity gaps raise liquidity and funding concerns for banks, the bulk of the widening appears to be the result of a shift in banks' interest among different tenors within government securities. The liquid nature of this asset class provides some comfort in the context of liquidity concerns arising from these maturity mismatches.

### **Improved profitability: impact of change in prudential regulations**

Profitability of the banking system at Rs 54.4 billion recorded 25.7 percent growth over CY08 – after falling for two consecutive years.<sup>35</sup> While improved banking profitability appears surprising given the performance of the real sector (amid a marginally lower NIM and rising NPLs), this was largely the result of amendments in prudential regulations<sup>36</sup> by the SBP. In particular, a sharp slowdown in expenses growth – due to lower provision related expenses – boosted profits. Indeed, excluding



provisioning expenses, growth in profits declined to modest 1.4 percent<sup>37</sup> (see **Figure 4.28**).

Amendments in prudential regulations enabled banks to use a part of the Forced Sale Value (FSV) of pledged collateral in provisioning for impaired assets. This reduced the amount banks had to set aside as provisions relative to gross income. The fall in provision related expenses supported banks' profitability in CY09.

### **Competition in the banking industry**

The Herfindahl-Hirschman Index (HHI)<sup>38</sup> provides a measure of the size of firms in relation to the industry, and hence indicates the level of competition among them.

<sup>33</sup> The SBP reduced the policy rate by a cumulative 250 bps during CY09; 100 bps on 21<sup>st</sup> April 09; another 100 bps in August 09 and a further 50 bps on 25<sup>th</sup> November 09.

<sup>34</sup> The maturity gap is defined as the difference between assets and liabilities, adjusted by total assets.

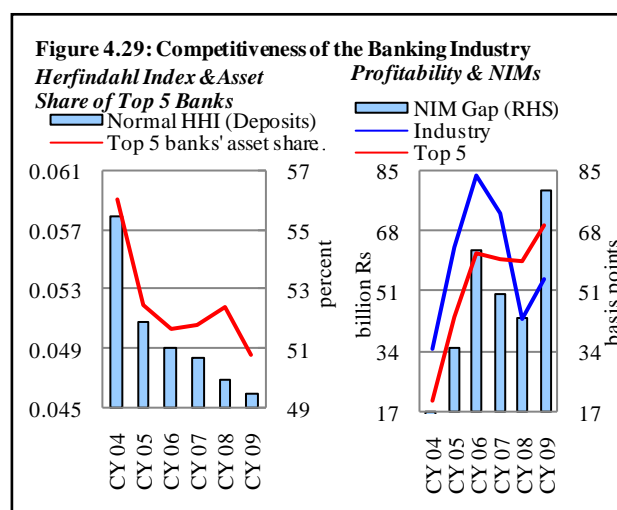
<sup>35</sup> However a significant increase in the asset base during CY09 constrained the improvement in key profitability indicators such as Return on Assets (ROA) which improved from 0.8 percent in CY 08 to 0.9 percent in CY09.

<sup>36</sup> The SBP allowed banks to avail the benefit of FSV up to 40 percent of collateral value; BSD Circular No. 10 of 2009, after having withdrawn it completely vide BSD Circular No. 7 of 2007.

<sup>37</sup> It may be noted, that computation of profits excluding provisioning expenses is simply based on adding back provisioning expenses to after tax net profits; and therefore does not adjust for tax related expenses.

An analysis of the HHI based on deposit mobilization highlights that competition between banks has seen at a sustained rise since CY04. Increased competition for customer deposits is also reflected in the falling asset share of the industry's largest 5 banks<sup>39</sup> (see **Figure 4.29**). This suggests that these banks have faced increased competition from smaller players - providing some evidence of a reduction in the market dominance of the largest five banks.

However, despite the emergence of a more level playing field, the largest banks continued to enjoy the highest profitability in the industry – particularly over the last two years. While the HHI indicates higher competition for deposit mobilization, it does not specify the relative costs at which different banks fund themselves through deposits. In particular, the widening gap between Net Interest Margins of the four largest private banks and the industry highlights the competitive advantage these banks enjoy in the form of access to a lower cost deposit base. The next section highlights how this appears to be a key determinant of spreads that banks are able to generate.

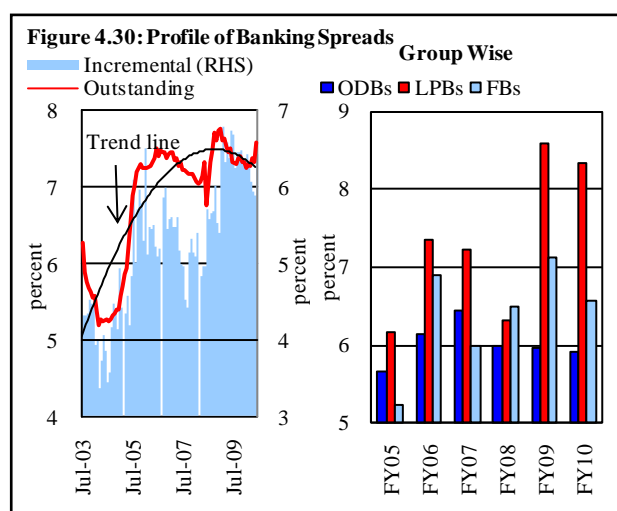


### **Banking Spreads, and the Composition of Banks' Deposit Base<sup>40</sup>**

Banking spreads<sup>41</sup> are widely considered an indicator of banks' efficiency in intermediating between borrowers and lenders (depositors). The size of this spread has wide ranging implications, not least because of its impact on optimal savings and investment decisions of economic agents, and hence the real sector. Banking spreads are considered to be influenced by a range of factors including market power of participants, intermediation costs, as well as credit and liquidity risks.

Overall banking spreads in Pakistan appear to trend downwards, particularly since the introduction of the 5 percent regulatory floor on returns on Profit and Loss Sharing (PLS) deposits<sup>42</sup> (see **Figure 4.30**).

However, a closer analysis highlights considerable heterogeneity in the size of banking spreads. In particular, the largest four private banks appear to have the highest



<sup>38</sup> The Herfindahl-Hirschman Index (HHI) is defined as the sum of squares of market shares based on customer deposits of all banks in Pakistan. The Normal HHI presented here ranges between zero and one – with a value closer to zero indicating a higher degree of competition in the industry.

<sup>39</sup> This includes NBP, and the four largest private banks namely; ABL, HBL, MCB and UBL.

<sup>40</sup> The analysis in this section is based on data available up to 30<sup>th</sup> June 2010 and is based on the fiscal year i.e. Jul – Jun.

<sup>41</sup> Spreads are defined as the difference between Weighted Average Lending (WAL) and Weighted Average Deposits (WAD) Rates.

<sup>42</sup> The SBP imposed a 5 percent floor on returns on PLS Savings products effective 1<sup>st</sup> June 08; BPRD Circular No. 7 of 2008.

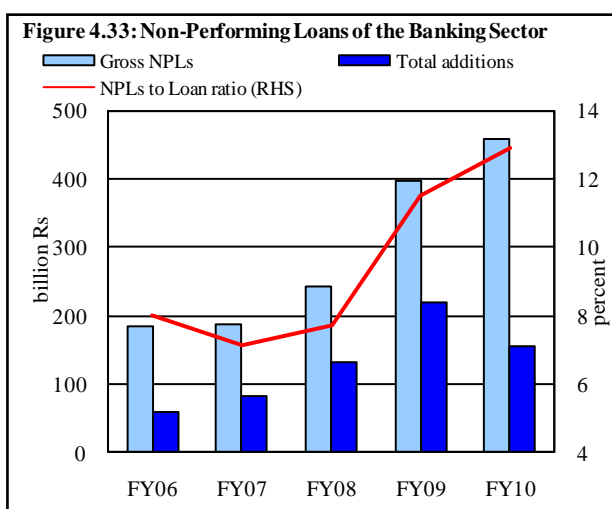
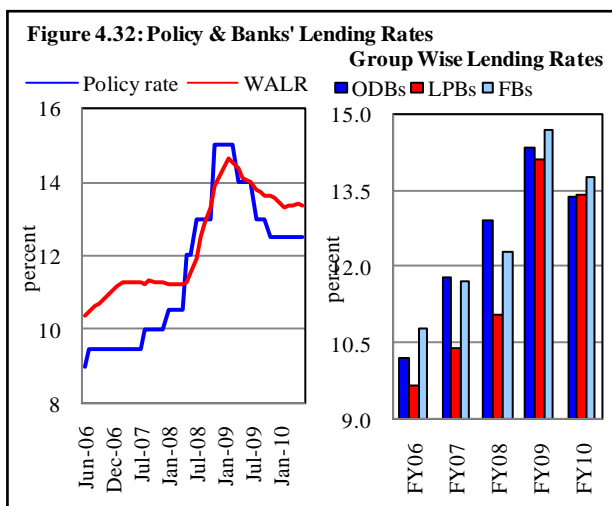
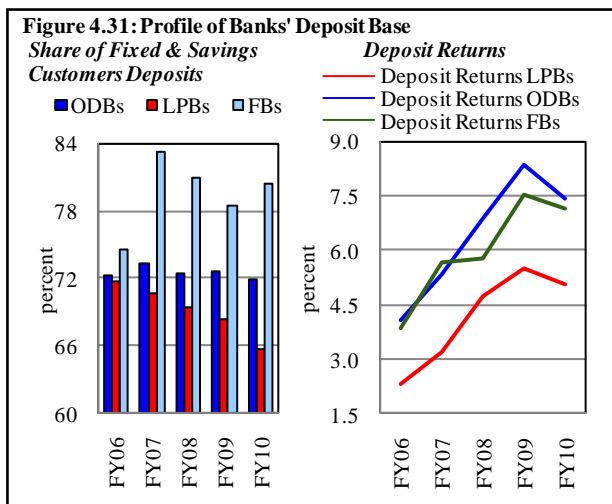
spreads in the industry over the FY 05-10 period, while all other domestic private banks have the lowest.

Since deposits constitute the main funding source for banks in Pakistan, the level of banking spreads must be seen in the context of the composition of banks' deposit bases, and returns offered on these liabilities. It appears that the largest four privatized banks enjoy the lowest cost deposit base in the industry – perhaps due to their vast retail branch networks. In addition they have the lowest and falling share of costly fixed and savings deposits in their deposit base compared with foreign and other domestic banks (see **Figure 4.31**).

This lower cost deposit base – due to a higher share non-remunerative deposits compared to other industry players – depresses the weighted average deposit returns offered by these banks; while it appears that other domestic private banks compete for deposit mobilization by attracting longer-tenor deposits by offering higher returns. Therefore while, lending rates amongst bank groups reveal relatively lower rates at the large privatized banks (see **Figure 4.32**), their higher spreads appear to be a reflection of their access to a relatively stable and low cost funding source.

### Non-Performing Advances

Deteriorating asset quality is one of the main challenges faced by the banking industry since FY08. Non-performing loans (NPLs) of the banking sector increased by 15.6 percent and reached Rs 459.8 billion during FY10. Although the pace of growth decelerated sharply from 64.9 percent in FY09, the stock of NPLs increased by 61.9 billion during FY10 (see **Figure 4.33**). While a large part of this rise in NPLs emanated from the high financial cost of borrowing and subsequent fall in the repaying capacity of borrowers, a part of this increase was also expected owing to the rapid credit extension in previous years.<sup>43</sup> The economic slowdown both at the international and domestic level during FY08 also contributed to the rise of NPLs.



<sup>43</sup> Rapid credit expansion increases the probability of default in the years to come. Borio and Lowe (2002)



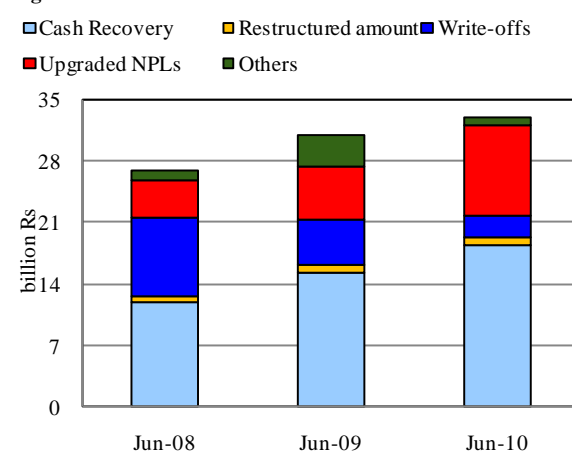
Credit off-take recovered somewhat on the one hand and the increase in NPLs stock decelerated on the other during FY10. This resultantly ended in shoring up the overall NPLs to loan ratio. While total additions to the stock of NPLs remained lower during the review period compared with the FY09, reductions in NPLs for FY10 stayed almost the same as in the previous year. Therefore, incremental amount of NPLs experienced a drop during FY10.

The total reduction in NPLs during FY10 amounted to Rs 101.6 billion compared with Rs 96.1 billion in the previous year. Of this, cash recoveries contributed Rs 55.6 billion relatively higher than Rs 45 billion in FY09. The reductions in other sub-categories remained lower than in FY09 (see **Figure 4.34**).

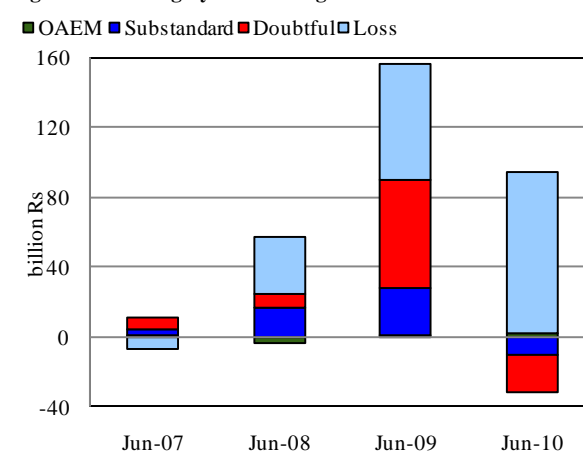
A category wise analysis illustrates that of the total increase of Rs 61.9 billion in overall NPLs, Rs 93 billion were classified under the loss category,<sup>44</sup> whereas NPLs in the substandard and doubtful categories witnessed a decline during FY10 (see **Figure 4.35**). A possible explanation for this movement within classification may be the continued non repayment of classified loans and consequent movement of these from the substandard and doubtful categories into the loss category. The decline in both substandard and doubtful categories also shows that fresh additions remained low, compared to the reductions in the period under study.

Provisioning remained lower than the change in total NPLs in absolute terms; however, the growth rate of provisioning superseded the growth of NPLs. As a result, the coverage ratio improved to 73.2 percent as on end June-2010 from 70.2 percent in the same period last year. This also led to some improvement in the net NPL to net loan ratio from 3.7 percent to 3.8 percent at end June-2010.

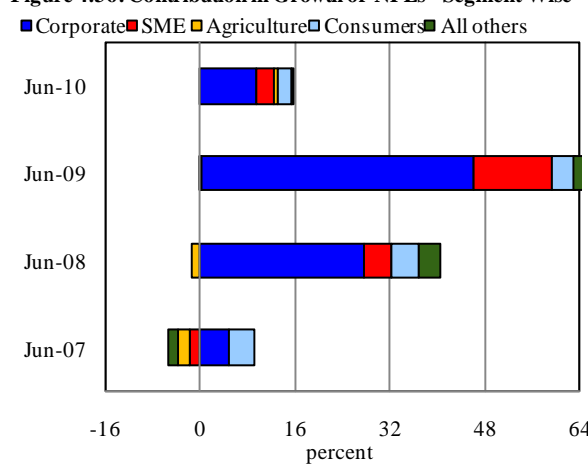
**Figure 4.34: Reductions in NPLs**



**Figure 4.35: Category Wise Changes in Gross NPLs**



**Figure 4.36: Contribution in Growth of NPLs - Segment Wise**



<sup>44</sup> According to prudential regulations the loss category requires 100 percent provisioning means that the provisioning amount against the NPLs of the loss category must be equal to the amount of NPLs.



*Segment-wise analysis*

During FY10, the corporate sector accounted for 62.9 percent of the total rise in NPLs, compared to 63.1 percent in FY09 (see **Figure 4.36**). The sector experienced an increase in NPLs of Rs 38.1 billion. The amount of NPLs under SME segment during FY10 decelerated considerably as compared to the last year. However, the advances to the SME sector also witnessed a fall of Rs 16.6 billion during FY10. As a result, the NPLs to loan ratio for the SME sector increased to 27.1 percent in FY10, compared to 22.9 percent at end June FY09. Overall economic activity has a negative relationship with the NPLs of the banking sector.<sup>45</sup> In fact, FY09 was an extraordinary year when the global and domestic slowdown in economy hit the earnings of corporate and SME sectors; and resultantly their repayment capacity.

A detailed analysis of corporate NPLs shows that during FY10 NPLs under working capital experienced an increase greater than the total rise of NPLs, i.e. the NPLs under fixed investment declined during the period under study.

While growth of non performing advances in corporate and SME sectors experienced deceleration during FY10, the agricultural sector contributed Rs 2.1 billion in the rise of NPLs, compared to a fall of 0.5 billion in FY09. NPLs in the consumer sector has also shown an increase of Rs 9.8 billion in FY10, owing to the lower real income due to inflationary pressures in the economy. Hence, NPL to loan ratio for the consumer sector increased significantly from 9.1 percent in FY09 to 14.6 percent in FY10. This rise in NPL to loan ratio was a result of a decline in advances to the consumer sector<sup>46</sup> (see **Table 4.6**).

**Table 4.6: Non Performing Loans in the Consumer Sector**  
billion Rs; ratio in percent

	FY09			FY10		
	Advances	NPLs	NPL to Loan Ratio	Advances	NPLs	NPL to Loan Ratio
Consumers	327.7	30.0	9.1	270.2	39.8	14.7
<i>Credit cards</i>	36.5	2.8	7.7	28.9	4.6	15.9
<i>Auto loans</i>	80.5	5.4	6.6	65.3	5.8	9.0
<i>Durables</i>	1.2	0.1	7.8	1.0	0.1	13.7
<i>Mortgage</i>	76.5	9.1	11.9	73.1	13.6	18.6
<i>Personal loans</i>	132.9	12.6	9.5	101.9	15.6	15.3

Almost half of the total increase of Rs 9.8 billion in NPLs of the consumer sector was explained by NPLs under the sub-head of mortgage loans.<sup>47</sup> This might be an outcome of rising inflation which depressed real income of the individuals. However, during FY10, NPLs in the consumer sector concentrated more in the same banks as in FY09. Specifically the concentration of eight banks having the major share in consumer sector's NPLs increased to 83.7 percent in FY10 from 80.5 percent in FY09 (see **Table 4.7**).

<sup>45</sup> For details see the Financial Stability Review 2008-09.

<sup>46</sup> Advances to consumer sector experienced a fall of Rs 47.5 billion in FY10.

<sup>47</sup> Mortgage related NPLs encompass 35.4 percent of the overall consumer sector NPLs at end June 2010, second highest after personal loans (38.1 percent).

### Sector-wise analysis

NPLs of textile sector have the largest share in overall NPLs. Of a total rise of Rs 61.9 billion, the textile industry contributed Rs 26.2 billion; which is 42.3 percent of the overall increase in NPLs during FY10. As a consequence, NPL to loan ratio for the textile sector stood at 23.2 percent as of end June FY10, compared with 18.8 percent the year earlier. Among the textile industry, the spinning sector contributed the most due to higher cotton prices during FY10 that affected their profitability.

In contrast to the textile industry, the automobile industry witnessed a decline of Rs 2.5 billion in NPLs; possibly due to increased earnings on account of better production and higher sales during FY10. However, advances fell sharply and superseded the pace of fall in NPLs. Resultantly the NPLs to loan ratio for this sector deteriorated to 19 percent at end June-2010, from 17.7 percent a year earlier.

### Bank-wise composition of NPLs

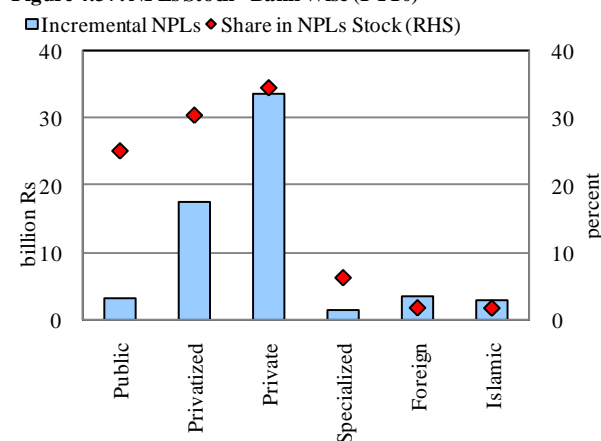
Bank wise composition shows that domestic private banks (ex. Islamic Banks) accounted for 34.7 percent of the overall stock of non performing advances followed by the four largest private banks (30.6 percent) and public banks (25.2 percent) as on end June 2010. In line with their shares of total NPLs, incremental amount of NPLs also followed the same pattern; with domestic private banks (ex. Islamic) accounting for the largest increase during FY10 (see **Figure 4.37**).

Within bank wise distribution, the sectoral breakup of NPLs illustrates that in the textile industry all the above mentioned bank groups have the equal contribution during FY10. While NPLs of the sugar industry mainly shared by both public and private banks, infected loans of cement industry are largely borne by the public sector banks (see **Figure 4.38**). Energy sector's non performing advances for the most part are captured by the private sector banks.

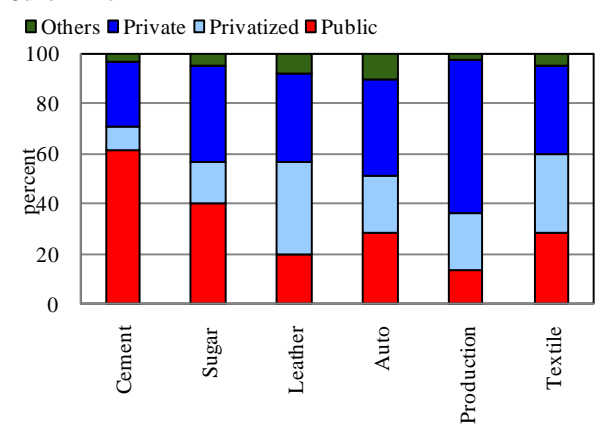
**Table 4.7: Bank Wise NPLs of the Consumer Sector**

billions Rs	FY09	FY10
UBL	8.7	11.5
MCB	2.8	4.8
SCBPL	3.3	3.9
Askari	2.2	3.6
BAFL	2.8	3.5
NBP	3.4	3.4
Faysal	1.2	1.7
Citibank	0.3	1.7
<b>Sub-total</b>	<b>24.7</b>	<b>34.1</b>
<i>Concentration</i>	80.5	83.7
Others	6.0	6.6
<b>Total</b>	<b>30.7</b>	<b>40.8</b>

**Figure 4.37: NPLs Stock - Bank Wise (FY10)**



**Figure 4.38: Bank Wise Share of NPLs in Major Sectors at end June-FY10**

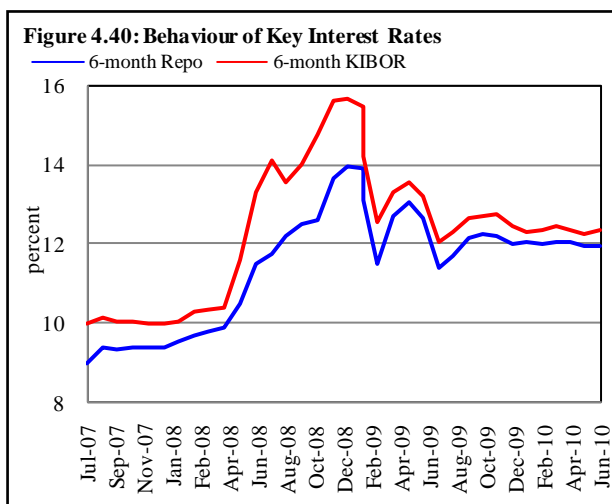
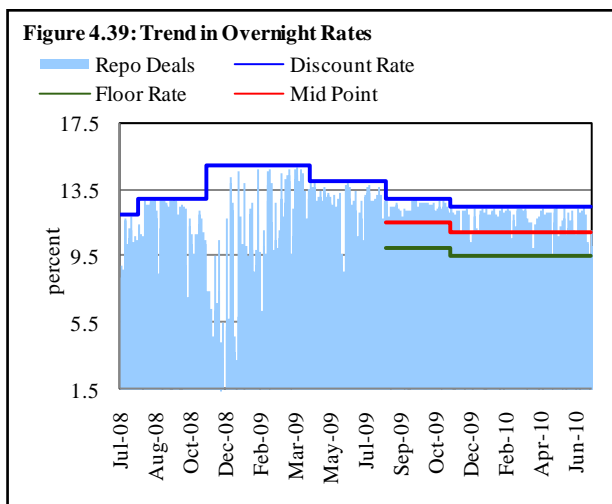


#### 4.4 Analysis of Money Market Activities

The money market remained fragile and witnessed excessively tight liquidity conditions compared to FY09. This liquidity squeeze was due to excessive government borrowings from the banking system for budgetary support and commodity operations; further compounded by the rising stock of NPLs. The SBP had to face the challenging job to square the liquidity position of the money market in the wake of fiscal slippages, coupled with hampered economic activities in the economy due to energy crisis and prevailing law and order situation.

During August 2009, the SBP introduced an interest rate corridor with the objectives of enhancing the monetary policy transmission mechanism, reducing volatility in overnight (O/N) rates of money market, and smoothing the flow of credit to the economy. These measures contributed to the stability of the overnight rate, keeping it close to the discount rate. Specifically, daily overnight rates fluctuated in the range of 7.4 – 13.8 percent during FY10 compared with 1.5 – 14.9 percent a year earlier (see **Figure 4.39**).

The bulk of credit extended to the corporate sector is linked to the Karachi Interbank Offered Rate (KIBOR); the movement of which depends upon the inter-bank liquidity conditions and economic activities. Following the subdued trend of economic activities, the deviation in KIBOR and Repo fell in FY10 compared to the higher variation seen in FY09. As a result of smoothening in both rates, the monthly average spread between both the bench mark rates came down from 136 basis points in FY09 to 41 basis points in FY10 (see **Figure 4.40**).



##### 4.4.1 Liquidity Management

Liquidity in the money market remained under stress despite an increase in the deposits of the banking system during FY10. The impact of this increase in deposits was diluted by rising NPLs, increasing net government borrowing for budgetary support and commodity operations. To cope with the resulting liquidity strain, the SBP conducted open market operations on 49 occasions during H1-FY10 and injected Rs 1949.7 billion net of absorption in the banking system. However, during H2-FY10, Rs 1181.6 billion was injected through open market operations (OMOs) on 40 occasions. A total net injection of Rs 3131.3 billion were made during FY10 compared to a net mop-up of Rs 133.6 billion during FY09 (see **Table 4.8**).

**Table 4.8: Net Flows through OMOs**  
billion Rs

	No.	Absorptions	Injections	Net Flow
FY08	87	1,246.7	232.35	-1,014.3
FY09	121	1,367.7	1234.1	-133.6
H1-FY10	49	167.9	2117.6	1,949.7
H2-FY10	40	321.8	1503.4	1,181.6
<b>FY10</b>	<b>89</b>	<b>489.7</b>	<b>3621.0</b>	<b>3,131.3</b>

In the face of continued liquidity pressures a few small banks still needed SBP support through the reverse repo ceiling facility; despite heavy injections in the system. To keep the overnight rate within the corridor, the SBP allowed reverse repo ceiling facility of Rs 724.2 billion during FY10 compared to Rs 874.5 billion in FY09. In tandem with subdued trading activities in the money market, some money market players with surplus liquidity availed the Repo Floor Facility of Rs 602.1 billion in FY10 since the introduction of interest rate corridor (see **Table 4.9**).

**Table 4.9 : Floor and Ceiling Facilities<sup>48</sup>**

billion Rs	Repo Floor Facility	Reverse repo Ceiling
H1-FY08	-	1424.0
H2-FY08	-	541.5
H1-FY09	-	632.0
H2-FY09	-	242.6
H1-FY10	179.0	269.0
H2-FY10	423.1	455.2

#### 4.4.2 Primary Market

##### *Treasury Bills*

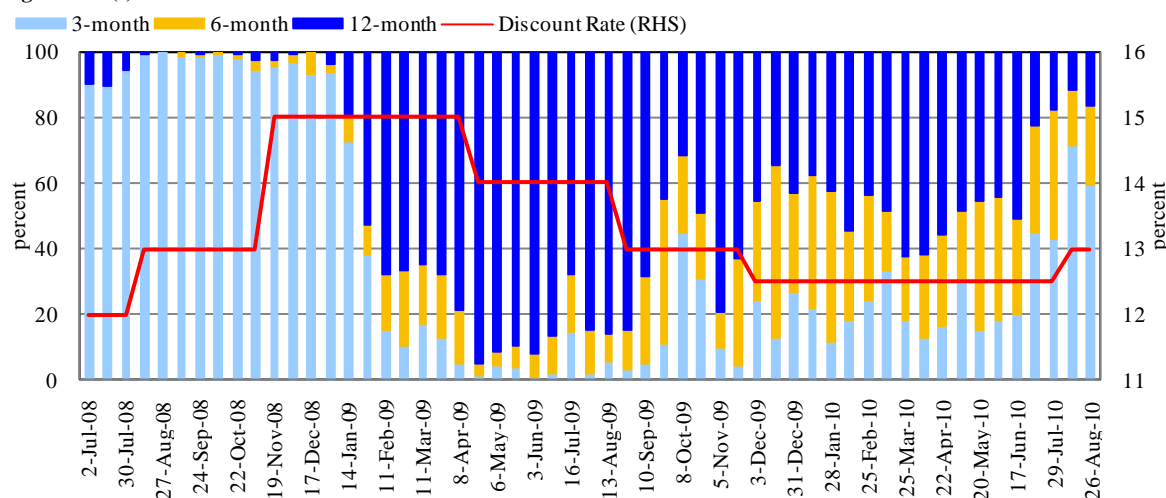
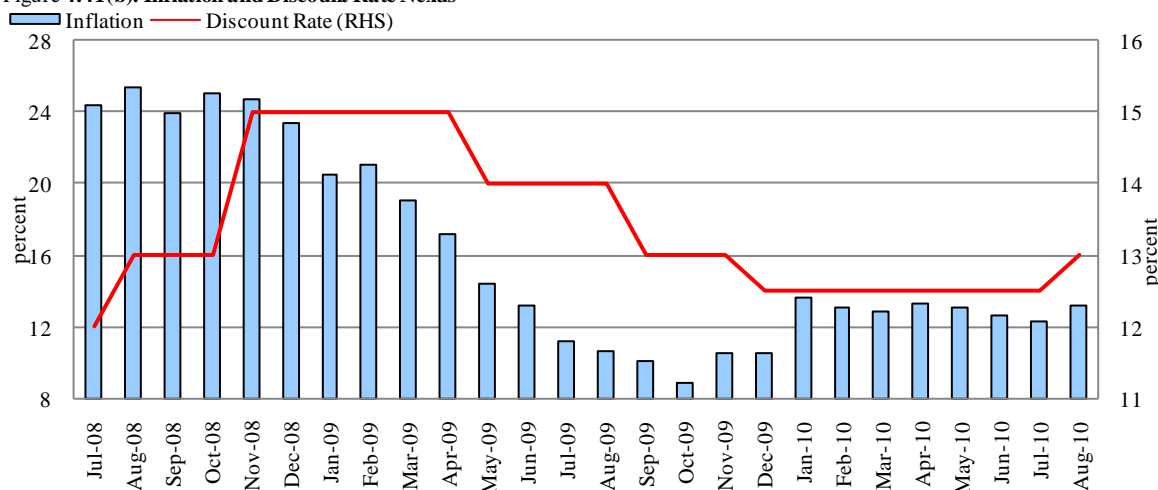
In order to plug the budgetary gap in revenue and expenditure and to address timing mismatch in revenue receipts and public spending, the government resorts to treasury bills auctions to borrow from the banking system as a normal course of business. Keeping in view fresh borrowing requirements and maturity profile of earlier borrowing, the government set a pre-auction target of Rs 470 billion for H1-FY10. For H2-FY10, the target of Rs 890.0 billion was set.

On the demand side, an offered amount of Rs 3131.2 billion against a target of Rs 1360.0 billion with a bid cover ratio of 2.34 was received in FY10, compared to the bid cover ratio of 1.81 in FY09. The larger offer was made by market participants, due to subdued private sector activities as a result of supply-side constraints from power shortages and a deteriorating security situation. The market participants largely focused on higher end of the yield curve and made investments in 12 & 6-month treasury bills; it was based on their expectation of further reduction in the discount rate. Keeping in view the reducing trend in discount rate on two occasions (one on 17<sup>th</sup> August 2009 and second on 25<sup>th</sup> November 2009), the participants offered 56 percent of their total bids in 12-month, 27 per cent in 6-month and 17 percent in 3-month maturities. However, when the discount rate was revised upward by 50 basis points on August 2, 2010, the market participants started to make investment in 3-month treasury bills in anticipation of further upward revision in discount rate (see **Figure 4.41 a & b**).

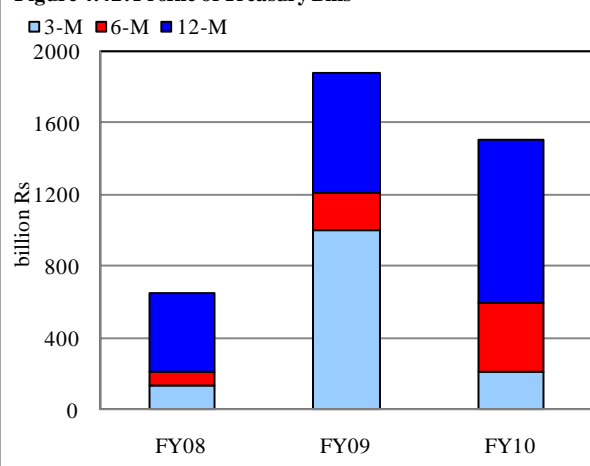
Keeping the target in view, Rs 447.3 billion adjusted for maturities was accepted in FY10 compared with Rs 296.2 billion in FY09. The share of 6 and 12-month treasury bills in total accepted amount of treasury bills increased from 11.0 and 36 percent in FY09 to 25.0 and 61.0 percent respectively in FY10. However the share of 3-month treasury bills declined from 53.0 percent in FY09 to 14.0 percent in FY10 (see **Figure 4.42**).

With a view to providing investment opportunities to the small investors and institutions who wish to risk non-acceptance of bids to invest directly in Government of Pakistan issued treasury bills and Pakistan Investment Bonds, the SBP has introduced the non-competitive bid option with a cap of 15 percent of the pre-announced auction targets. These bids are accepted at weighted average yield in each tenor as decided in the primary auction.

<sup>48</sup> Under the repo floor facility, the banks with surplus liquidity place their funds with SBP at the prevailing floor rate, while under the repo ceiling facility, the banks facing temporary liquidity shortage resort to the discount window to borrow from the SBP at the prevailing discount rate.

**Figure 4.41(a): Offered Amount in T-bill Auctions****Figure 4.41(b): Inflation and Discount Rate Nexus**

In tandem with increasing government borrowing from the banking system, the share of institutions other than banks, DFIs and NBFIs increased in treasury bills from around one percent recorded in FY09, to 4.8 percent in FY10; still substantially less than the 15 percent share of investment allocated for non-competitive bids. However, the increasing trend of non-competitive bids participation is expected to help to broaden the investment base and strengthening the economy gradually in future (see **Figure 4.43**).

**Figure 4.42: Profile of Treasury Bills**

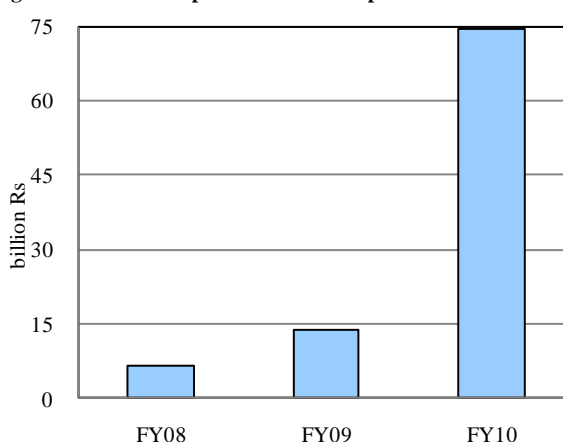
Looking forward, a pre-auction target of Rs 535.0 billion has been set for Q1FY11, which is 65 percent higher than the target for the same period last year. This may indicate that the government will continue with its expansionary fiscal stance. Continuing such an expansionary fiscal stance in the forthcoming quarters, the government would face increased pressure from a rising debt stock and interest payments. Delays in external inflows would also force the government to borrow heavily from the banking system.

During the first two months of FY10, due to a lower deficit gap and the materialization of the external inflows; the monthly average rates of all the three maturities declined to around 11.5 percent. During October and November FY10, the rates of all short term maturities inched up and touched a highest ever level of 12.6 percent due to a huge government borrowing needs. However, from December onward rates declined despite higher demand for funds by the government, because banks had few opportunities to invest their funds (see **Figure 4.44**).

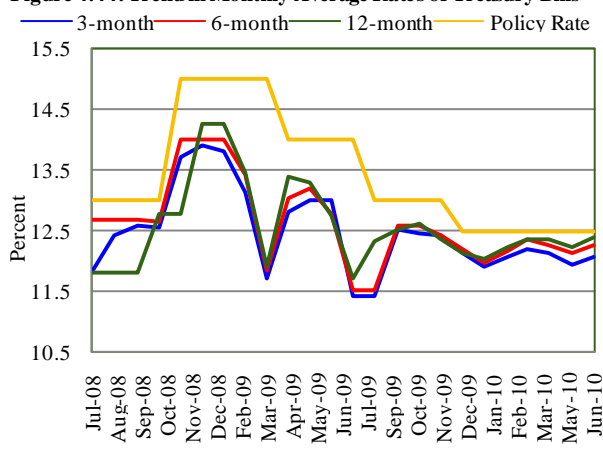
### **Pakistan Investment Bonds**

The government showed greater appetite for borrowing through long term securities, and

**Figure 4.43: Non-competitive Bids Participation Share**



**Figure 4.44: Trend in Monthly Average Rates of Treasury Bills**



**Table 4.10: PIBs Auction Profile**

billion Rs		3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	30-Year	Total
FY08	Target								120.0
	Maturity	0.1	14.4	-	-	-	-	-	14.5
	Accepted	5.2	10.8	-	23.9	8.6	9.1	16.1	73.7
	Excess/short of maturity	5.1	-3.6	-	23.9	8.6	9.1	16.1	59.2
FY09	Target								80.0
	Maturity	14.1	27.8	-	-	-	-	-	41.9
	Accepted	10.1	8.8	7.3	35	1.4	1.9	6.6	71.1
	Excess/short of maturity	-4.0	-18.9	7.3	35	1.4	1.9	6.6	29.3
FY10	Target								60.0
	Maturity	6.4	0.4	-	-	-	-	-	6.9
	Accepted	9.7	6.4	2.0	38.2	0.8	1.5	1.8	60.3
	Excess/short of maturity	3.28	6.01	2.0	38.2	0.8	1.5	1.8	53.5

as such set the target of Rs 60.0 billion against a maturity of Rs 6.9 billion -six times higher than that during FY10. From the demand side, keeping in view the widening deficit gap of the government, market players offered Rs 134.4 billion for investment in long term government securities. The

increased bids in Pakistan Investment Bonds (PIBs) were not surprising, amid subdued economic activities, coupled with expectations of decline in inflation. In view of the increasing demand of participants, Rs 53.5 billion net of maturities was accepted during FY10, compared to Rs 29.3 billion net of maturities had accepted in FY09 (see **Table 4.10**).

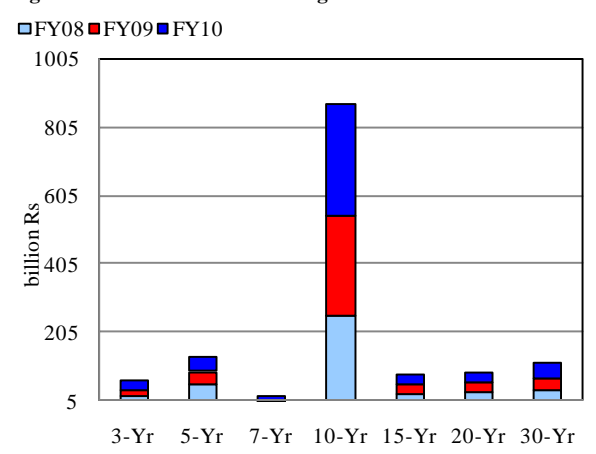
To increase secondary market liquidity, four combined auctions of 38<sup>th</sup> and 39<sup>th</sup> issues were reopened. However, a single fresh auction of the 39<sup>th</sup> issue was also held in FY10. The participants showed a greater appetite for investment in 3, 10, and 30-year PIBs by offering 14, 50 and 11 percent respectively of the total offered amount in PIBs. 5, 7, 15 and 20- year PIBs attracted 9, 2, 4 and 9 percent respectively of the total amount offered for investment in PIBs. Among the participants, banks preferred to invest in PIBs falling in the 3 to 10-year's maturities; while the other investors e.g. insurance, funds and pensions management institutions chose to invest in 15 to 30 - year maturities keeping in view their maturity gaps.

In line with the rising fiscal deficit and cost of fund management, the government preferred to generate resources from 10-year PIBs, and accepted 63 percent of the amount through this single maturity. This was followed by 3, 5-year PIBs with a share of 16, 11 percent respectively of the amount accepted in FY10. 7, 15, 20 and 30-year PIBs attracted the investment with a share of 3, 1, 2 and 3 per cent respectively.

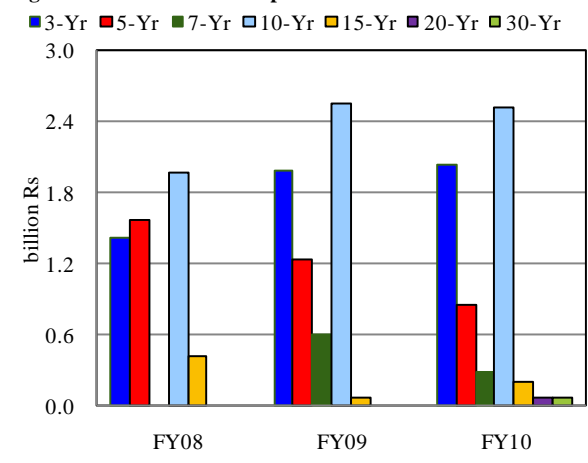
Despite the greater acceptance in 10-year PIBs, the share of the said maturity in outstanding stock declined marginally by 56 basis points in FY10, followed by a reduction in the share of 15, 20 and 30- year maturities by 53 to 77 basis points compared to FY09. However, the share of 3, 5 and 7-year PIBs in the outstanding stock increased by 186, 33 and 22 basis points respectively (see **Figure 4.45**).

A marginal downward trend was witnessed in non-competitive bids in the auctions of PIBs, as the total amount of Rs 6.0 billion was recorded in FY10 compared to Rs 6.4 billion offered in FY09. The share of 3, 10, 15, 20 and 30-year increased in FY10 - notably an increase of 3 percent was observed in 3-year PIBs. However, the share of investment in NCBs of 5 and 7-year maturities declined, despite the fact that the SBP increased the share of non-competitive bids from 10 to 15 percent in the respective auctions. This was aimed at encouraging non-financial institutions and individuals to invest in government securities; thereby broadening the distribution base (see **Figure 4.46**).

**Figure 4.45: Profile of Outstanding PIBs**



**Figure: 4.46: PIBs Non-Competitive Bids Profile**





### Government Ijara Sukuk

To support efforts to diversify the borrowings mix, the government and the central bank worked together to launch the GoP Ijara Sukuk. This was in recognition of the need to achieve eventual uniformity of regulatory reserves of Islamic banks and conventional banks, to ensure financial stability. Islamic Banks have been aggressively mobilizing deposits, and play a significant role particularly after the introduction of the minimum deposit rate and easing of reserve ratios. To meet the growing and diverse requirements of the economy, mobilization of long term resources have also been playing pivotal role in sustainable economic growth.

To cope with the liquidity requirements of Shariah compliant banking institutions, the target for the auction of fourth GoP Ijara Sukuk was set at Rs 10.0 billion during FY10. Increasing appetite for investment in these instruments was observed, as bids of Rs 30.4 billion were received against the target from the Shariah compliant banking institutions. Keeping the demand in view, Rs 4.4 billion

**Table 4.11: GoP Ijara Sukuk Auction Profile**

billion Rs

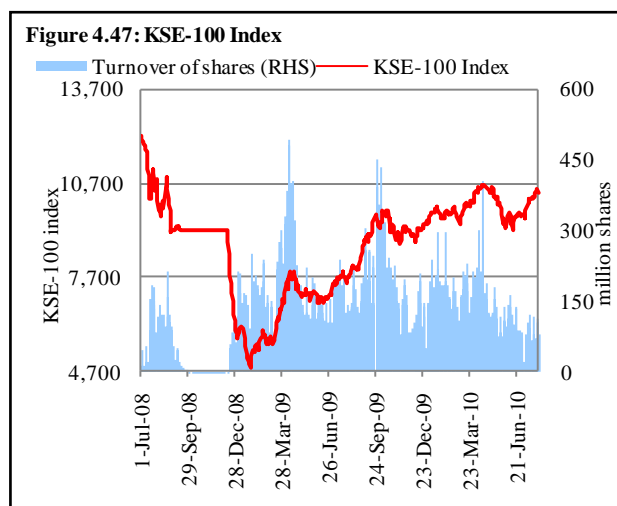
3-Year Maturity-wise Sukuk	Date of Issue	Date of Maturity	Target Amount	Offered Amount	Accepted
GoP Ijara Sukuk-I	26-Sep-08	26-Sep-11	10.0	9.5	6.5
GoP Ijara Sukuk-II	29-Dec-08	29-Dec-11	10.0	7.3	6.0
GoP Ijara Sukuk-III	11-Mar-09	11-Mar-12	10.0	21.4	15.3
GoP Ijara Sukuk-IV	17-Sep-09	17-Sep-12	10.0	30.4	14.4

net of target was absorbed from the only auction held in FY10, compared to Rs 27.8 billion accepted against the target of Rs 30.0 billion during FY09. Total bids of Rs 38.2 billion had been received in FY09 (see **Table 4.11**).

In the near future, the government also plans to launch an Ijara Sukuk, by pledging assets of 2,200 acres of land of Jinnah Terminal at the Quaid-e-Azam International Airport in Karachi. The Sukuk will generate around Rs 35.0 billion to be used in financing of the fiscal deficit. The maturity of the Sukuk will be of one, two and three years. All formalities have reportedly been completed for the issuance of these Sukuks.

### 4.5 Analysis of Capital Market Activities

In the wake of improved economic growth, easing in inflationary pressures, increased foreign investment in the equity market, easier monetary policy stance and increasing investment by commercial banks, the asset markets came out of the stress and remained bullish during FY10.



The KSE-100 index staged a recovery, rising by 35.7 percent to 9,722 in FY10, from 7,162.0 in FY09. This was in stark contrast to a decline of 41.7 percent in FY09. Market capitalization also increased by 26.0 percent to Rs 2732.4 billion in FY10 compared to Rs 2,120.6 billion in FY09. The increased capitalization represents 18.5 percent of GDP at end FY10.

**Table 4.12: Profile of Equity Market**

	Units	FY08	FY09	FY10
Listed companies	number	652	651	651
Listed capital	billion Rs	706	782	910.0
Market capitalization	billion Rs	3777.7	2120.6	2732.4
Market capitalization as % of DGP	percentage	36.7	16.2	18.5
New listed companies	number	7	8	8
New debt instruments listed	number	7	1	2
Amount of debt instruments	billion Rs	22.3	4.3	5.0
<b>KSE-100 Index (end period)</b>		<b>12289</b>	<b>7162.0</b>	<b>9722.0</b>
High		15676.3	12221.5	10677.5
Low		11162.2	4815.3	7272.7
Average volume per day (shares)	billion shares	0.2	0.1	0.16
Total average per day value	billion Rs	25.6	4.4	6.9
Total trading days	number	247	245	249
<b>LSE-25 Index</b>		<b>2749.6</b>	<b>1713</b>	<b>3092.7</b>
LSE market capitalization	billion Rs	3514	2018	2622.9
<b>ISE-10 Index (end period)</b>		<b>2749.6</b>	<b>1713</b>	<b>2441.2</b>
ISE-10 capitalization	billion Rs	2872	1705	2261.7
SCRA investment net inflows	mln.US\$	-232.1	-537.2	573

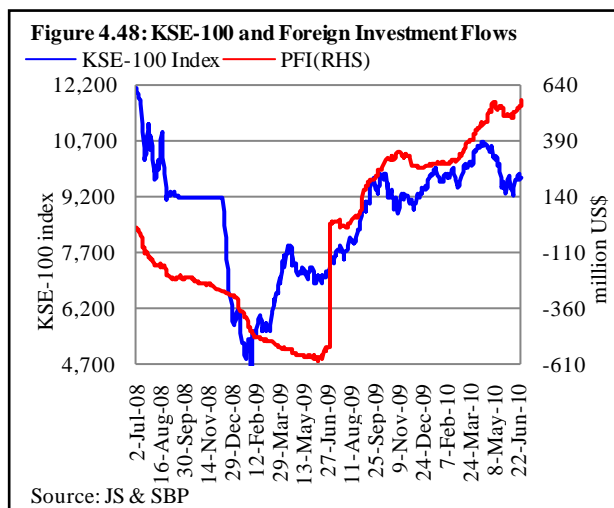
Source: KSE

During the year under review, the KSE-100 Index reached a high of 10,677.5 and a low of 7,270.7 with a variance of 9 during FY10 compared with that of 22 during FY09 showing the stability and growth.

Average daily volumes stood at 161.27 million shares in FY10, compared to 114.47 million shares in FY09. The daily average value of trading volumes increased from Rs 4.4 billion in FY09 to Rs 6.9 billion in FY10. The total Index Points

Movement (IPM) during the period under review was 2559.7, compared to (-5126.9) recorded in FY09 (see **Figure 4.47 & Table 4.12**).

Foreign buying reached a fresh high at the local bourse which helped the market recovery in FY10. Net foreign investment was recorded at US\$568.3 million in the period under review (end June 10) as compared to net outflow of US\$537.2 million during FY09. This was the highest foreign portfolio investment since NCCPL started publishing this data in March 2008. The increased foreign investment in the local bourse was due to improving economic fundamentals e.g. current account, remittance and CSF inflows. Moreover, better valuations attracted foreign investment to the local bourse (see **Figure 4.48**).



A major chunk of portfolio investment in the local bourse came from the USA followed by the UK and Luxemburg; whereas UAE and Chile based investors withdrew their investments from the equity market due to an economic recession in their respective countries over the last couple of years. Moreover, foreign investment helped the local bourse to outperform its regional peers.

The MSCI Index of Pakistan registered growth of around 26.8 percent in FY10 compared to the top performers of regional peers' as well as non-regional countries. Keeping in view the quick recovery and growth of the local bourse, compared to the growth of other regional and non-regional countries indexes also highlights the weak correlation of Pakistan's equity market with the rest of the world (see

**Table 4.13).**

Pakistan was to be upgraded from the Frontier Market Index to the Emerging Market Index of MSCI in June 2010; however this transition has been delayed.

### Initial Public Offerings

Initial public offerings (IPOs) are another key indicator of a capital market's depth. Eight IPOs were announced at the local bourse, worth Rs 5.0 billion in FY10. Interestingly eight initial public offerings worth Rs 4.3 billion had also registered in the previous fiscal year. Six of these received a lukewarm response from investors, while two remained undersubscribed (see **Table 4.14**). Amongst the eight IPOs in FY10, two belonged to the power generation and fertilizer sectors, whereas the others were from the chemical, construction, textile and telecom sectors. Six of these issues were oversubscribed. Undersubscription of Nishat Chunian Power and Agritech dragged the average subscription down to 0.7 times.

**Table 4.13: Region/Country-wise Performance of MSCI Index**

	FY07	FY08	FY09	FY10
EM Asia	1.4	0.9	-20.0	20.4
EM Far East	1.4	0.9	-21.7	18.9
Europe	29.0	-14.0	-36.9	2.7
Indonesia	1.6	1.2	-25.7	62.4
Philippines	2.0	0.6	-2.6	31.8
Thailand	1.3	1.1	-20.9	30.4
India	1.6	0.9	-6.2	30.2
Malaysia	1.6	0.9	-14.6	30.2
Pakistan	<b>1.4</b>	<b>0.8</b>	<b>-57.2</b>	<b>26.8</b>
Singapore	55.4	-7.2	-27.2	25.1
Brazil	1.6	1.5	-40.5	18.6
Switzerland	20.8	-9.4	-27.4	14.8
Netherland	34.8	-14.8	-38.9	14.3
USA	18.4	-13.9	-28.5	12.0
Hongkong	25.8	0.7	-18.5	11.0
Saudi Arabia	-46.2	36.2	-41.3	9.9
China	1.8	1.0	-10.7	8.5
U.K.	23.1	-16.5	-37.2	4.7
Germany	45.8	-8.5	-39.4	4.5
Korea	32.0	-13.9	-14.6	1.3
Japan	6.1	-13.5	-24.6	-0.9
France	28.2	-13.9	-36.4	-2.0
Kuwait	41.3	4.6	-44.9	-5.6
UAE	1.5	21.4	-61.4	-10.7
Bahrain	11.1	34.5	-67.1	-42.8

Source: MSCI Bara

It is also worthwhile to mention that 3 of the 8 IPOs (Ghani Gases, Fatima Fertilizer and Amtex) were offered through the book building process, raising an additional Rs 2.7 billion. Through book building process an underwriter attempts to determine the offer price of an IPO based on demand from institutional investors

**Table 4.14: Listing Profile FY10**

million Rs

Company	Date of Listing	Share Capital Issued	Already Paid up Capital	Public Issue	Premium	Total Amount subscribed	Subsc. by underwriters
Nishat Power Ltd.	7-Oct-09	3541	3316	225		274	
Nishat Chunian Power Ltd.	22-Oct-09	3674	2724	950		707	243
Ghani Gases Ltd. (i)	5-Jan-10	725	685	40	16	75	
Fatima Fertilizer Company Ltd.(ii)	8-Mar-10	20000	19525	475	166	788	
Safe Mix Concrete Products Ltd.	18-Mar-10	200	100	100	25	127	
Agritech Ltd.(iii)	12-Apr-10	3924	3758	167	333	115	385
Amtex Ltd.(iv)	13-Apr-10	2415	1805	610	55	239	
Wateen Telecom Ltd.(v)	27-May-10	5275	4175	1100	2007	2007	
<b>Total</b>		<b>39753</b>	<b>36086</b>	<b>3667</b>	<b>2603</b>	<b>4333</b>	<b>628</b>

Source: KSE

### Corporate Debt Instruments Profile

As an alternate source of financing to the corporate sector, two TFCs for mobilizing an aggregate amount of Rs 5.0 billion were floated in the local bourse during FY10. During the last fiscal year, a

**Table 4.15: Profile of Debt Instruments issued in FY09 and FY10**

million Rs

	Company	Tenor	Issue date	Maturity	Amount	Coupon Rate
<b>FY10</b>	Engro Fertilizers Limited (III)	7	8-Feb-10	8-Feb-17	2,000.000	KIBOR + 2.40%
	Allied Bank Limited (II)	10	9-Oct-09	9-Oct-19	3,000.000	KIBOR + 1.30%
	<b>Total</b>				<b>5,000.00</b>	
<b>FY09</b>	Pakistan Mobile Communication	5	5-Dec-08	5-Dec-13	<b>4,256.900</b>	KIBOR+1.65%

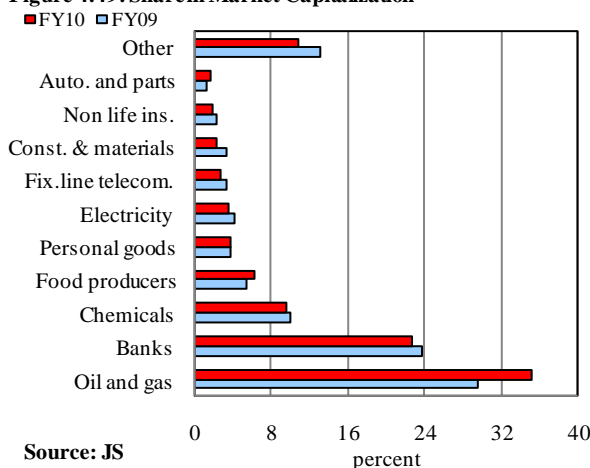
Source: KSE

single TFC for generating resources of Rs 4.3 billion had floated by the communication sector through stock market. During FY10, the first Term Finance Certificate (TFC) was issued in September 2009, which was priced at KIBOR plus 1.3 percent, while the second issuance took place in February 2010 at a price of KIBOR plus 2.4 percent (see **Table 4.15**).

### Sectoral Performance

Following the bullish trend in equity markets during the entire fiscal year under review, capitalization also registered a growth of 26 percent to reach to Rs 2731.4 billion in FY10; compared to a decline of 44 percent in FY09. Oil & Gas sectors with a share of 35 percent, was the major contributors in total market capitalization followed by banks and others with a share of 23 and 11 percent respectively. The share of the remaining sectors falls in the range of 2-9 percent (see **Figure 4.49**). 21 of the 32 sectors have increased their share in total capitalization in FY10, and the share of the remaining eleven sectors has declined.

**Figure 4.49: Share in Market Capitalization**



### Corporate Performance

During 2009, due to a slowdown in economic activities, amid subdued external demand, as well as a deteriorating domestic law and order situation, high inflation, a depreciated exchange rate, widening gap in balance of payment and other allied problems - the corporate sector did not keep its pace of growth witnessed in 2008. Out of the 32 corporate sectors, 19 sectors posted after tax profit in 2009, compared to 28 sectors that had posted a profit after tax during 2008. Out of these sectors, oil & gas exploration remained the top profit earners, followed by commercial banks, fertilizer and telecom & communications sectors.

The after tax profit growth witnessed in sugar and allied sectors followed by telecom & communications, cement and cable & electric goods sectors. Out of 629 companies' 161 (32 out of 33 sectors) declared dividend in 2009 compared to 173 companies (31 out of 33 sectors) had declared dividend in 2008. The highest average dividend was paid by cable & electric goods sectors, followed by oil & gas exploration sectors

14 out of 33 sectors posted losses in 2009, compared to 5 sectors that had suffered losses during 2008. Investment banks & companies, refineries, power generation and textile spinning sectors posted the major net losses during FY09 (see Table 4.16).

**Table 4.16: Corporate Performance**

PAT in million Rs

Earning Profile							
Sector	2008			2009			%growth in net profit
	No. of companies	Net profit after tax	Dividend paid by No. of companies	No. of companies	Net profit after tax	Dividend paid by No. of companies	
Sugar and allied	37	115.38	2	37	2,759.08	15	2291.2
Tech & comm.	9	-2,290.6	2	10	10,636.31	3	364.3
Cement	21	1,546.55	2	21	6,947.71	3	349.2
Cable & electric goods	9	497.79	3	9	1,526.76	3	206.7
Pharmaceutical	8	426.35	6	8	1,290.98	4	202.8
Insurance	38	-4,765.4	12	38	4,154.09	3	187.2
Transportation	5	944.15	3	5	1,992.45	1	111.0
Textile weaving	18	-552.6	1	18	-172.5	2	68.8
Commercial banks	25	40,586.20	5	25	57,469.99	3	41.6
Oil and gas exploration	4	80,497.90	4	4	91,012.64	4	13.1
Tobacco	3	5.76	2	3	6.31	2	9.5
Glass & ceramics	10	155.72	3	11	167.91	2	7.8
Fertilizer	4	16,727.80	4	4	15,426.45	4	-7.8
Food & personal care products	22	769.15	13	23	689.03	23	-10.4
Jute	5	774.35	1	5	667.20	1	-13.8
Chemical	26	1,715.20	10	26	1,475.48	9	-14.0
Engineering	13	1,533.15	6	13	484.34	5	-68.4
Auto assebling	13	3,677.25	4	13	732.60	6	-80.1
Miscellaneous	26	1,820.14	9	26	277.81	4	-84.7
Textile composite	60	8,138.49	17	60	241.90	16	-97.0
Oil and gas marketing	6	25,164.80	5	6	-2,355.9	3	-109.4
Modarabas	34	928.71	16	34	-117.7	9	-112.7
Auto parts & accessories	12	281.60	5	11	-51.1	5	-118.1
Power generation	13	10,768.90	5	15	-5,755.1	5	-153.4
Inv.Banks and Companies	30	31,743.67	5	29	-27,216.5	4	-185.7
Refinery	4	10,138.87	3	4	-12,354.8	1	-221.9
Vanaspati and allied	10	8.90	1	10	-14.3	1	-260.3
Synthetic & rayon	19	2,119.64	5	19	-3,400.8	6	-260.4
Paper and Board	10	428.06	4	10	-765.8	2	-278.9
Leasing	18	661.83	3	16	-1,349.3	0	-303.9
Woolen	5	7.50	0	5	-35.4	1	-572.5
Textile spinning	107	-615.0	12	106	-4,931.1	10	-701.8
Leather and tanneries	5	-2.7	0	5	-68.1	1	-2385.9
Total:	629	233,957.49	173	629	139,370.72	161	-40.4

Source: KSE