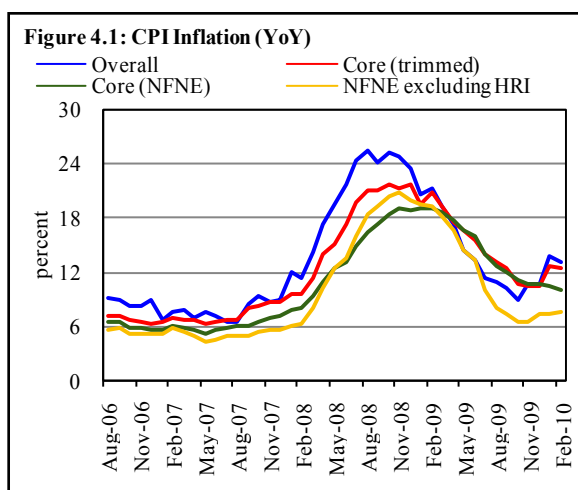


4 Money and Banking¹

4.1 Monetary Policy

Improved prospects of macroeconomic stability² in FY10 allowed SBP to maintain the accommodative monetary policy initiated in April 2009.³ SBP cut the policy rate twice in the first half of the fiscal year, representing a cumulative reduction of 150 basis points.⁴ However, the recovery in aggregate demand in the economy as evident from rebounding inflationary pressures, rising imports in recent months, and excessive fiscal spending held the central bank from a more aggressive easing. Therefore the SBP chose to keep the discount rate unchanged in January 2010 monetary policy announcement.

The major concern has been the trend decline in headline inflation that bottomed out in October 2009 and gradually rose from 8.9 percent YoY in October 2009 to 13.0 percent in February 2010 (see **Figure 4.1**). The inflationary pressures emanated mainly from, (1) adjustments in electricity tariff rates that have started to show up in CPI index⁵; (2) a sharp weakening of rupee value in December 2009 onwards; and (3) rise in international prices of key



¹ This section is based on the data available up to end February 2010.

² This was particularly noticeable in: (1) considerable decline in headline inflation; (2) sharp decline in imports that resulted contraction in current account deficit; and (3) recovery in LSM production growth.

³ In the current ease in monetary stance, SBP first decreased the policy rate by 100 basis points in April 2009.

⁴ Policy rate was cut by 100 basis points in August 2009 followed by another 50 basis points in November 2009.

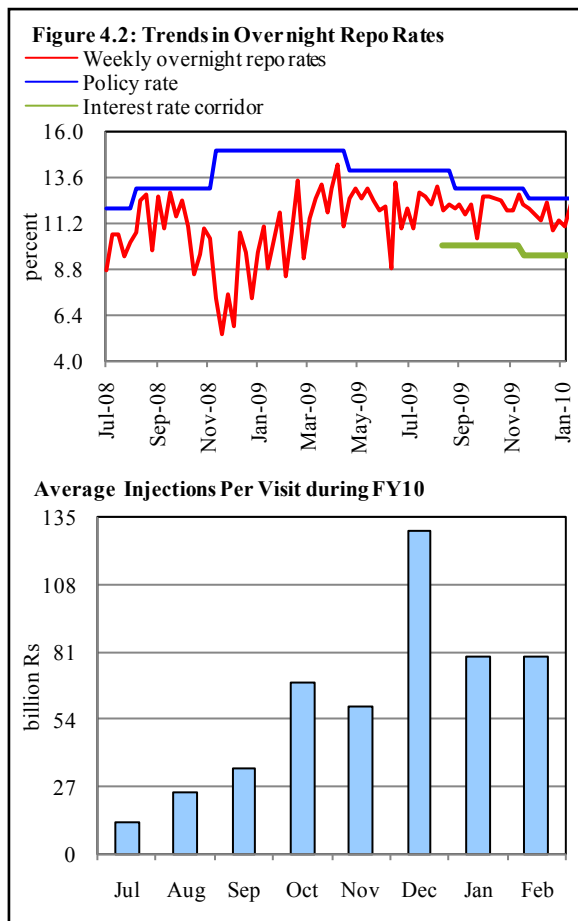
⁵ Rationalization of electricity and gas prices became inevitable given the efforts of the government to phase out power subsidy.

commodities such as oil, sugar and pulses. Most of these pressures are visible in CPI food prices.

Although current level of inflation is much lower when compared with February 2009 (21.1 percent), it has the potential to ignite inflationary expectations and offset the previous achievements of a tight monetary policy. More importantly, the rise in core inflation, measured by 20 percent trimmed mean, during February 2010 also indicates persistence in inflationary pressures. The SBP was also mindful of the strong second round effects of broad based inflationary pressures from food and energy.

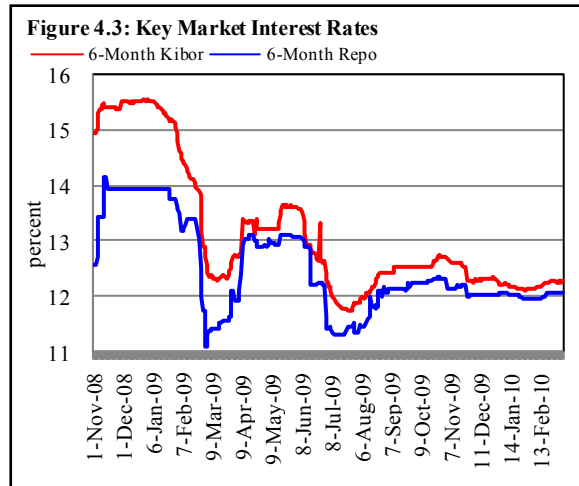
The concerns of inflation expectations were more pronounced given the rising fiscal deficit and subsequent government borrowings. In fact, fiscal deficit in Q2-FY10 was not only higher than Q2-FY09, IMF also allowed relaxation in the quarterly target for the fiscal deficit. While the increase in the fiscal deficit was unavoidable given the lingering payments of power related subsidies and war against terrorism; it led to high budgetary borrowings from the banking system.

In specific terms, lower external receipts in Q2-FY10 increased government reliance on the banking system for budgetary borrowings. Unlike Q1-FY10, however, the budgetary borrowings from the commercial banks were lower in Q2-FY10 as the government largely adhered to its pre-auction targets that were set lower for Q2-FY10 in anticipation of increased external inflows. Resultantly, reliance on SBP borrowings increased during Oct-Feb FY10. As a result, reserve money grew by 10.6 percent in Jul-Feb FY10 compared with a fall of 2.5 percent in Jul-Feb FY09.



Interestingly, hefty borrowings of PSEs and lower than expected retirement of commodity finance loans in Q2-FY10 led to a substantial drain of rupee liquidity from the interbank market October 2009 onwards. The liquidity strains became more severe as commercial banks have been investing heavily in government papers since the inception of IMF program in November 2008.⁶ All these factors complicated liquidity management by the SBP.

Therefore, to reduce volatility in inter-bank money market rates and avoid the transmission of high inter-bank rates to retail lending rates, the SBP conducted a number of OMOs throughout FY10 (see **Figure 4.2**). The frequent OMO injections reduced excess volatility in the overnight rates and other market rates in line with the reduction in policy rate (see **Figure 4.3**).



The timely SBP measures to counter liquidity concerns and reducing WA lending rates did indeed help commercial banks to lend to private sector. As a result, private sector credit grew by 7.5 percent in Oct-Feb FY10 compared with 1.4 percent in the preceding year. Although credit off-take is high, it appears that credit growth could have been even higher were it not for banks' cautiousness given the still-prevalent credit risk in the economy. Moreover, as a large part of banks' liquidity was stuck in PSEs and commodity finance related loans; banks' ability to lend to private sector was limited. Thus, during Jul-Feb FY10, the money multiplier reduced significantly compared with Jul-Feb FY09. As a result, money supply grew by 5.7 percent compared with 10.6 percent growth in reserve money during Jul-Feb FY10.⁷

Thus, although M2 growth has remained significantly lower than reserve money growth during Jul-Feb FY10, the continuation of government borrowing from the SBP poses a risk for generating inflationary pressures. Moreover, with the gradual

⁶ This is also evident from the fact that commercial banks' excess SLR ratio rose to 18.3 percent by end December 2009 as against 10.3 percent in the same month a year earlier.

⁷ During Jul-Feb FY09, growth in M2 recorded at 2.0 percent whereas reserve money fell by 2.5 percent.

recovery seen in the manufacturing sub-sector and improvements in the financial position of the corporate sector, credit risk is reducing gradually. Therefore, banks' willingness to lend to the private sector is expected to improve going forward. Furthermore, the government also appears keen on debt settlement in the commodity finance sector and circular-debt.

4.2 Developments in Monetary Aggregates⁸

The growth in broad monetary aggregate (M2) accelerated to 5.7 percent during Jul-Feb FY10 from 2.0 percent in the corresponding period of FY09 (see **Table 4.1**). However, these broad numbers do not capture the shift in composition of M2 growth after the first quarter of FY10. While the growth in M2 during Q1-FY10

Table 4.1: Monetary Aggregates (Jul-Feb)

flows in billion Rupees, growth in percent

	Flows				Growth	
	Jul-Feb		Oct-Feb		Jul-Feb	
	FY09	FY10	FY09	FY10	FY09	FY10
Broad money (M2)	91.6	291.5	106.9	252.9	2.0	5.7
NFA	-301.0	-46.6	-118.1	-80.7	-45.1	-9.0
SBP	-305.3	-25.2	-132.6	-68.4	-63.6	-7.8
Scheduled banks	4.3	-21.4	14.5	-12.2	2.3	-11.1
NDA	392.6	338.0	225.1	333.5	9.8	7.3
SBP	212.8	167.7	-40.7	96.7	27.5	19.1
Scheduled banks	179.7	170.3	265.8	236.8	5.5	4.6
of which						
Government borrowing	359.3	184.0	254.1	148.7	23.8	9.0
For budgetary support	348.0	237.5	226.7	199.4	25.5	14.1
SBP	299.6	61.0	72.8	145.6	29.0	5.2
Scheduled banks	48.4	176.5	153.9	53.8	14.6	34.2
Commodity operations	13.3	-52.1	28.0	-50.8	10.5	-15.5
Non government sector	193.8	226.7	40.0	236.8	6.4	7.1
Credit to private sector	131.9	137.7	41.6	212.2	4.6	4.7
Credit to PSEs	62.0	89.2	-1.5	24.8	54.6	33.5
Other items net	-160.5	-72.7	-69.0	-52.0	31.7	29.7

⁸ The discussion here onwards is based on NFA and NDA adjusted for SDR.

was driven largely by an improvement in NFA of the banking system, the sharp acceleration in M2 growth thereafter is explained largely by an uptrend in seasonal credit demand from the private sector mainly visible in Q2-FY10.

Moreover, during Oct-Feb FY10, the government borrowed more from the central bank to meet budgetary expenses compared to Q1-FY10 (though monetization remained within the quarterly target agreed with the IMF).

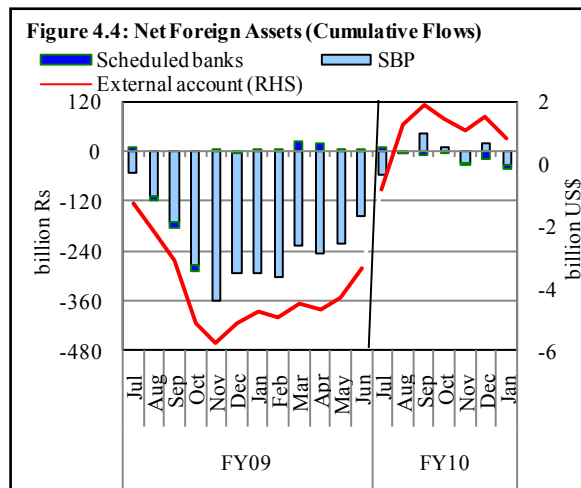
On the other hand, the improvement in NFA, visible since December 2008, has shown reversal October 2009 onwards.

Net Foreign Assets (NFA)

The trend improvement in NFA of the banking system, visible since December 2008, reversed as pressures on external account re-emerged October 2009 onwards (see **Figure 4.4**). As a result, the NFA of the banking system showed a depletion of Rs 80.7 billion in Oct-Feb FY10.

The depletion in the NFA of the banking system during Oct-Feb FY10 was mainly evident in the SBP NFA. The contraction in SBP NFA was despite the lower net intervention in the forex market as SBP completely shifted the financing of oil imports to the interbank market by mid December 2009. Indeed, the increased repayment of official loans, particularly Sukuk bond in January 2010, overshadowed the receipt of a second IMF tranche of US\$ 374 million for budgetary support in December 2009 as well as other official inflows.⁹

The NFA of scheduled banks witnessed a depletion of Rs 21.4 billion during Jul-Feb FY10 in contrast to a net expansion of Rs 4.3 billion in the corresponding period a year earlier. The high oil import payments, fall in foreign investments inflows, substantially lower net inflows under foreign private loans, and low retirement of foreign currency loans by traders were major factors responsible for



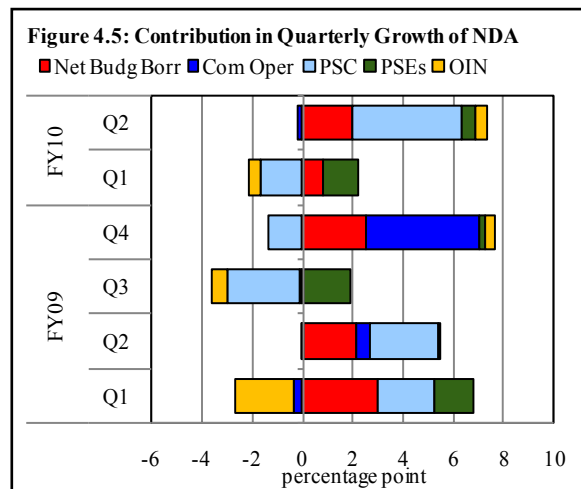
⁹ The first tranche of IMF budgetary finance of US\$ 745 million was received in August 2009.

this reversal in NFA of scheduled banks. These factors were strong enough to offset improvements arising from higher inflows under FE-25 deposits.

Net Domestic Assets (NDA)

The NDA growth changed dramatically after Q1-FY10. During Q1-FY10, NDA had a negative contribution to M2 growth. However thereafter, NDA experienced a sharp increase, mainly due to:

- (1) A strong rise in private sector credit, and
- (2) Increased recourse of the government to borrow from the banking system (see Figure 4.5).

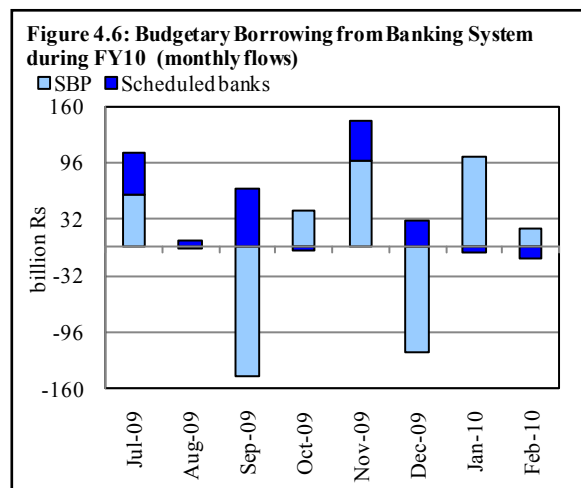


Government Budgetary Borrowings

Government budgetary borrowings from the banking system rose sharply October 2009 onwards (see Figure 4.6).

This is mainly explained by:

- (1) rising fiscal spending as Q2-FY10 fiscal deficit¹⁰ is higher compared with the same quarter last year¹¹, and (2) lower availability of external budgetary financing.¹² These factors overshadowed the higher inflows



¹⁰ It must be noted here that part of the rise in fiscal deficit in Q2-FY10 was inevitable in the wake of expenditure on power subsidies payments and war against terrorism.

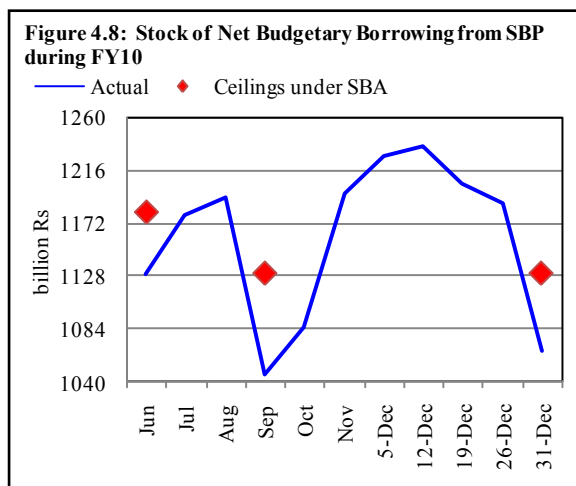
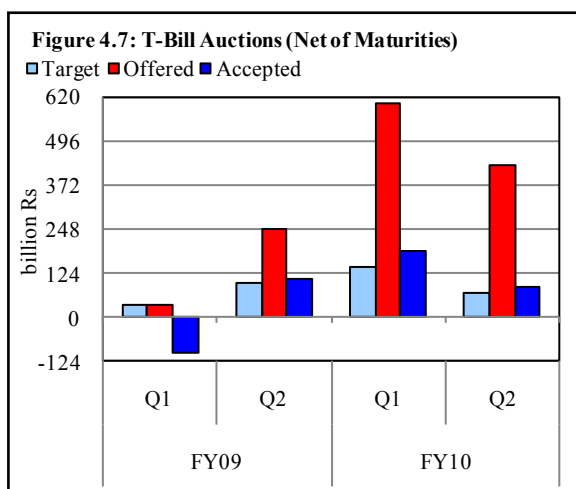
¹¹ IMF also provided relaxation in the target of fiscal deficit for Q2-FY10.

¹² Country received Rs 23 billion external budgetary inflows during Q2-FY10 compared with Rs 33 billion in the same quarter last year.

from non-bank sources as well as some availability of the second tranche of bridge finance from the IMF.¹³

Within the banking sector, borrowings from the commercial banks fell October 2009 onwards. This was because the government largely adhered to its pre-auction targets that were set lower for Q2-FY10 in anticipation of revenue receipts such as coalition support funds (see **Figure 4.7**). Resultantly, reliance on SBP borrowing increased during Oct-Feb FY10. Indeed, the government's increased recourse to SBP borrowing was made possible due to the available room for financing resulting from disciplined borrowing in the first quarter. However, in the absence of sufficient commercial bank borrowings, government borrowings from the central bank had exceeded its quarterly limits by the end of third week of December 2009 (see **Figure 4.8**). However, this possible breach of IMF target was avoided due to non tax-receipts in the final month of December 2009 (see **Box 4.1**).

More importantly, in the last few T-bill auctions, banks started to lock into shorter tenor government papers. This behaviour possibly reflects: (1) market anticipation



¹³ To facilitate orderly budget execution, the IMF is providing bridge financing until pledged donor support from FoDP is realized. In this regard, the first tranche of US\$ 745 was received in Sep 09, and the second tranche of US\$374 was received in Dec 09.

for an increase in interest rate in the wake of renewed inflationary pressures, and (2) liquidity constraints. Moreover, anecdotal evidence suggests that increased bidding by commercial banks, particularly for three month papers, also reflects high demand from money market funds (see **Figure 4.9**).¹⁴

Commodity Finance

Stock of commodity finance fell by Rs 52.1 billion during Jul-Feb FY10 compared to net increase of Rs 13.3 billion in the corresponding period last year.

The decline in the stock of commodity finance is mainly explained by retirement of loans availed for wheat procurement; stock of wheat finance declined to Rs 200.6 billion by end-February 2010 from its peak of Rs 276.8 billion in June 2009. Even at this level, the stock of wheat finance is considerably higher than the average of the past three years' end- February level of Rs 53.8 billion. Therefore, outstanding wheat financing must be retired well before March 2010 so that provincial governments can meet the procurement target for the 2010 wheat crop.

Box 4.1: Decline in Government borrowing from SBP in December 2009

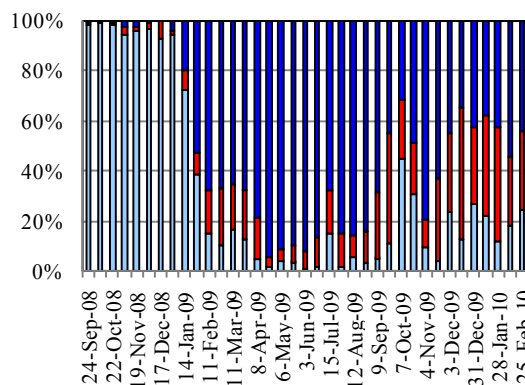
There was a sharp decline in government borrowing from SBP in the last week of December 2009. This fall was on account of a jump in government deposits with the central bank following the transfer of SBP's profit (Rs 65.0 billion) to GoP; a part of which also includes transfer from general reserves funds.^{1,2} These additional resources enabled GoP to retire Rs 37.1 billion of its debt with the central bank in January 2010. As a result, GoP deposits with SBP also declined in this month.

¹ SBP maintained its general reserve funds to mitigate the requirement for general risk management.

² It is interesting to note here that the cumulative transfer of SBP profit to the government reached Rs 135 billion in the first six months of FY10 compared with Rs 89.9 billion for the whole FY09.

Figure 4.9: Offered Amount in T-bill Auctions

■ 12-month ■ 6-month ■ 3-month



¹⁴ Indeed, increased interest of money market funds in short-term government papers was consequent to lower return offered by banks on their deposits.

At the same time, retirement under rice finance was also delayed, as PASSCO could not offload the stock of 2008 rice crop without incurring losses at the prevailing offered tender price of rice. The delays in loan retirement hampered the availability of bank finance for the procurement of 2010 rice crop.¹⁵

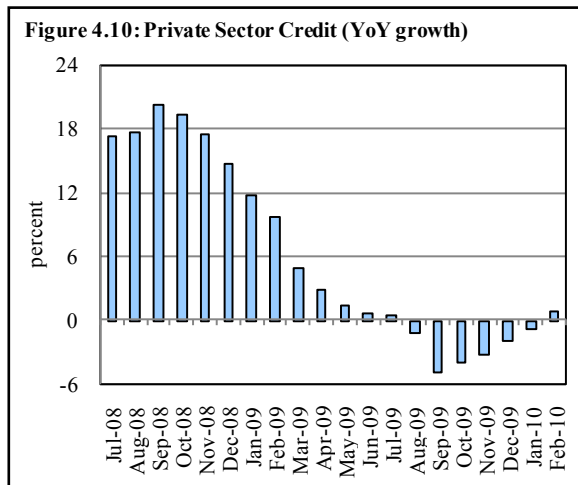
However, with recent recovery in tender price, PASSCO is in a position to offload a significant portion of 2008 rice crop in the domestic market. Retirement of bank loans in coming months is likely to accelerate as the government has also allowed the TCP and PASSCO to export surplus rice in the international market.¹⁶

4.3 Credit to Public Sector Enterprises

The public sector enterprises' (PSEs) borrowing from commercial banks increased by Rs 89.2 billion during Jul-Feb FY10 compared with Rs 62.0 in the corresponding period last year. This increase stemmed mainly from (1) high credit demand from a power holding company in September 2009¹⁷, (2) a few POL related PSEs have availed the cushion for fresh lending after settlement of part of their outstanding bank credit with the issuance of PPTFCs,¹⁸ and (3) borrowing requirement from a public sector steel mill to finance its unfunded LC imports of raw material.

Private Sector Credit (net)¹⁹

The trend decline in private



¹⁵ Consequently, PASSCO could not meet the procurement target for rice crop in FY10.

¹⁶ One of the agency claims that the differential in their storage and procurement cost and the issue price for rice in recent international tenders started to decline, whereas the other agency remained unable to attract buyers for procured rice at desired price.

¹⁷ The power holding company issued a government backed privately placed term finance certificates (PPTFCs), which was meant to settle significant part of inter corporate debt in the energy sector.

¹⁸ Within POL related PSEs, high borrowing from an oil refinery was to make payments to government on account of petroleum development levy in December 2009.

¹⁹ Private sector credit comprises of banks' investment and advances to the private sector. The data on private sector credit is based on monetary survey covering the period of Jul-Feb FY10.

sector credit, visible for twelve consecutive months, reversed from October 2009 onwards representing recovery in aggregate demand in the economy as well as increase in private sector participation in commodity finance (particularly for cotton, rice and sugarcane) (see **Figure 4.10**).

Consequently, cumulative credit to private sector grew by 4.7 percent during Jul-Feb FY10; slightly higher than the growth seen in the corresponding period a year earlier.²⁰ Most of the credit growth was seen in commerce and trade, cement, construction, power, fertilizer and agriculture machinery (see **Table 4.2**).

Table 4.2: Private Sector Credit

billion Rupees

	Jul-Jan		Jul-Sep		Oct-Dec		Jan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Private sector credit*	131.9	137.7	90.3	-74.6	112.8	199.2	-45.3	-12.2
Business sector advances	159.0	123.7	83.2	-65.6	110.9	190.2	-35.1	-1.0
Total working capital	36.1	75.6	49.2	-84.1	23.5	162.4	-36.5	-2.7
Seasonal finance	55.8	38.4	2.5	-38.7	47.5	63.4	5.8	13.7
Fixed investment	123.6	48.4	34.1	18.7	87.9	27.3	1.7	2.4

* pertains to Jul-Feb period

Procurement of crops explained part of the rise in credit demand

A look at the advances data suggests that procurement of crops such as rice, sugarcane and cotton mainly increased the seasonal credit demand from private sector in Q2-FY10; the major portion of which is visible in working capital loans (see **Table 4.3**). It appears that lower than targeted procurement of rice from PASSCO in FY10 resulted in a rise in procurement by private rice traders which in turn increased their running finance requirements. Moreover, a fall in rice production in India and Philippines resulted in higher imports of rice from Pakistan, which in turn increased the demand for trade related loans, most of which is mainly visible under export financing schemes (EFS).

²⁰ While the sharp rise in private sector credit during Q2-FY10 was entirely explained by a robust demand for incremental running finance; demand for fixed investment loans remained relatively low (see **Table 4.2**).

Table 4.3: Advances for Working Capital Loans (including trade loans)

billion Rupees

	Jul-Jan		Jul-Sep		Oct-Dec		Jan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Seasonal finance	55.8	38.4	2.5	-38.7	47.5	63.4	-0.7	13.7
Rice	17.9	19.6	-11.3	-7.7	26.3	24.8	8.8	2.5
Cotton	29.6	20.9	6.7	-11.5	20.2	34.1	-2.7	-1.7
Sugar	-1.8	-2.3	-7.7	-21.8	0.0	0.6	7.6	18.8
Fertilizer	10.2	0.2	14.8	2.3	1.0	3.8	-14.4	-5.9
Commerce & trade	-10.8	5.4	0.9	-10.9	-1.7	21.4	-27.9	-5.2
Exports of commodities	-0.7	3.4	8.9	-3.0	0.7	6.4	-6.5	0.0
Retail trade	3.0	8.5	-2.9	-2.4	1.3	12.8	-10.2	-2.0
Power	2.7	-2.4	10.0	-17.0	-3.4	18.9	-11.6	-4.3
Construction	-7.5	-3.0	-5.3	-4.2	0.2	2.2	-4.4	-1.0
Building related	-7.6	-0.1	-4.8	-1.2	-1.0	1.2	-3.7	-0.1
Cement	6.4	4.6	4.3	2.2	2.3	2.5	-2.1	-0.1
Overall	36.1	75.5	49.2	-84.1	23.5	162.4	-49.6	-2.7

Textile sector demand for advances picked up in Q2-FY10, mainly from spinners and ginnerers. This was due to a confluence of favorable domestic and external factors: (1) good domestic cotton crop, (2) fall in global production of raw cotton, - mainly in US and China, and (3) recovering demand for textile products in advanced economies. This environment provided an opportunity for Pakistani exporters to increase market share²¹ by capitalizing on better cotton crop and explains higher working capital requirements in Q2-FY10.

Growth in running finance advances to *fertilizer manufacturers* during Q2-FY10 was led by high import demand. The rise in import demand emanated mainly from (1) slowdown in domestic production, (2) inadequate existing stock of DAP to meet expected shortfall²² and (3) a few companies built up inventories to benefit from anticipated increase in international prices of phosphate rock since Dec 2009.

²¹ Market share of textile exports increased, particularly in China, from 29 percent in CY08 to 40 percent in CY09. These exports mainly comprised of low value added categories of cotton yarn and raw cotton.

²² A sharp off-take of DAP fertilizer March 2009 onwards depleted inventories and prompted a few companies to import DAP in Q2 FY10.

Besides running finance, long-term loans extended to fertilizer sector also remained strong during Jul-Jan FY10. In fact, delays in commencement of the projects had actually accelerated their cost overrun expenses in the initial months of FY10. However thereafter, long-term credit demand from the fertilizer sector fell sharply as one of the major fertilizer plants is expected to start its operations by March 2010.

Demand led recovery seen in few sectors

Mild recovery seen in commodity producing sectors and rising trade volume led to increased credit demand from the commerce and trade sector; this reflected in both working capital and trade related advances. Furthermore, revived construction activities domestically increased the working capital requirements of construction and allied industries. Finally, high tractor imports during Q2-FY10 under the Benazir Tractor Scheme partly explain credit demand for long-term loans under agriculture machinery in this period.

Banks' appetite for private sector credit October 2009 onwards

During the first three months of FY10, banks' lending to the private sector was constrained by weak credit demand as well as high government recourse to deficit financing.²³ However, October 2009 onwards a number of factors dramatically changed the credit outlook for banks. For instance: (1) seasonal demand for credit picked-up, (2) government borrowing target from commercial banks in Q2-FY10 fell sharply compared to the preceding quarter, and (3) pace of worsening in the asset quality of banks slowed down.²⁴ Consequently, bank finance to private sector recorded a strong rise in Q2-FY10.

This strong revival in banks' lending to the private sector was despite looming rupee liquidity concerns in the interbank market. This suggests that the lending to the corporate sector may have been higher if the rupee liquidity strains had not hit the interbank market.

In particular, continued strong credit demand from PSEs and low pace of retirement of outstanding commodity finance loans in FY10 exerted pressures on the market liquidity.²⁵

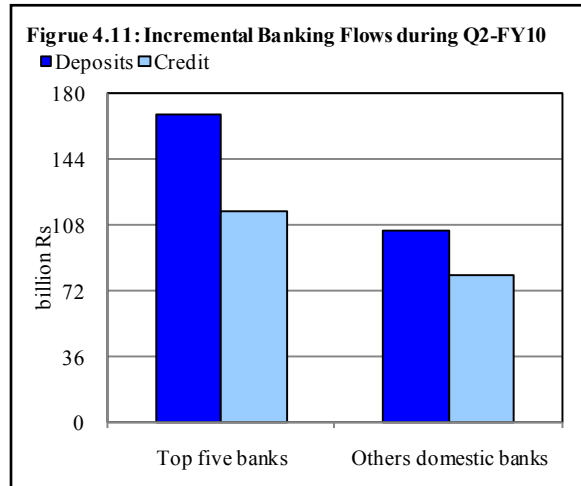
²³ During Q1-FY10, net accepted amount in T-bill auction was Rs 142.6 billion as against a net target of Rs 144.2 billion.

²⁴ The lower concerns regarding credit quality are evident from a sharp slowdown in NPLs growth during the same period. More specifically, growth in NPLs during H1-FY10 was limited to 8.6 percent compared with a strong growth of 30.0 percent in the same period last year.

²⁵ It may be recalled that in the latter half of FY09, the rising NPLs of the corporate sector made banks more conservative in terms of taking incremental exposures on the corporates. At the same

Though deposits of the banking system witnessed robust growth in Q2-FY10, this was not sufficient to ease liquidity concerns in the interbank market. Therefore, to address liquidity concerns in the interbank market SBP conducted huge OMO injections throughout FY10 so far.

The analysis of group-wise incremental advances by banks suggests that the increase in private sector credit during Q2-FY10 remained broad based as most of the banks had increased their lending activity (see **Figure 4.11**).²⁶



4.4 Deposit Mobilization²⁷

Despite a considerable fall in incremental deposit returns, the banking industry recorded deposit growth of 4.6 percent during Jul-Feb FY10 in contrast to a contraction of 0.6 percent in the corresponding period last year (see **Figure 4.12**).²⁸

Monthly data shows an erratic trend in deposit growth September 2009 onwards.

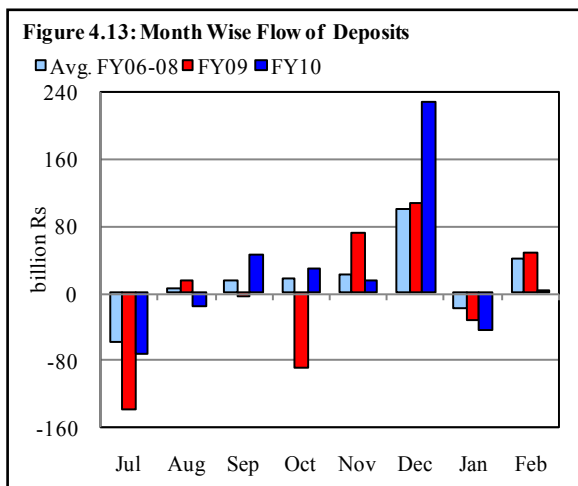
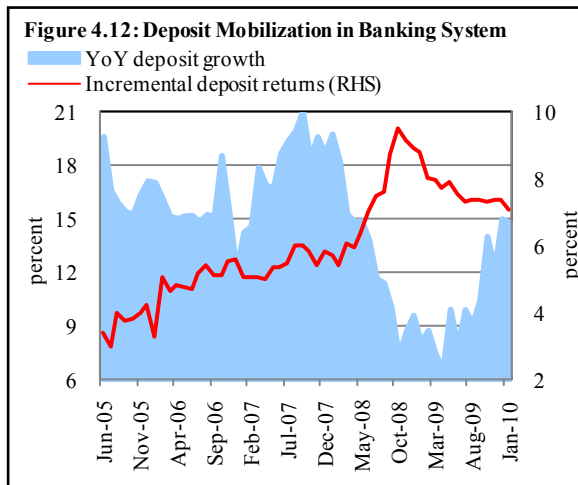
time, government preference to raise funds from banks after the inception of stabilization program in November 2008 provided a safe avenue for banks to put their funds in government papers. The impact of high government demand on banks finance was further compounded by a strong rise in credit demand from a few public sector enterprises to meet their financing gap which arose as the government has been consistently facing problems in releasing the subsidy payments to these institutions on time.

²⁶ Interestingly, one large public sector bank that experienced strong growth in government deposits also enjoyed considerable advances growth.

²⁷ The analysis is based on total deposits of the banking industry including government deposits.

²⁸ It may be noted that the increase in the deposit rate last year was primarily a reflection of banks' efforts to attract deposits at the height of the rumor driven withdrawal period in Oct-Nov 08. Deposit rates have since exhibited a downward trend; however, appear to have stabilized in recent months.

While deposits witnessed a sharp increase during Sep-Oct FY10 compared with net withdrawals in the same months of FY09²⁹; the pace of growth was much lower in November 2009 (see **Figure 4.13**).³⁰ The unusual development however was the exceptional increase in the month of December 2009. Although, the deposits of the banking system generally experience a sharp rise in the month of December each year followed by withdrawals in the subsequent month, the increase in the deposit base during December 2009 was stronger than the same month in the previous year, as well as the average for December FY06-08 (see **Figure 4.13**). Other factors that explain deposit growth during Oct-Feb FY10 include: (1) monetary expansion stimulated mainly by NDA - in particular private sector credit, and (2) a mild recovery in the domestic economy as evident from LSM growth.^{31,32}



²⁹ It may be noted that deposit inflows during Sep and Oct FY10 were also higher than the average for FY 06-08.

³⁰ However the higher growth in Nov 08 must be seen in context of sharp withdrawals of preceding month of Oct 08; whereas deposits witnessed an increase in Oct 09.

³¹ During Jul-Jan FY10 the large scale manufacturing index increased by 2.3 percent against a contraction of 5.4 percent in the same period last year.

³² The improved performance of the chemical, construction, commerce and trade sectors provided impetus to their deposits.

Further analysis suggests broad based deposit growth across banks during Oct-Feb FY10.³³ More importantly, in contrast to the previous quarter, **top 5 banks**³⁴ staged a recovery during the period under review (see **Table 4.4**).

Within the **top 5** category, *large privatized banks* – that experienced contraction in deposits during the previous quarter - recovered considerably during Oct-Feb FY10. Interestingly, *large privatized banks* increased their share of short to medium term deposits in efforts to support their interest income.³⁵ In

particular, one *large privatized bank* that experienced sharp withdrawals in its fixed deposits during the first two months of FY10 recovered in Q2-FY10 by mobilizing shorter tenure deposits from corporates and individuals.³⁶

Further, the *large public sector bank*³⁷ in the **top 5** category experienced strong deposit growth by mobilizing sizeable government agency deposits and benefitted from higher provincial government deposit inflows mainly in Dec-Jan FY10.

Other banks' deposit growth during Oct-Feb FY10 contributed 2.4 percentage points to total deposit growth during this period. This relatively lower contribution mainly reflects large withdrawals experienced by two *merged banks* during this quarter that contained deposit growth of the group. Excluding these banks, contribution of **other banks'** deposit growth to total deposit growth increased to 3.2 percentage points during Oct-Feb FY10.

Table 4.4: Contribution in Growth of Deposits
percentage points

	FY09	FY10	
	Jul-Feb	Jul-Feb	Oct-Feb
Top 5 banks	-0.8	1.3	3.3
Others	0.3	3.3	2.4
<i>of which</i>			
<i>Private domestic banks*</i>	-0.6	2.6	2.0
<i>Foreign banks</i>	0.3	0.1	-0.1
<i>Islamic banks</i>	0.5	0.7	0.5
All Banks	-0.6	4.6	5.7

*Excluding Top 5 and specialized banks

³³ All bank groups experienced deposit growth during Oct-Feb FY10 except the Merged and Foreign Bank categories.

³⁴ These banks are categorized on the basis of their asset size and branch network. This category includes five banks namely; NBP, MCB, ABL, HBL, UBL.

³⁵ Three large privatized banks increased their share of demand liabilities in total deposits from 68.4 percent in Feb FY09 to 75.1 percent in Feb FY10.

³⁶ In order to reduce the burden of interest expenses and support its earnings, this bank has reduced its efforts in mobilizing longer tenure deposits.

³⁷ This bank's deposit growth during Oct-Jan FY10 was 7.2 percent, of which contribution of government deposits was 5.2 percentage points.

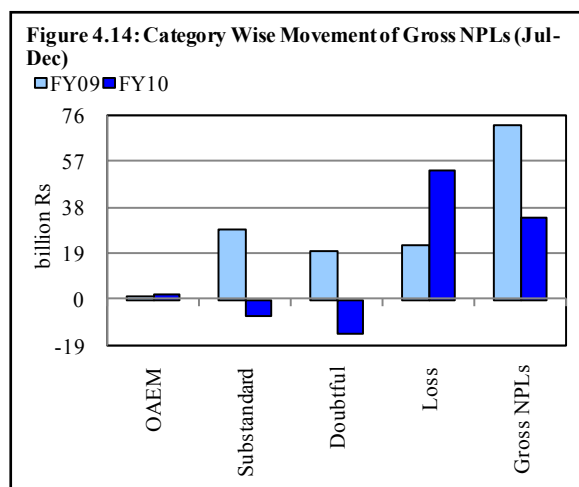
A recently merged bank³⁸ experienced considerable withdrawals in its deposit base despite a steep rise in its deposit returns; higher than the industry average.³⁹ This suggests that these withdrawals may relate to increased uncertainty among the bank's customers stemming from a subsequent and currently ongoing acquisition process.

4.5 Non Performing Loans

NPLs of the banking system witnessed a relatively lower rise of Rs 34.2 billion during H1-FY10 compared with a strong increase of Rs 72.4 billion in the corresponding period a year earlier. This slowdown was evident in corporate sector NPLs and mainly the result of a sharp deceleration in advances growth, and improved repayment capacity of borrowers due to: (a) relatively stable input prices, (b) falling interest rates, (c) a mild recovery in the domestic economy, and (d) high earning from arrival of better cotton crop.⁴⁰

Though the lower pace of NPLs growth in H1-FY10 released some pressures on asset quality of banks, the provisioning requirements for infected loans saw a marginal rise. More specifically, provisioning increased by Rs 27.5 billion in H1-FY10; slightly higher than the rise recorded in H1-FY09. This anomaly is perhaps due to a change in the composition of

incremental gross NPLs. In particular, the gross NPLs in the loss category increased sharply in H1-FY10 compared with H1-FY09 (see **Figure 4.14**).^{41,42}



³⁸ The category of merged banks includes those banks merged in the last five years.

³⁹ Merged banks registered incremental deposit returns of 7.7 percent for the Oct-Jan FY10 period, against an industry weighted average rate of 7.4 percent.

⁴⁰ A closer look at the recent data on movement in NPLs also supported this assertion as cash recovery increase by Rs 23.2 billion in H1-FY10 compared with Rs 18.8 billion in the corresponding period of FY09. On the other hand, new addition in NPLs during H1-FY10 was also limited to Rs 81.0 billion; much lower than a strong rise of Rs 115.3 billion in H1-FY09.

⁴¹ It is pertinent to note here that the increase in provisioning during H1-FY10 was despite the fact that SBP allowed banks to avail the benefit of 40 percent of Forced Sale Value (FSV) of collateral while calculating provisioning requirement w.e.f September 30, 2009.

⁴² In FY09, the benefit of Forced Sale value (FSV) of collateral was 30 percent.

A sectoral break-up of gross NPLs shows that the contribution from the corporate sector in gross NPLs growth remained at 5.8 percent during Jul-Dec FY10; this was much lower than the corresponding period FY09 (see **Table 4.5**). While, the distribution shows a large number of borrowers in the agricultural sector, the value of NPLs is concentrated in the corporate sector. As a result, the average size of corporate sector NPLs stood at Rs 78.3 billion by end Dec 2009 (see **Table 4.6**). This suggests that a small number of large borrowers has the potential to cause significant deterioration in asset quality of the banks.

Table 4.5: Break-up of Increase in Gross NPLs (Jul-Dec)

Segments	Increase (billion Rs)		Contribution in growth (percent)	
	FY09	FY10	FY09	FY10
Corporate	51.5	23.1	21.3	5.8
Agriculture	15.4	2.0	6.4	0.5
SME	-1.0	1.4	-0.4	0.4
Consumer	4.5	6.1	1.9	1.5
Others	2.0	1.6	0.8	0.4
Total increase	72.4	34.2	30.0	8.6

In the corporate sector, textile, sugar and cement are the main sectors contributing to the increase in gross NPLs during H1-FY10.⁴³ The rise in textile sector NPLs seems quite surprising given the recent increase in external demand coupled with better cotton crops. One of the possible explanations is the operational bottlenecks that the textile

Table 4.6: Average size of NPLs by end December 2009
number in thousands, average size in billion Rs

	No of borrowers	Avg. size of NPLs
Corporate	3.5	78.3
Agriculture	203.4	0.1
SME	58.0	1.4
Consumer	170.5	0.2
Commodity finance	0.6	7.5
Other	42.9	0.7

sector has been facing in last few years. These mainly include extended gas and power outages-and a recent sharp depreciation of rupee against US dollar which has made foreign currency borrowing more expensive for a few corporates. All these factors, hampered the repayment ability of a few borrowers in this sector.

⁴³ Of the total net increase in NPLs of the corporate sector (Rs 23.1 billion), textile sector accounted for Rs 14.6 billion.