Special Section: THE NON-FINANCE SECTOR

An assessment of financial stability necessarily entails an analysis of the financial position of the borrowers of bank credit – be they households, corporations, farmers or small businessmen. While strong economic growth helps in strengthening the ability of the borrowers to honor their obligations, its impact is not equitable for all sectors of the economy, as gains from economic growth are not equally distributed. In this backdrop, this section makes an attempt to assess the financial position of two major borrowers of the financial sector i.e. the corporate sector[1] and the households,[2] with total share in credit at 68.5 percent.[3]

A. Household Sector

The household sector is one of the key drivers of the economy as private consumption expenditure is 75 percent of GDP (at current market prices for FY07) and private savings constitute 75.9 percent in national savings. Strong economic growth in recent years has pushed the per capita income to US $925 in FY07 compared to only US $503 in FY02. These statistics provide a certain degree of comfort about the financial health of the household sector, which has a crucial role in determining the potential risks to financial stability, as a major source and user of funds to the banking sector.

In the absence of specific information on the assets and liabilities of the household sector, the analysis in this section is based on selected financial indicators that can provide useful information regarding its financial position.

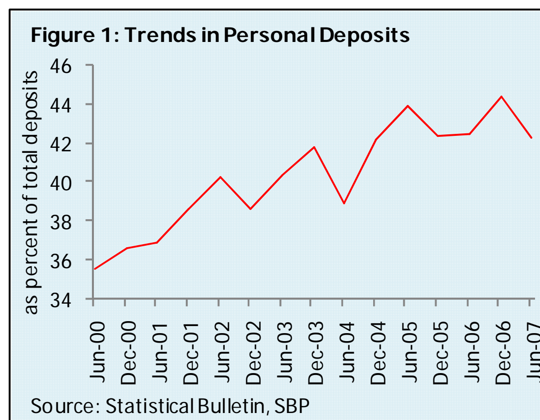
A.1 Household Income

Household income is estimated on the basis of the proportion of personal deposits with banks, investments made by households in the stock market and in NSS instruments.

Personal Deposits

The distribution of deposits by account holders indicates that personal deposits have grown by 17.4 percent during CY06, which is higher than the 13.1 percent increase in the overall deposits of the banking sector in the same period. Strong growth in personal deposits is also visible from their generally increasing share in total deposits (**Figure 1**). Specifically, personal deposits constitute 44.4 percent of total deposits as of end CY06, depicting a growth of 146 percent since end-CY00. This strong growth in personal deposits is a reflection of healthy economic activities and surge in workers' remittances, which reached an all time high level of US$ 5.5 billion during FY07, depicting a general improvement in the financial condition of the household sector. Importantly, this increase in personal deposits has been realized despite the prevalence of negative real returns on deposits. Lack of alternate investment opportunities, liquidity preferences of depositors, and limited consumer awareness are some of the other contributory factors in the sharp rise in the proportion of personal deposits with banks.

Figure 1: Trends in Personal Deposits



Source: Statistical Bulletin, SBP

A break-up of personal deposits by size of account shows that the share of personal deposits of a size less than Rs 40,000 has declined from 14.3 percent in CY05, to 10.3 percent in

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[1] 54.2 percent of total credit.

[2] 14.3 percent of total credit.

[3] As of end-June CY07.

CY06, and this trend is seen to continue in H1-CY07. This, along with the rising share of large-sized deposits (more than Rs 1.0 million) suggests a possible worsening of income distribution (**Table 1**). While this is not a welcome development from a social point of view, these changes in income distribution have some positive implications for the stability of the banking sector, especially in the short run. The banking sector has been aggressively lending to high and middle income households in recent years. Increasing share of deposits from these particular income groups is likely to keep the repayment capacity of the household borrowers intact in the presence of the continued tight monetary stance of the central bank. Notwithstanding, the consumer loan portfolio can potentially be impacted to some extent due to the aggressive lending practices of the banking sector in the last few years, an occurrence usually accompanied with some slippages in credit appraisal standards. The fact remains that a rise in NPLs is expected to be lower due to the strong overall macroeconomic position and other favorable developments in the financial health of the household sector. This argument is further supported by the sectoral NPLs data discussed in the section on household debt.

Table 1: Break-up of personal deposits by size
Amount in billion Rupees

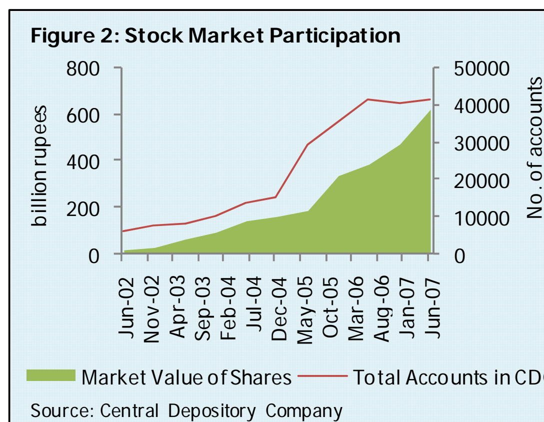
Category	CY05		CY06		HI-CY07	
	Accounts	Amount	Accounts	Amount	Accounts	Amount
upto 40,000	10,577,508	158.8	11,054,391	133.8	10,047,468	128.8
40,000 - 90,000	3,899,381	232.4	2,712,595	163.6	3,059,306	184.4
90,000 - 500,000	2,298,261	384.7	2,691,093	486.1	2,517,996	441.3
500,000 - 1000,000	156,779	107.1	188,325	130.3	206,772	143.2
1M - 6M	75,087	146.2	110,368	214.9	134,617	285.2
over 6 M	4,998	77.6	9,634	170.9	16,403	243.8
Total	**17,012,014**	**1,106.8**	**16,766,406**	**1,299.5**	**15,982,562**	**1,427**

Investments in stock market

Another important indicator to estimate household income is the growth in the accounts held by individuals in the Central Depository Company. There are two types of accounts in CDC, investor accounts and corporate accounts. The total number of accounts held in CDC by June CY07 was 40,226, in which investor accounts had an overwhelmingly share of 97.8 percent.

Investor accounts have grown by over 573 percent since June CY02, showing an insurmountable increase in investments made by individuals in the stock market. **Figure 2** shows the number of accounts held in CDC and the total market capitalization of stocks held in these accounts.

Figure 2: Stock Market Participation

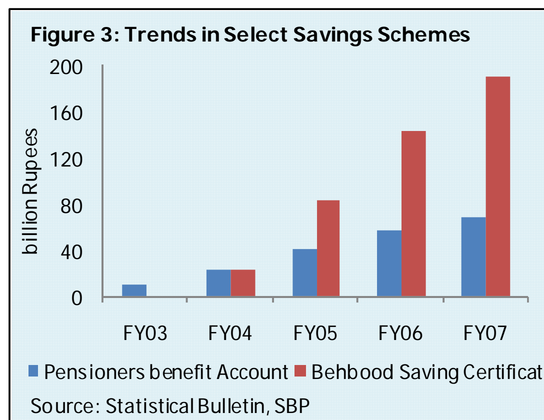


Source: Central Depository Company

Investments in NSS

Whereas there is no reliable source of the split between individual and institutional investments in NSS, investments in two schemes i.e. Behbood and Pensioner's Benefit Account is made entirely by individuals. Since their introduction, the outstanding investments in these schemes have reached Rs 259.2 billion by end FY07 (**Figure 3**). While a portion of the amount invested in these schemes can be attributed to substitution from other schemes, the massive

Figure 3: Trends in Select Savings Schemes



Source: Statistical Bulletin, SBP

rise also entails fresh investment. Specifically, people have invested in these schemes by using the benefits of a joint family system, where the head of the family makes consumption and savings decisions. In sum, investment trends in these schemes provide an indication of improving financial position of the households.

All the three possible indicators of households' financial savings/wealth indicate visible improvement during the years. Therefore, it can be safely concluded that the financial health of the household sector has a satisfactory and improving trend.

A.2 Household Debt

Consumer finance was one area that benefited the most from the steep decline in interest rates during FY02-05. As shown in **Table 2**, growth in consumer finance was around 60 percent in FY04, and 69.0 percent in FY05. However, with the gradual rise in interest rates, the growth in consumer finance has reduced steadily in the last two years, with FY07 showing substantially lower growth at 17 percent.

Table 2: Consumer Finance

Flows-billion Rupees

	FY04	FY05	FY06	FY07
House loan	4.4	19.7	15.8	11.5
Auto loan	9.1	38.1	31.9	7.7
Credit cards	5.8	7.0	14.2	9.3
consumer durables	1.8	-0.7	0.1	-0.5
Personal loans	22.8	38.4	28.2	21.9
Others	2.0	-17.6	0.0	0.9
Consumer loans	45.9	84.7	90.3	50.7
	Share in flow (%)			
House loan	9.6	23.2	17.5	22.6
Auto loan	19.8	44.9	35.4	15.1
Credit cards	12.7	8.3	15.7	18.3
Consumer durables	4.0	-0.8	0.1	-1.0
Personal loans	49.6	45.3	31.3	43.1
Others	4.3	-20.8	0.0	1.8
Consumer loans	100.0	100.0	100.0	100.0
	Growth in stock (%)			
House loan	131.9	252.5	57.5	26.5
Auto loan	48.6	137.1	48.5	7.8
Credit cards	89.3	57.0	73.4	27.7
consumer durables	551.8	-33.1	7.6	-32.8
Personal loans	73.1	71.1	30.6	18.1
Others	11.9	-93.8	2.4	74.6
Consumer loans	59.7	69.0	43.5	17.0

Consumer finance is probably the most sensitive to interest rates, and not surprisingly the interest rates rise in the last two years has arrested the phenomenal growth in consumer finance, especially the growth in loans for consumer durables, which have declined by around 33.0 percent. Additionally, all types of consumer loans have witnessed softening of YoY growth in FY07 as compared to the previous year.

The decline in consumer loan growth is a welcome sign both in terms of reducing excessive demand pressures in the economy and in terms of improving the debt position of the household sector. Nonetheless, growth in mortgage finance and credit cards still remains robust.

In order to assess how the credit risk of consumer finance has changed over the years, **Table 3** shows the segment-wise share of NPLs. The share of consumer loans is 14.3 percent in total loans at end-June FY07, but the share in NPLs is relatively low.

The low infection ratio of household debt, combined with healthy indicators of household wealth, lead to the conclusion that the overall financial position of the household sector remains above average.

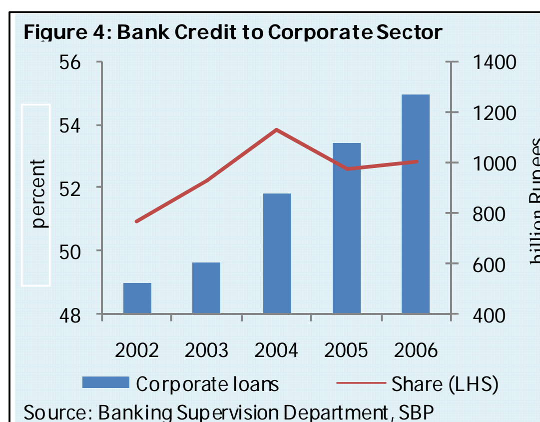
Table 3: Segment-wise Gross NPLs and Gross Loans Outstanding (end-period)
Billion Rupees

	Jun-06		Jun-07		NPLs to Loan Ratio (%)	
	Loan	**NPLs**	**Loan**	**NPLs**	**Jun-06**	**Jun-06**
Consumers	296.5	5.56	354.4	12.74	1.9	3.6
Credit Cards	33.5	0.34	*44.5*	*2.95*	*1.0*	*6.6*
Auto Loans	97.8	1.32	*107.6*	*2.56*	*1.4*	*2.4*
Durables	1.5	0.15	*1.0*	*0.16*	*10.1*	*15.7*
Mortgage Loans	43.1	0.40	*58.1*	*1.69*	*0.9*	*2.9*
Others	120.5	3.36	*143.3*	*5.51*	*2.8*	*3.8*

B. Corporate Sector

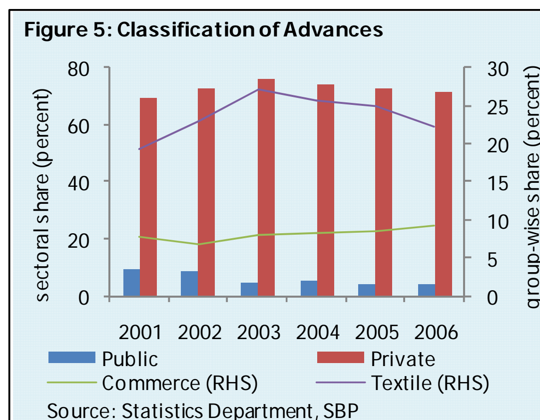
The performance and financial position of the corporate sector is a significant determinant of financial stability, given the inter-dependence between the banking sector and the medium to large-sized firms and corporations. Despite the gradual diversification of bank loans and advances into various sectors, banks still generate substantial revenues from the corporate sector and in turn these firms have a heavy reliance on bank loans, given the dearth of other financing options. The corporate sector,[4] comprising of industrial and manufacturing firms in the public and private sector, continues to be the largest recipient of bank credit (**Figure 4**), accounting for almost 53 percent of the total advances extended in CY06.[5] The leading segments of the corporate sector in Pakistan are mainly agro-based industries, including textile, sugar and the fertilizer industry. Oil exploration and marketing firms, the automobile industry and consumer electronic industries are some of the other major components of the corporate sector.

Figure 4: Bank Credit to Corporate Sector



Source: Banking Supervision Department, SBP

Figure 5: Classification of Advances



Source: Statistics Department, SBP

The corporate sector is dominated by the textile industry in terms of asset size and credit allocation. **Figure 5** shows the distribution of bank credit to different sub-groups of the corporate sector in terms of the volume of credit allocation. The overall credit extended to the textile sector constituted 21.6 percent of private sector credit in CY06, whereas the second highest amount of credit was disbursed to the commerce sector, which accounted for 9.2 percent. **Figure 6** also shows the share of public

[4] The overall corporate sector comprises of approximately 52,000 public and private companies which are registered with the SECP. The financial analysis in this section is based on the financial data of the companies listed on the Karachi Stock Exchange (KSE), prepared by SBP's Statistics Department. The number of companies analyzed varies across the years under consideration.

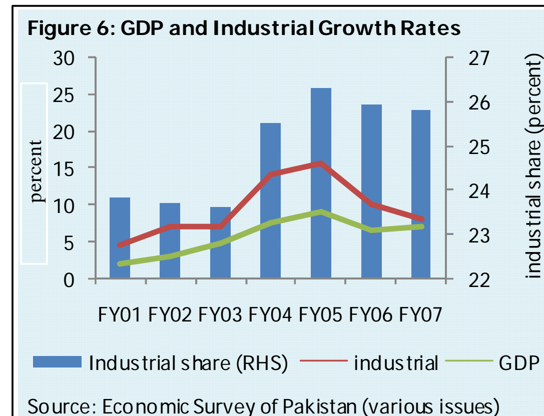
[5] The decline in the percentage share of corporate credit since CY03 is primarily due to a proportionate increase in consumer loans and credit to the SME sector. SBP's contractionary monetary stance, resulting in a rise in the cost of borrowing, has also had a certain degree of impact on the credit appetite of the sector.

and private sector in credit distribution. Credit to public sector entities has decreased over the period CY01–CY06,[6] mainly on account of privatization of state-owned enterprises.

B.1 Sectoral Performance Analysis

In general terms, the performance of the corporate sector is affected by various factors such as the prevailing interest rates, energy prices, and domestic and foreign (trading partners) countries' economic condition. Furthermore, the corporate sector enjoys strong backward and forward linkages with other sectors of the economy. The overall corporate sector maintained a steady earnings growth rate throughout FY01-FY05 on account of strengthening macroeconomic performance. However, rising oil prices in the international markets, the reduction in the domestic output of steel, and problems with agro-based products such as cotton and sugar-cane in subsequent years contributed towards declining industrial growth, from 15.5 percent in FY05 to 8.0 percent in FY07.[7] As a percent of GDP, the corporate sector accounted for 23.6 percent in FY03 (**Figure 6**). The share reached a peak of 26.3 percent in FY05 which witnessed a modest reduction in FY07.

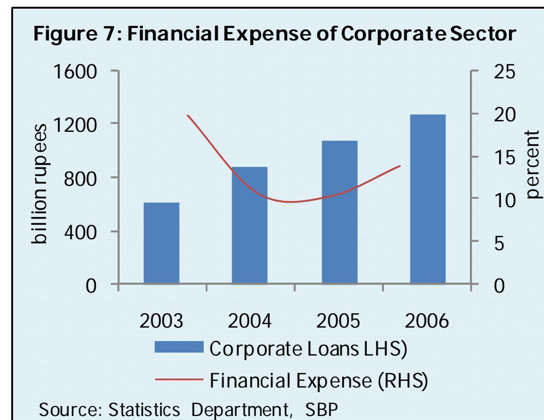
Figure 6: GDP and Industrial Growth Rates



Source: Economic Survey of Pakistan (various issues)

Since FY02, the corporate sector has greatly benefited from the consumption boom which resulted from factors such as an unanticipated large inflow of workers' remittances and easy access to consumer financing, especially in a benign interest rate environment which prevailed from FY02 to FY04. The consumer financing schemes by various commercial banks in particular, created demand for consumer durables and other products which resulted in a large increase in the production of automobiles and home appliances. The construction sector also witnessed a strong surge in the demand for building materials and related products. However, due to rising inflationary pressures in FY05, SBP started to tighten monetary policy, and is continuing to do so until inflationary pressures subside. This has had a certain degree of impact on the borrowing cost of the corporate sector as depicted in **Figure 7**.

Figure 7: Financial Expense of Corporate Sector



Source: Statistics Department, SBP

Table 4 shows the growth rates of production in different industries. The textile industry, after witnessing 27.2 percent growth in FY05, experienced modest growth in FY06 as the cotton crop was badly affected by untimely rains. However, its growth in FY07 has improved to 8.5 percent. Moreover, the electronics industry continued to witness substantial growth in the period FY02-FY06. However, its growth reduced to 9.4 percent in FY07. This is mainly due to less interest in availing consumer finance at relatively higher rates, in addition to ongoing strengthening of banks' risk management framework and credit appraisal standards.

[6] Bank Credit data is on Calendar year (CY).

[7] It may be noted that the textile industry accounts for 24.5 percent of the manufacturing sector whereas the sugar industry has a 4.1 percent share (Source: Federal Bureau of Statistics).

Table 4: Growth Rates of Selected Industries (percent)						
Items	FY02	FY03	FY04	FY05	FY06	FY07
Textile	7.55	3.6	6.5	27.2	3.2	8.5
Food, Beverages & Tobacco	4.27	1.4	13.7	3.1	5.2	8.0
Petroleum Products	14.37	3.1	4.7	9.7	2.2	-1.8
Pharmaceuticals	2.28	2.3	14.0	4.1	12.6	12.2
Chemicals	4.85	14.2	25.1	10.0	11.2	11.7
Non-Metallic Mineral Prod	2.48	9.8	18.5	26.9	13.2	23.1
Automobile	1.02	46.6	50.7	34.0	25.8	3.8
Metal Industries	2.17	11.6	7.7	4.2	-15.9	18.0
Fertilizers	-33.35	-7.4	65.5	25.7	5.0	-7.7
Electronics	37.39	27.9	61.6	38.3	37.9	9.4
Leather Products	-4.78	-2.5	31.5	-5.3	5.8	8.6
Paper& Board	-38.73	15.6	7.6	3.9	13.3	-2.2
Engineering Industries	0.71	35.7	16.1	21.7	30.8	28.8
Rubber Products	12.66	22.3	15.6	9.9	9.8	15.6
Wood & Wood Products	-1.67	7.1	87.8	238.7	40.6	30.3
Overall	3.48	7.5	18.4	17.9	9.5	8.4

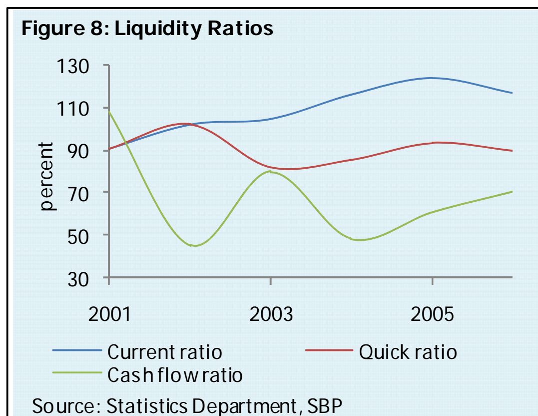
Source: Federal Bureau of Statistics

B.2 Financial Indicators of the Overall Corporate Sector

Financial performance of the corporate sector is assessed on the basis of trends in liquidity, solvency and profitability ratios. As shown in **Figure 8**, the corporate sector's ability to meet short term obligations was satisfactory in CY06. The receivables turnover ratio has been quite low in the period under consideration (average 0.74). This suggests that despite increasing sales, various firms are accumulating short-term claims.

The operating cash-flow ratio also gives an indication of the liquidity position as it measures the extent of current liabilities covered by the operating cash-flows generated by the company. This ratio as shown in **Figure 8** shows a mixed trend throughout the period CY01-CY05, however it is starting to rise in CY06.

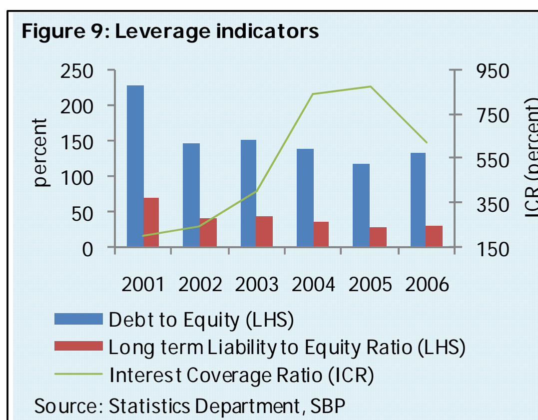
Figure 8: Liquidity Ratios



Source: Statistics Department, SBP

The leverage ratios indicate that the corporate sector has replaced its expensive debt with either equity or has benefited from the low interest environment until FY05 by financing its expansion plans at a lower cost, which has served to improve the overall debt to equity position of the corporate sector in CY05. However, with a contractionary monetary stance in CY05 and CY06, the debt-equity ratio has started to deteriorate. At the same time though, the long-term liabilities to equity ratio showed a declining trend (**Figure 9)**. The interest coverage ratio highlights the ability of companies to service their debt. In CY01, the ratio was 200 percent, or in other words, the operating profit was twice the interest expense which then improved considerably to 871 percent in CY05, before declining to 623 percent in CY06.

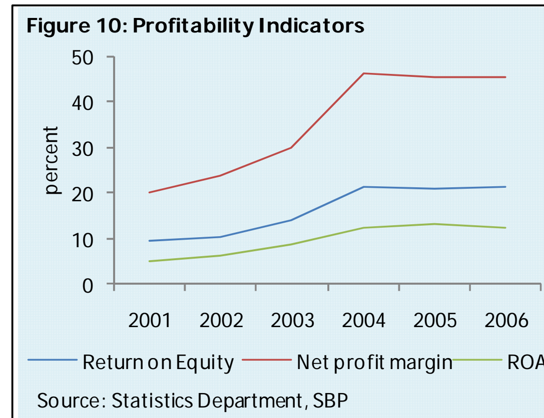
Figure 9: Leverage indicators



Source: Statistics Department, SBP

The overall impact of low interest rates and inflow of workers' remittances leading to a rise in consumption spending resulted in a surge in the profitability of the associated corporate entities in recent years. However, the overall profitability of some of the sectors has not been consistent, which impacted the overall performance and decreased the net profit margin. This includes the textile sector, which suffered from low yield of cotton crop and competition in the exports market, and the sugar industry. Despite these short-comings, the performance of the corporate sector has considerably improved its ROE (return on Equity), ROA (return on Assets) and its net profit margin as shown in **Figure 10**.

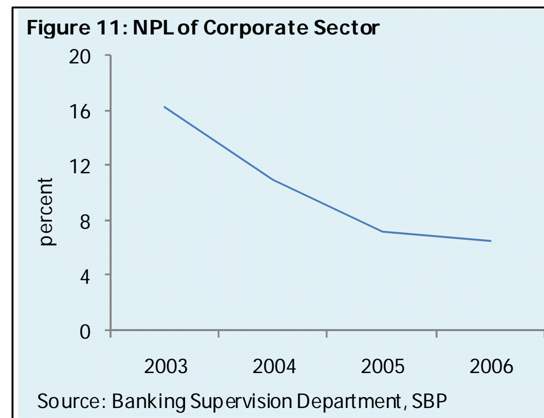
Figure 10: Profitability Indicators



Source: Statistics Department, SBP

Another significant feature of the performance of the corporate sector is the share of corporate non-performing loans to total NPLs. **Figure 11** shows a declining trend of corporate NPLs, reflecting a healthy corporate borrowing environment. Sector-wise NPLs on the other hand raise some concerns for the textile sector.

Figure 11: NPL of Corporate Sector



Source: Banking Supervision Department, SBP

B.3 Sector-Wise Financial Analysis[8]

The average current ratio improved from 90.7 percent[9] in CY05 to 116 percent[10] in CY06. The average current ratio of the textile composite sector for the period CY01 – CY06 has remained at an average of 100 percent, indicating stable health of the industry (**Figure 12**). On the other hand, the transport and communication sector has had a sound current ratio averaging 120 percent for the period CY01 – CY06. Furthermore, the sugar and allied sector witnessed a high leverage ratio (**Figure 13**).

Figure 14 shows the sector-wise solvency ratio, indicating low solvency for the cement sector and a high solvency ratio for the transport and communication sector. For other sectors, the average solvency ratios for the period CY01-CY06 have been less than 10 percent. Generally, a higher solvency ratio indicates sound financial health of the company. Although there are no industry averages to compare, a ratio of 20 percent and above is considered to be satisfactory. **Figure 15** gives the sector-wise ROA analysis for the period CY01-CY06. Interestingly, the ROA for cement and sugar industries were negative in CY01 indicating negative profitability (or losses). In general, the ROA for all the sectors has improved considerably, except the textile composite sector which largely depends on favorable climatic conditions and availability of water for the production of its raw material.

[8]The number of companies varies from year to year. CY01 includes the analysis of 506 companies, CY02 481, CY03 463, CY04 451, CY05 443 and CY06 includes 440 companies. The data on the corporate sector has been obtained from the forthcoming SBP publication, "Balance Sheet Analysis of Joint Stock Companies 2001-2006".

[9] 443 companies

[10] 440 companies

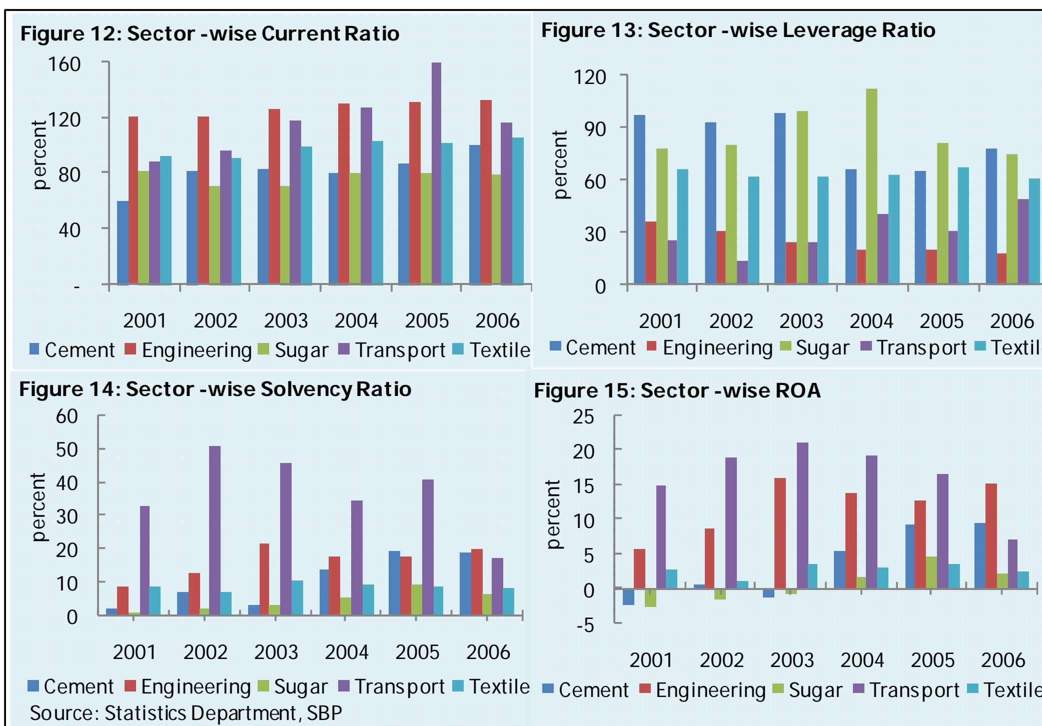


Figure 12: Sector-wise Current Ratio

Figure 13: Sector-wise Leverage Ratio

Figure 14: Sector-wise Solvency Ratio

Figure 15: Sector-wise ROA

Source: Statistics Department, SBP

Corporate financing patterns

Traditionally, there are four ways a business can finance itself, depending upon the nature of its financing requirements: (1) by taking loans from commercial and investment banks; (2) by issuing shares in the equity market, (3) by issuing long term bonds or debentures (TFCs), and (4) from its own retained earnings. For meeting short-term or operational financing requirements, companies acquire working capital finance from banks. The remaining options are normally used when medium to long-term financing is required, for instance when an expansion in production capacity is needed. The prevailing interest rate structure and general economic conditions play a significant role in the borrowing decisions. **Table 5** and **Figure 16** show the proportion of corporate financing raised from the various available sources in the last five years. Quite obviously, bank financing is overwhelmingly large in comparison with the financing generated through issuing stocks (IPO) or bonds (TFCs).[11] **Figure 17** shows the percentage composition of corporate borrowings from the banking sector

Table 5: Corporate Financing from Different Sources

billion Rupees

Year	Banks	IPO*	TFC*
CY02	524.5	0.1	4.7
CY03	606.5	2.5	19.5
CY04	873.0	21.7	0.0
CY05	1,076.2	9.8	6.6
CY06	1,269.6	3.0	3.0

Source: SBP and KSE

* The IPOs and TFCs issued by financial institutions are not included.

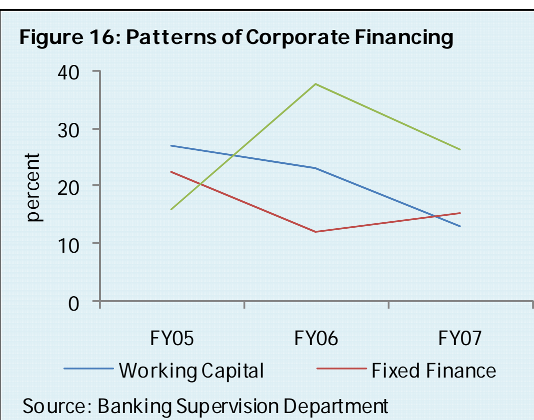


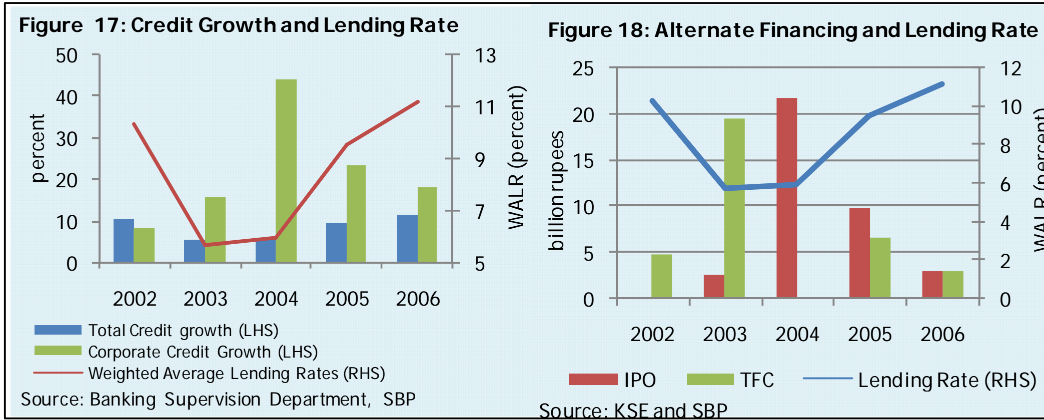
Figure 16: Patterns of Corporate Financing

Source: Banking Supervision Department

[11] This indicates that the corporate sector of Pakistan, like any other developing country's corporate sector, goes against the traditional 'pecking order' which states that the firms choose internal finance over external financing.

alone, highlighting the rising share of long-term (fixed finance) borrowings in the last two years.

Figure 18 shows the effect of increased interest rates on overall credit and corporate credit growth for the period CY02-CY06. The gradual increase in lending rates from CY05 onwards has had a certain degree of impact on the corporate sector's credit appetite.



In the recent past, some progress has been made to raise financing through the mode of Private Equity, as discussed in **Box 1**.

Box 1: Private Equity

Economic theory suggests that the private sector provides a sound mechanism for efficient utilization of resources, stimulating the overall growth of the economy. However, the role of the government also cannot be ignored in the development process. The favorable political and regulatory environment crowds-in new private investment that boosts production and increases employment.

Private equity is a distinct asset class that can play a vital role in meeting the financing needs of the corporate sector by providing them growth capital. The concept of private equity was originated in the post-World War II period, when the industrial economies were recovering from the post war recession and there was a huge demand for investment funds. Since then, it has been a major source of injecting investment in either newly created projects, or in projects with an immediate need of funds. Private equity is regarded as the medium to long-term finance directed towards potentially high growth, high risk enterprises. It is an equity investment which is raised from the private market in companies that are not listed on stock exchanges.

Private Equity investment has been booming in developed economies. The U.S. is currently the largest recipient of private equity funds (**Table 1**). Among the emerging economies, private equity has not yet yielded successful results till now. This is mainly due to their low standards of corporate governance and the lack of availability of information to make corporate decisions and to monitor the performance once the investment has been made. Furthermore, private equity placements are also not very successful in these countries as the legal systems in developing countries also impede the interests of private equity investors. Additionally, the illiquidity of domestic capital markets in developing countries does not offer the requisite exit mechanism to private equity investors, either through an IPO launch or through opportunities to divest from the project. However, it is expected that private equity investments will grow rapidly with the gradual liberalization of capital accounts across emerging economies and the associated elimination of restrictions on foreign ownership of domestic assets.

Table 1: Top recipients of private Equity Investments

Billion US $

	2004	2005
US	43.8	53.3
UK	22.4	29.6
France	6.1	9.1
Sweden	1.9	3.7
Spain	2.3	3.4
Germany	4.4	3.4
Netherlands	1.9	2.9
Japan	7.1	2.1
Others	20.1	30.3
Total	110	137.8

Source: Thomson Financial/ IFSL estimates based on EVCA

In case of Pakistan, sustainable economic growth has resulted in strong corporate earnings in recent years, which coupled with the remarkable performance of the Karachi Stock Exchange (KSE), has created a considerable demand for private equity in the country. It was only in the year 2006 that the first private equity fund was established in the financial sector. In recognition of this development, SECP has also formulated guidelines for the creation and working of private equity funds vide the (Draft) "Private Equity and Venture Capital Fund Regulations 2007", which have been placed on the SECP website for comments.
There have been a few private equity transactions in the corporate sector, some of which are:

- the purchase of 51 percent stake of Habib Bank Limited by the Agha Khan Fund for Economic Development
- Majority shares of Pakistan's largest refinery (National Refinery Limited) purchased by a Saudi private equity firm.

Factors such as the over-dependence of the corporate sector on banks for meeting its financing requirements, the listing legislations on the stock exchanges which require companies to demonstrate a track record of at least one year to issue shares at premium, obstruct companies from seeking long term finance from the equity market. Hence there is great potential for private equity to flourish as a suitable investment option in the corporate sector.