FINANCIAL STABILITY REVIEW

State Bank of Pakistan

FSR Team

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The team bears the responsibility of all errors and omissions. The analysis and commentary in the report are entirely those of the team and do not necessarily represent the views of the SBP management.

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Note: As communicated in our earlier publications, quarterly performance review (QPR) of the banking system has been replaced by bi-annual Financial Stability Reviews (FSR). Our current FSR covers the developments during the first half of 2011. The next FSR will examine the trends in the second half of 2011 and will be released in May 2012. In the meantime, we would continue to post quarterly banking statistics (including Financial Soundness Indicators) on SBP website.

Financial Stability: Overview and Outlook

Banking trends have entrenched further, barring few exceptions

Banking trends that were highlighted in our last report[1] have solidified during the period under review (January-June, 2011), barring few exceptions. The asset base of the banking system has soared by 8 percent (Rs. 577 billion), the most significant rise in a half year since 2007, on the back of a robust increase in investments, overwhelmingly in government papers[2]. Deposits were up by 9.4 percent (Rs. 515 billion), the strongest half yearly growth in the last four years, on the back of stellar inflow of workers' remittances.

Banks' earnings continued to accumulate, adding another Rs. 77 billion to industry's profit before tax, compared to Rs. 59 billion during the same period last year *(Table 1).* Positively, concentration in profits has dropped (share of top 5 banks down from 95 percent in Dec-10 to 78 percent in June-11), ensuring that even smaller banks have a share, albeit marginal, in overall profits. Further, growing profits have also helped reduce the number of loss making banks, from 17 in June-10 to 8 in June-11. However, source of profits is shifting away from interest income through advances to investments in government papers. Specifically, returns from investments in government securities now account for almost 30 percent of banks' interest income, up from 24 percent in June-2010. This trend is neither desirable nor sustainable, first because it compromises intermediation function and second since any sharp cut in discount rate can discernibly knock these profits[3]. Credit risk proves intractable, with non-performing loan ratio inching up to 15.3 percent, from an already high 14.7 percent in Dec-2010. But liquidity has improved further, as does the solvency, particularly when measured in terms of capital adequacy ratio.

While fiscal slippage has offered banks' an excuse for risk-aversion….

During the half year under review, government's dependence on the banking system has remained strong, amid poor tax collection (tax to GDP ratio of 9.4 percent) and steadily diminishing contribution of the external funds in deficit financing (9 percent in FY11 compared to above 50 percent during FY01-07). Furthermore, from Nov 2010 onwards, the commercial banks have become a major source of deficit financing as government shifted its borrowings away from the central bank. While this shift has somewhat helped the government keep its borrowings from SBP within agreed limits[4], it is likely to aggravate the budget deficit as return on government securities is now being earned by commercial banks instead of SBP[5].

As a consequence, banks' appetite for investment in government papers continues unabated, pushing the share of net investments in banks' total assets to 34 percent, highest in a decade. Unsurprisingly, share of net advances has experienced a concomitant drop, further sliding down to 43.9 percent by June-11. With rise in investments (22.4 percent) outpacing the growth in advances (1.04 percent[6]) by a wide margin, advances to deposits ratio (ADR) of the

[1] Quarterly Performance Review of the Banking System, based on the data of December 2010.

[2] 90.6 percent of incremental investments during H1-CY11 were in government papers.

[3] Incidentally, SBP have cut its discount rate by 200 basis points since June 2011. While the immediate effect on banks' balance sheet may not necessarily be negative (because of revaluation gains), it would reduce future interest income from government securities, a key earning source in recent times.

[4] SBP& MoF mutually agreed to keep outstanding stock of borrowing from SBP below September 2010 level of Rs. 1,155 billion (on cash basis).

[5] Government borrowings from the central bank helps SBP earn interest income. This translates into higher profits for SBP which are ultimately transferred to government as non-tax revenues. In case of interest income accumulated by commercial banks, the benefit to government is only partial, dictated by effective tax rate on banks' earnings.

[6]Credit disbursement has not been that anaemic when viewed on quarterly basis. However, many of the firms which took credit in the first quarter paid back in the second, making half yearly numbers appear slack then the actual off-take.

banking sector has further come off, dropping from 61.4 to 56.7 percent during H1-CY11. Steadily declining ADR[7] succinctly captures some important trends in the banking sector. First, it indicates availability of ample loan-able funds within banks and thus improved liquidity. By the same token, it underscores banks' growing risk aversion towards private sector credit which is ostensibly riskier and less attractive when risk free investments offer decent returns. Finally, it highlights banks' receding role as financial intermediaries, particularly when viewed in terms of socially and economically desirable allocation of credit[8].

.... private sector crowding out has other reasons too

While these trends heighten the concerns about private sector crowding out, poor credit off-take by the private sector has other reasons as well. In fact commercial banks, sitting on enough liquidity, have the wherewithal to extend the required private sector credit, provided there is sufficient demand in place, commensurate with their risk appetite. But with severe energy crisis, poor law and order situation and a challenging economic environment, demand for such credit is subdued[9]. Admittedly, with government receiving growing portion of the banking credit at rates quite attractive to banks, the cost of borrowings for private sector remains high, prompting firms to confine their borrowings to immediate working capital needs. However, an improved law and order situation, uninterrupted supply of requisite energy and a healthy economic growth in general would have a more salutary effect on credit off-take than drop in the interest rates alone.

Table 1: Key Banking Statistics (Rs Billion)

	CY08	CY09	Jun-10	Dec-10	Jun-11
Total Assets	5,628	6,516	6,782	7,138	7,715
Investments (net)	1,087	1,737	1,893	2,142	2,620
Advances (net)	3,173	3,240	3,231	3,349	3,383
Deposits	4,218	4,786	5,128	5,450	5,965
Equity	563	660	668	697	723
Profit Before Tax (ytd)	63	81	59	111	77
Profit After Tax (ytd)	43	54	36	65	51
Provisioning Charges (ytd)	106	97	30	70	30
Non-Performing Loans	359	446	460	548	579
Non-Performing Loans (net)	109	134	123	182	186

Recalcitrant credit risk would take time and effort (particularly on part of PSCBs and mid-sized LPBs) to tame

Of all risks that banks have to confront with, credit risk remains the most significant and intractable. Its significance is obvious from the fact that 79.3 percent of banks' risk weighted assets can be ascribed to credit risk alone. And it is intractable as the rise in NPLs continues unabated. During H1-CY11, banks accumulated another Rs. 31.4 billion to infected assets (compared to a rise of Rs. 27.8 billion during same period last year), pushing non-performing loan ratio (NPLR) from 14.7 to 15.3 percent.

[7] Alternatively, investments to deposit ratio (IDR) has been consistently rising, reaching 44 percent by June-2011.
[8] In strict sense, conversion of deposits into any type of lending is intermediation, whether the ultimate borrower is government or the private sector. However, lending to private sector is discernibly productive as it helps promote economic activity and job creation.
[9] Parallels can be drawn with an economy that is on the horizontal part of aggregate supply curve and far away from its potential level of GDP. For such an economy, increase in aggregate demand does not translate into inflation, at least in the pure Keynesian world. Likewise, crowding out would have been more potent, had there been a strong demand for private sector credit. But with banks maintaining excess liquidity amid steadily falling ADR, the possibility of a full-scale crowding out is limited.

Bank-wise break up reveals that two groups are particularly vulnerable to mounting credit risk: mid-sized[10] local private banks (LPBs) and public sector commercial banks (PSCBs). While slack economic growth and attendant rise in credit risk is understandable and indeed relevant for all banks, mid-sized LPBs and PSCBs have infection ratios (25.6 percent and 21.5 percent respectively) far higher than industry average (15.3 percent). The explanation lies, in case of LPBs, primarily in the choice (if they have much) of borrowers; since bulk of the quality borrowers are served by big banks, mid-sized banks are compelled to choose relatively riskier borrowers, also because they need to earn enough to compensate for their much higher cost of deposits than of the top five banks. In case of PSCBs, their credit standards partially explain above average infection ratios.

With bulk of incremental deposits being placed in investments, why the trend in NPLs is not receding? First, the rise in NPLs (at least at its current pace) can be dictated by a handful of banks. Second, as breakup of NPLs reveals, incremental NPLs are primarily in the Loss category. Since NPLs are typically classified into loss category after 360 days[11], it suggests these advances were granted in the past. While growing portion of investments in asset mix is likely to decelerate the pace of NPLs, that alone would not be enough to turn the tide. Banks need to improve their credit risk management at the same time, ensuring their incremental NPLs are well contained, if not totally avoided.

...though other risks are well-contained

Other risks to the banking system remain well contained. In fact, liquidity position of the banks has been comfortable in general, with industry maintaining excess liquidity than statutorily required, thanks to growing share of investments in banks' portfolios. Further, the increasing share of long term deposits in the funding mix has kept funding liquidity risk at bay. Market risk remains subdued, amid relatively stable exchange rate and interest rate during the period, notwithstanding the lackluster performance of the equity market.

Despite having comfortable CAR, banks struggle to meet growing MCR....

Solvency profile of banks has improved further, with Capital Adequacy Ratio (CAR) inching up by 10 bps to reach 14.1 percent by Jun-11. Much of the improvement took place in Tier-I or the core capital (up by 3.5 percent) as the banks, benefiting from a period of easy earnings, started to accumulate reserves and enhance their paid-up capital to meet growing minimum capital requirements (MCR). While all except five banks have CAR above the required 10 percent, almost half of the banks face the challenge of meeting MCR of Rs. 7 billion. With deadline for higher MCR of Rs. 8 billion around the corner (30th Dec-2011), this will impose further pressure on the banks to comply with growing capital requirement.

Part of banks' difficulty in meeting MCR is on account of its growingly higher regulatory requirement: from Rs. 6 billion by Dec-09 to Rs. 7 billion by Dec-10, further Rs. 8 billion by Dec-11 and then gradually up to Rs. 10 billion by Dec-13. In the current domestic as well as international business environment, raising additional capital has been a challenge for many banks. On the other hand, the case of CAR is characterized by favorable trends both in numerator and denominator of the ratio[12], helping majority of the banks stay well above the

[10] These banks, when ranked on the basis of asset size, fall between top 11-20 banks.

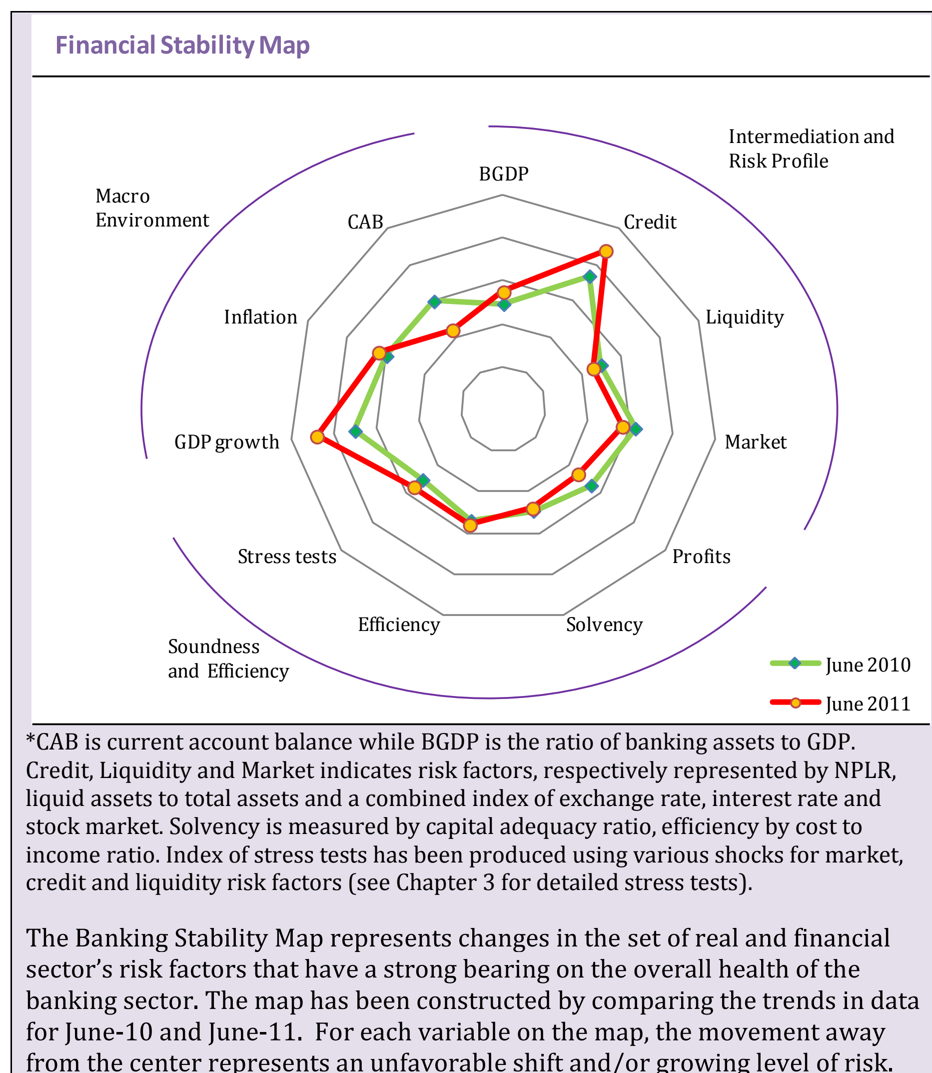
[11] Classification of a loan into loss category varies in terms of loan types. For instance, corporate, SME, and consumer (auto and mortgage) loans are classified as loss after 360 days, while corporate-trade bills and consumer (credit cards & personal) loans are classified as loss after 180 days of non-payment of interest and or principal. On the other hand, agricultural loans are classified as loss after 2 years.

[12] Simply put, CAR= regulatory capital/ risk weighted assets.

minimum requirement of 10 percent. First, as changing asset mix has increased the share of safer investments in banks' portfolios, risk weighted assets have declined, shirking the denominator. Second, SBP's drive to enhance MCR has also increased capital base of the banking system, expanding the numerator. These trends collectively explain improved CAR of the banking industry, notwithstanding the challenge posed by higher MCR.

....still the system appears sound & resilient

Since CAR reflects adequacy of banks' capital in the context of their risk profiles, a comfortable CAR underscores a resilient banking system against adverse shocks. Unsurprisingly, results of stress tests conducted on June-2011 data corroborate this notion of soundness of the banking industry in general. Financial Stability Map (*Box-1*) provides another look at the movements in key macroeconomic indicators and risk factors.



*CAB is current account balance while BGDP is the ratio of banking assets to GDP. Credit, Liquidity and Market indicates risk factors, respectively represented by NPLR, liquid assets to total assets and a combined index of exchange rate, interest rate and stock market. Solvency is measured by capital adequacy ratio, efficiency by cost to income ratio. Index of stress tests has been produced using various shocks for market, credit and liquidity risk factors (see Chapter 3 for detailed stress tests).

The Banking Stability Map represents changes in the set of real and financial sector's risk factors that have a strong bearing on the overall health of the banking sector. The map has been constructed by comparing the trends in data for June-10 and June-11. For each variable on the map, the movement away from the center represents an unfavorable shift and/or growing level of risk.

IBIs are solvent, liquid and profitable, but face unique risks

Islamic banking institutions (IBIs) have registered 17.5 percent growth during H1-CY11, with bulk of incremental assets channeled into government securities. On average, IBIs are more solvent, liquid, and profitable than the rest of the banking sector and these indicators have improved during the period under

review. Reputational and Displaced Commercial Risk (DCR[13]), though dormant, can pose significant challenge to the future growth prospects of the industry. The former risk arises on account of limited size of financing portfolio based on profit and loss sharing (2.9 percent in total financing by IBIs[14]), the hallmark of Islamic banking. DCR on the other hand emanates from the practice that, contrary to contractual obligations with their PLS depositors, IBIs find it hard to transfer the losses to investment account holders as this may prompt withdrawals.

Financial Markets, NBFIs, and the Payment Systems

Financial markets remain stable in general

Domestic financial markets remained stable during the period under review, despite some bouts of mild strain. External inflows kept the value of domestic currency almost stable, as PKR depreciated by a marginal 0.35 percent against the dollar. Healthy external inflows on the back of workers' remittances and price-led export earnings buffeted banks' deposits and liquidity profiles, apart from helping central bank accumulate reserves (up by 9.2 percent in H1-CY11). In the money market, the yield curve flattened during H1-CY11 as the short-term rates inched up with a decline in the longer term maturities. The capital market managed to post a marginal growth of 4 percent during the half year under review. However, the trading volumes and activities in the corporate debt market largely remained low. Lastly, the derivatives market, already quite small in size, shrank further as insipid credit to private sector coupled with stable exchange rate and interest rate dampened the demand for new contracts.

DFIs witness marginally weak performance while leasing contracts.

During the period under review, the asset base of the Development Finance Institutions (DFIs) managed to grow marginally by 4 percent, primarily on account of stronger growth in investments. Share of advances in total assets remained intact (around 35 percent), though at significantly lower level than what DFIs' nature of business would warrant. While all eight DFIs except one were able to post profits during H1-CY11, higher provisioning on account of growing NPLs reduced industry profits when compared with the same period last year. DFIs' solvency ratios (CAR of 56.7 percent) have been significantly better than those of banks (14.1 percent), suggesting ineffective utilization of their strong capital base. The leasing sector has kept on shrinking amid strong competition from the banking sector.

Insurance and mutual funds experience strong growth

In contrast, the mutual funds industry witnessed its revival as the money market investments improved the net assets of the industry by 24 percent in H1-CY11. Finally, the insurance industry witnessed a growth of 16.6 percent in its asset base with the life business experiencing a much strong growth[15] (24 percent). On the contrary, the nonlife insurance has been affected by a significant drop in the consumer finance activities and a higher claims ratio, though it has still managed to post reasonable profits from rising investment income.

Though e-banking gains share in retails' volume, paper-based modes still dominate in value

During the half year under review, the payment systems have functioned smoothly, with amount transacted through retail payment system growing by 14 percent (YoY) against 11.6 percent in the corresponding period last year. In terms of volume, share of e-banking transactions has gained momentum, reaching 42 percent by June-11. However, in terms of value, retail payments are still dominated by paper based transactions (particularly through cheques), with 86 percent share in all transactions settled. Large value payment system in

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[13] DCR refers to the risk arising from assets managed on behalf of investment account holders. The risk is effectively transferred to the IBIs' own capital because IBIs forgo part of its *Mudarib's* share on such funds.
[14] As IBIs continue to rely on mark-up based and mortgage/lease type modes of financing.
[15] This analysis is based on published annual audited accounts of 2010.

Pakistan has become efficient and more reliable with the launch of Pakistan Real time Interbank Settlement System (PRISM). In recent months, system availability on average remained around 96.5 percent, with reported downtime primarily due to securities settlement interface of PRISM. Lastly, in the area of branchless banking, Pakistan is experiancing a rapid expasion, with four banks offering services through various operational setups. As more banks are planning to enter this growing segment, there is a strong potential to significantly improve financial inclusion in the years ahead.

Going forward, major reversal in banking trends in unlikely

Going forward, a mild pick-up in private sector credit is likely as the borrowing cycle of some key industries resumes, though receding commodity prices would keep the growth in check. Further, the challenging business environment in general and banks' risk aversion amid high credit risk would limit the possibility of a perceptible reversal in asset mix away from the government papers. The current monetary policy stance will make banks' asset selection challenging in the months ahead; banks will either have to live with lower returns on their investments (a key source of profits in recent times) or to aim for greater private sector credit, which in a difficult economic environment, would truly test their ability to adroitly manage an already high credit risk.