Chapter 1 Financial Intermediation

The asset base of banking sector observed a strong 12.2 percent growth in H2-CY12 (5.9 percent in H2-CY11) primarily backed by accelerated growth in customer deposits and decent increase in the equity base. The unprecedented growth in banks' investment contributed a major part in asset growth. The private sector witnessed 5.1 percent growth, a likely response to 204 bps reduction in WALR, was a welcome sign. Healthy growth in saving deposits after SBP's move of raising minimum floor rate on saving deposits by 100 bps, a partial substitution from fixed deposits to saving & current deposits, and high financial borrowing were also few financial highlights of banking sector during H2-CY12.

Figure 1.1

Changes in Banking Assets

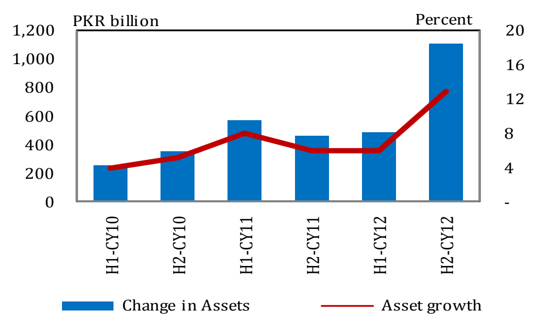


Figure 1.2

Flows in Asset Components (PKR billion)

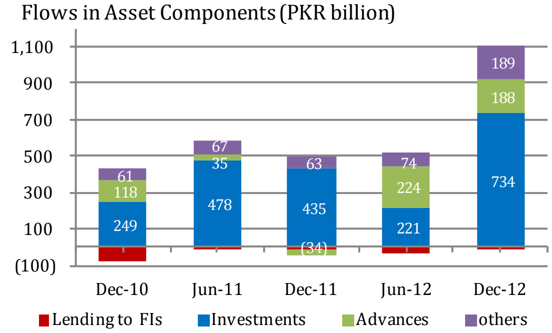
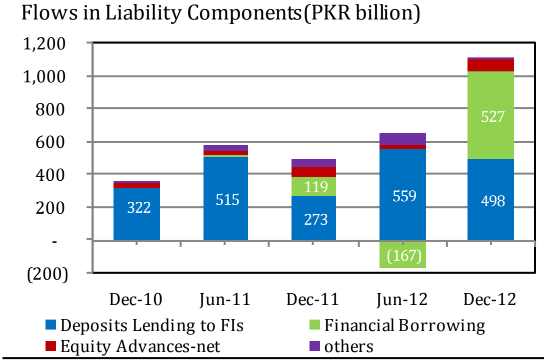


Figure 1.3

Flows in Liability Components(PKR billion)



The banking system asset soared by 12.2 percent during H2-CY12 (5.9 percent for H2-CY11 and 18.9 percent YoY). Persistent government borrowings to meet revenue-expenditure gap[20] and relatively higher seasonal private credit off-take primarily financed by strong deposit flows of 7.2 percent helped banking sector post healthy growth. This increase was quite phenomenal as banking sector has not witnessed double-digit increase in assets in half year since CY07 and was unprecedented in value terms as well **(Figure 1.1)**.

The surge in assets, though broad based, was driven by exceptional 31.1 percent growth of banks' investment in government papers. Resultantly, total investment (net) not only touched the new high of PKR 4 trillion but also surpassed the level of net advances for the first time. Since last few years, slow economic growth and infrastructure issues (consistent energy supply shortages and law and order concerns) resulted in lower demand for credit from private sector. This coupled with the sufficient availability of high yielding risk free government papers remained the main contributing factor behind banks' flight to safe havens **(Figure 1.2).**

In line with the usual credit cycle and seasonal pattern, gross advances increased by 5.1 percent during H2-CY12, particularly in the last quarter of the year. Importantly, the growth in domestic advances was entirely contributed by private sector while the public sector made net repayments mainly due to retirement of self-liquidating commodity financing. The accelerated growth in private sector credit was perceptibly driven by a host of factors including some improvement in real economic activities especially the LSM, downward movement in lending rates, decline in NPLs, improved liquidity position, and

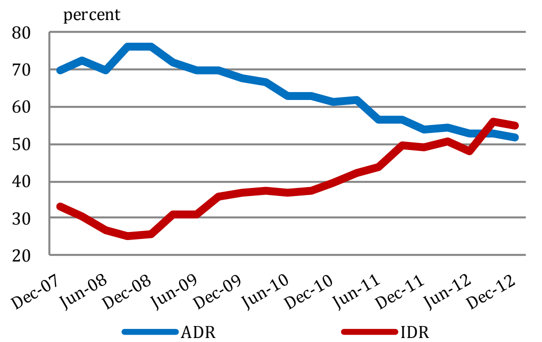
[20] The fiscal deficit during FY13 remained 8.0 percent of the GDP as against the target of 4.7 percent

receding returns on government papers.

On the funding side, healthy 7.2 percent growth in deposits and doubling of borrowings during H2-CY12 supported the surge in assets in H2-CY12 **(Figure 1.3)**. The growth in deposits came from consistent rise in saving deposits, which responded well to SBP move of raising minimum floor of saving deposit rate[21] and increase in current deposits in parallel with increased seasonal disbursement[22]. Fixed deposits, generally being more rate sensitive, saw deceleration in growth pattern during the period under review. The overall deposits growth was partially attributable to continued capital inflows in the shape of workers' remittances and rise in Foreign Currency (FCY) deposits on account of continuous depreciation in domestic currency. On the other hand, banks' borrowings swelled by around 100 percent. Most of these transitory funds were borrowed from the central bank to match rollover of government securities and for export refinance purposes. The equity base grew by 9.18 percent due to strong profit providing additional funding sources besides strengthening the solvency of the system.

Figure 1.4

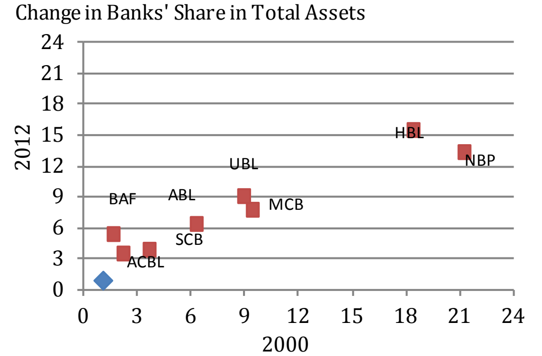
Shift in Asset Mix



Over the last few years, challenging economic and business environment and deterioration in asset quality made banks to adopt cautious approach towards lending, which limited the credit flows to high quality private borrowers and for meeting seasonal financing needs of both public and private sector. Increased reliance of Government on bank borrowings also dampened the risk appetite of the banking system. These developments led to a continuous decline in advances to deposit ratio (ADR) for last few years, the trend that also persisted during the period under review. However, rate of decline in ADR subsided during CY12 due to improved credit disbursements and steady growth in customers' deposits. It observed decline of 40 bps during H2-CY12 **(Figure 1.4)**. On the flip side, investment to deposits ratio (IDR), went up by 610 bps during the period under review.

Figure 1.5

Change in Banks' Share in Total Assets

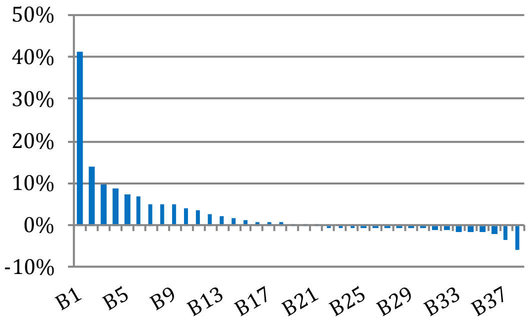


It was highlighted in the FSR for H2-CY11 that, over the years, top banks had shed their market share due to various restructuring and consolidation measures **(Figure 1.5)**. Though overall trend remain the same, growth in top institutions outstripped industry growth during H2-CY12 which led to a marginal increase in the share of top institutions. Analysis highlighted that small and medium sized banks though expanded in size yet at a slower pace than the industry average that

[21] Minimum saving rate was increased from 5 percent to 6 percent w.e.f. May 01, 2012.
[22] A part of credit disbursement normally returns to banking system.

Figure 1.6

Bank-wise contribution in Credit Flows in H2-CY12



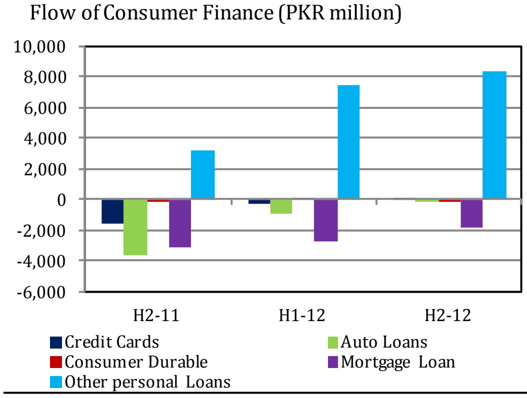
B stands for bank

Table 1.1 Segment-wise domestic credit flows in H2-CY12

		PKR billion
	Public Sector	Private Sector
Fixed Investment	18.5	35.7
Workign Capital	22.1	80.2
Trade Finance	(2.6)	3.6
Commodity Finance	(40.5)	17.5
Others	(0.1)	22.5
Total	(2.5)	159.3

Figure 1.7

Flow of Consumer Finance (PKR million)



decreased their share in assets base.

Subsequent to some seasonal retirements in third quarter, the flow of advances picked up pace in the fourth quarter with 5.1 percent growth during H2-CY12 (net retirements of 1.1 percent in H2-CY11). However, in sharp contrast to previous half, growth was mainly contributed by private sector, while flows to public sector moderated primarily due to retirements in self-liquidating commodity finance. As a result, share of private sector advances inched up to 79.4 percent in H2-CY12 from 78.4 percent in H1-CY12.

A 204 bps decline in Weighted Average Lending Rate (WALR) in response to monetary easing[23], moderation in NPLs, a marginal recovery in real economic activities[24] and improved liquidity conditions due to strong deposit growth helped reasonable growth in private advances flows. Nonetheless, the bank-wise credit disbursement reveals a skewed distribution pattern indicating major part in credit disbursement was shared by only few banks[25] **(Figure 1.6).**

The domestic sector advances growth was quite broad based, though 88 percent of it went to corporate sector during H2-CY12. Remaining financing was distributed across SMEs, Agri-financing and Consumer loans. Analysis of uses of private advances indicated flows to all three segments of working capital, fixed investment, and trade finance **(Table 1.1)**. The working capital needs were driven by seasonal production process in textile, sugar, and rice industries. Fixed investment credit demand was quite diversified as it was availed by manufacturing, commerce and trade, and real estate sectors. Particularly, in manufacturing sector, the food industry utilized the financing for the capacity enhancement[26].

Consumer financing flows remained subdued and limited to few banks. Most of the 2.8 percent increase in the financing took place in personal loans that grew by 7.0 percent during H2-CY12 and superseded the net retirement in other consumer segments **(Figure 1.7).** These fresh disbursements emerged mainly from a bank, which enhanced the personal loan limits during the period under review[27].

[23] SBP slashed its policy rate cumulatively by 250 bps in three consecutive monetary policy statements during H1-CY12.
[24] The LSM Index grew by 2.13 percent during Jul-Dec 2012 against 0.83 percent during the same period in CY11.
[25] The data reveals that 73 percent of gross credit disbursement was made by only four banks which collectively have 29 percent share in banking assets.
[26] "The State of Pakistan's Economy - Second Quarterly Report 2012-13" , State Bank of Pakistan
[27] State Bank under R-7 of Prudential Regulations (PRs) capped combined credit card and personal loan limits to a single borrower at PKR 5 million, both on secured as well as on unsecured basis subject to the condition that the overall unsecured/clean facilities on account of credit card and personal loan of the individual does not exceed PKR 2 million. Banks, therefore, prescribe various personal loan products within these limits.

Table 1.2: Sector-wise Credit Flows in H2-CY12		
		PKR billion
	Public Sector	Private Sector
Production & Transmission of	(1.5)	11.2
Sugar	2.5	(19.2)
Agri Business	(19.8)	23.5
Chemical & Pharmaceuticals	0.0	(3.2)
Financials	(0.7)	5.4
Cement	-	(5.0)
Shoes & Leather	-	(0.8)
Electronics and Electrical	-	1.8
Textile	-	67.3
of which	-	-
Spinning	-	35.2
Composite	-	12.1
Weaving	-	5.0
Others	42.8	121.6
Total	**23.3**	**202.7**

Figure 1.8

Half Yearly Credit Flows in Textile Sector (PKR billion)

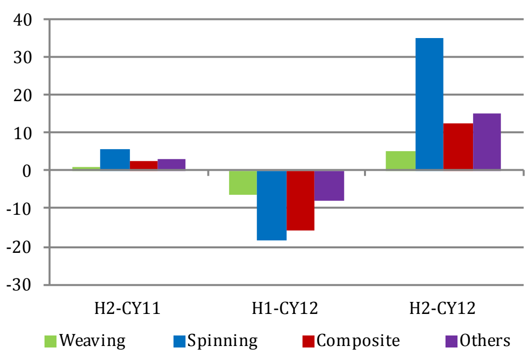
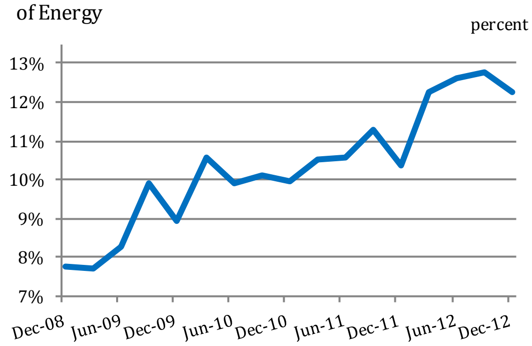


Figure 1.9

Share of Banks' advances in Production & Transmission of Energy



Textile sector remained the major user of the banking sector advances due to seasonal peak in production process as well as for investments to overcome the energy shortages[28] **(Table 1.2)**. The key part of the financing was availed by spinning followed by composite and weaving **(Figure 1.8)**. The increase in textile advances was in line with corresponding growth (YoY) in export value[29]. Analysis of export refinance exhibited 17 percent increment[30] during the half year (39 percent in Q4-CY12), which is highest since 2008.

The sugar sector credit demand which kick start with crushing season in the fourth quarter, remained negative during H2-CY12 due to higher net payments in the third quarter. However, the overall net retirement in H2-CY12 was significantly lesser than H2-CY11. The overall credit growth in agribusiness although was marginal, yet the private sector credit demand in this sector was still relatively high due to enhanced utilization of fertilizer owing to increase in wheat cultivation area and better gas availability.

The flow of credit to "Power & Transmission of Energy Sector (PTES)" continued during the half year as it added another PKR 9.7 billion. Over last few years and more specifically during CY12, banks' credit exposure in PTES increased significantly **(Figure 1.9).** The banks' advances to PTES grew by 33 percent in CY12 to reach PKR 493 billion. The sluggish pace of overall advances coupled with high expansion rate of PTES advances increased concentration in this sector to 11.7 percent of the gross advances during CY12 (7.2 percent in CY-08). The increase came as no surprise in wake of looming energy crisis. The Government increased reliance on banking sector for payments to Independent Power Producers (IPPs), Oil Marketing Companies (OMCs) and electricity transmission companies, increased concentration on banks' balance sheets. Much of the advances extended were generally backed by the Government guarantees, which create contingent liabilities and at times require conversion into direct government debt. This actually happened last year when the Government converted its contingent liabilities through one-off settlement on account of unpaid subsidies to IPPs through issuance of PIBs and MTBs. However, the circular debt accumulated again with addition of PKR 123 billion to energy sector during CY12. The lingering energy sector issues not only kept the banks' exposure on PTES high and rising but also continued to increase public sector concentration on banks' balance sheets.

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[28] The textile sector is currently facing multiple challenges such as (i) gas curtailment, (ii) lower textile prices in international market, and (iii) strong competition from Bangladesh which has signed Preferential Trade Agreement (PTA) with USA and EU in textile sector.

[29] Source: Federal Bureau of Statistics.

[30] A reduction of 150 bps in EFS rate and increased uncertainty about the effective cost of borrowing in foreign currency (FE-25 loans) made EFS loans more attractive, which enhanced EFS loans during H2-CY12.

Figure 1.10

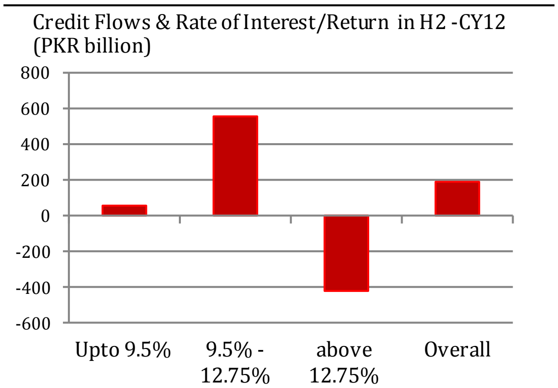


Figure 1.11

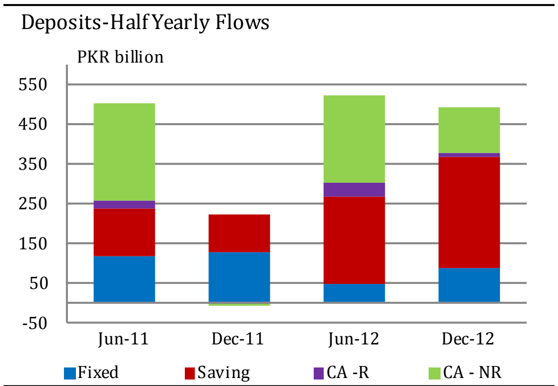
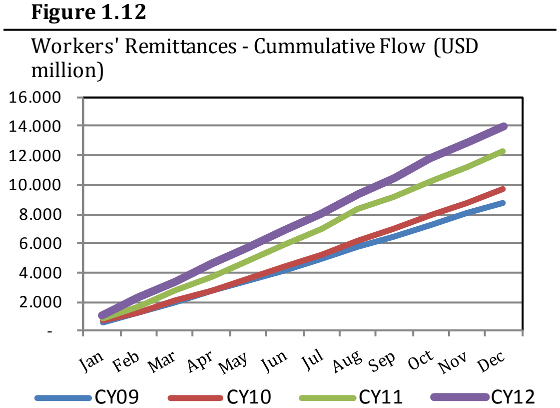


Figure 1.12



With private credit expansion during H2-CY12 and a declining trend in lending rates, flow of credit at higher rate declined consistently. For instance, rate wise distribution of private credit exhibited that entire credit pickup was observed at borrowing cost up to 12.75 percent as against net retirements above this threshold **(Figure 1.10).** This seems an obvious outcome as most of the financing is KIBOR linked and the dip in lending rates subsequent of slashing of policy rate, decreased the borrowing cost and partly contributed to improved private sector credit growth during the half year.

Public sector financing observed a marginal decrease of PKR 2.5 billion during H2-CY12 against the decline of PKR 97.3 billion[31] in H2-CY11. The substantial financing to PSEs was balanced out by net retirements of PKR 40.5 billion against commodity finance operations in H2-CY12. However, this retirement fall short of net payment of PKR 63.0 billion in H2-CY11 due to multiple reason, including one off-settlement of PKR Rs 78 billion towards unpaid subsidies during November, 2011, enhanced borrowing needs of Trading Corporation of Pakistan's (TCP) for the import of fertilizers and credit off-take for sugar financing (net payment in H2-CY12). The higher retirements were seen against wheat financing due to aggressive off-loading of stock during the period under review. Despite substantial retirement the outstanding stock of commodity financing remained high and is expected to increase further due to rise in wheat support price[32] and continuing import of fertilizer on account of underutilized capacity of local fertilizer companies owing to gas shortages. Such a hasty recourse to borrowing again poses a risk of accumulation of government liabilities.

The period under review was marked with a strong deposit growth of 7.2 percent mostly because of hefty uplift in Current Account and Saving Account (CASA) deposits **(Figure 1.11).** The saving deposits surged by 11.8 percent during H2-CY12 (5.0 percent in H2-CY11) apparently responded well to SBP move of raising minimum payable rates on saving deposits by 100 bps to 6 percent. The higher return with already instilled liquidity features perhaps have made saving deposits more preferable[33]. A reasonable 6 percent growth in current account was in line with an increase in seasonal credit disbursement and supported overall supply of funds. Fixed deposits, however, observed deceleration and continue to lose weight in overall customer deposits. The robust growth was also consistent with increasing

[31] The decline was mainly on account of the one-off settlement of PKR 390 billion against circular debt.
[32] The post review statistics show that fresh lending for public sector commodity operations in fact surpassed the previous levels.
[33] In March 2013, SBP has made it mandatory for banks to pay returns on saving deposits on average daily balance. This policy stance may further stimulate the saving deposit growth.

Figure 1.13

Maturity-wise Flows of Fixed Deposits

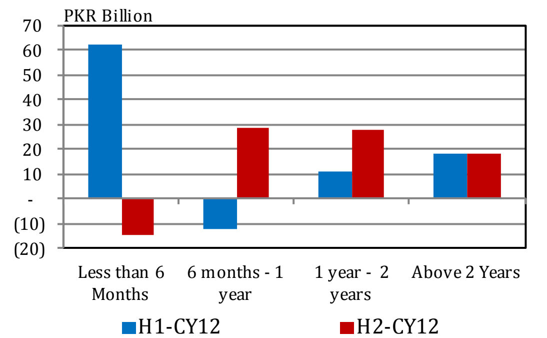


Figure 1.14

Size-wise Deposit Flows (PKR billion)

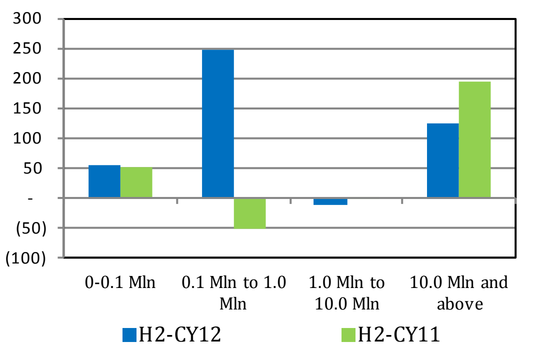
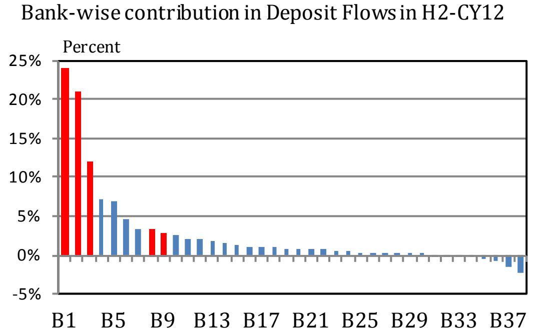


Figure 1.15

Bank-wise contribution in Deposit Flows in H2-CY12



B stands for bank and red bars indicate Top-5 banks

flows of worker remittances **(Figure 1.12)**. Depreciation of rupee by 2.6 percent against USD during the period under review also added to growth in deposits as FCY deposits edged up by 5.4 percent during H2-CY12 against 10.1 percent increase in corresponding period of last year.

The observed deceleration in fixed deposits in both halves of CY12 may be attributed to (i) banks' extra efforts for raising short-term funds[34] in interest rate declining scenario, (ii) stiff competition from National Saving Scheme (NSS), which offer relatively higher interest rates with a lower cost of pre-mature withdrawals, as institutions also allowed to invest in NSS since April 2012; and (iii) higher minimum rate offered on saving deposits that made fixed deposit relatively less attractive. The maturity profile of fixed deposits indicates increasing volume of deposits falling in maturities range of six months to two years while deposits up to six months maturity declined. The change in deposit maturities corroborate well with the increase in minimum saving rate (**Figure 1.13)**.

The size-wise deposit analysis revealed major contribution from medium sized deposits that was in sharp contrast to corresponding period of last year when most of the increase in deposit came from large sized institutional deposits **(Figure 1.14).** Bank-wise deposit distribution showed that 62 percent deposits were mobilized by top 5 banks, more than their respective cumulative share of 54 percent in overall deposits **(Figure 1.15).** However, few mid-size banks also exhibited decent growth in deposit collection during the period under review.

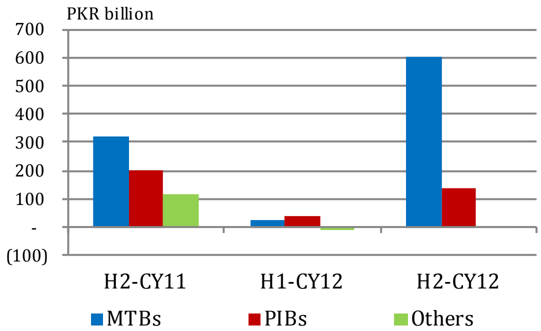
Borrowings from financial institutions increased by around 100 percent over the half year, which increased the total quantity of these transitory funds to PKR 1 trillion. This high level of borrowings resulted from amplified repo activity for meeting consistently high market liquidity requirements of banks in order to match rollover of government securities in wake of high financing needs of the Government. As a result the share of secured borrowing swelled by 5 percentage points to 94 percent during H2-CY12. The channelization of most of the borrowings into Government papers, indicate indirect monetization of the Government debt.

The continued flow of funds into Government securities during H2-CY12 helped investment to grow by an accelerated pace of 22.5 percent **(Figure 1.16).** Consequently, the share of Government securities in total investments enhanced to 88.7

[34] Short-term liquid funds are normally referred to Current Account – Saving Account (CASA)

Figure 1.16

Flow of banks' investment in Government Securities



percent on Dec 31, 2012. Among government securities, banks invested heavily in short term instruments that lifted up the outstanding T-bills by another 31 percent. Such a high concentration of investment in Government securities pose re-investment risk that already materialized with the decline in market interest rates and interest margin over the second half of CY12. In contrast to investment in government securities, banks' investments in equities declined by 11 percent despite the decent performance of equity market during the half year under review.

The equity of banks, representing 9.1 percent of the assets base, grew by 9.18 percent (8.5 percent in H2-CY11) during H2-CY12. The buildup of retained earnings at the back of healthy year to date profits, capital injections by a few banks for meeting the Minimum Capital Requirements (MCR), and improvements in revaluation surpluses attributed to healthy growth in net worth of the banking system.