3.1. The Banking Sector

*The banking sector remained resilient with robust solvency backed by healthy profitability. The Capital Adequacy Ratio (**CAR**) remained well above the minimum regulatory requirements. Strong liquidity indicators further strengthened. However, asset quality emerged as the key concern when the cost-push factors undermined borrowers' payback capacity and some industry specific factors led to a rise in the level of NPLs. While the financing demand decelerated, banks also opted for investment in risk free government papers. The deposit growth revived as the attractiveness of saving and fixed deposits increased. The on-going COVID-19 pandemic presents a multidimensional challenge for the banking sector as their business continuity, profitability, and solvency could experience stress, going forward.*

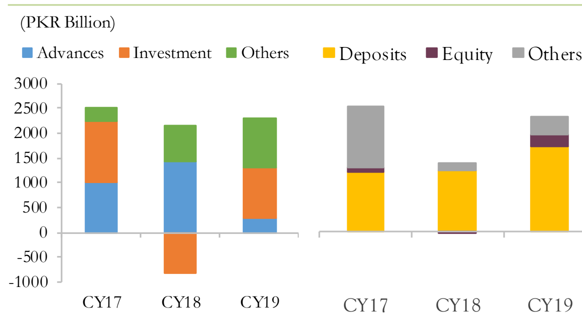
Banks remained cautious throughout the CY19…

Economic uncertainty prevalent in the first half of CY19, and the subsequent stabilization measures adopted to rein in the macroeconomic imbalances made the banking sector risk averse. It rebalanced the earning assets portfolio from risky advances towards safer investments. As a result, the asset base of the banking sector expanded by 11.73 percent in CY19 compared to 7.31 percent growth in CY18 (**Chart 3.1.1**).[173]

The slackness in economic activity setting in, the healthy returns on offer, and the termination of higher denominated bearer prize bonds, encouraged the banking sector savers.[174] There was a marked recovery in growth of saving and fixed deposits, though current deposits decelerated. Still there was some shortfall in funding to support the asset growth, a portion of which the banks met by borrowing from SBP.

As the interest rates spiked and the size of investments grew, the net interest income soared. lifting the overall profitability and, eventually, the equity base of the banks.

Chart 3.1.1: Asset and liability composition of the banking sector (flows)



Source:SBP

…and kept the soundness largely intact, though asset quality emerged as a possible vulnerability…

The vast majority of indicators of financial soundness related to liquidity, profitability, and solvency remained in a comfortable range. Banks had ample liquidity to meet both short and long term obligations. They also exceeded the Basel III liquidity requirements of Liquidity Coverage Ratio and Net Stable Funding Ratio by a significant margin. The CAR along with the leverage ratio stayed well above the prescribed minimum benchmarks. The interbank exposure remained range bound leading to lower interconnectedness and cross-sectional systemic risk. However, increase in the infection ratio due to build-up of NPLs indicated some deterioration in asset quality.

Overall, the banking sector moved towards a better state of stability as indicated by the Banking System Stability Map (**BSSM**) (movement towards

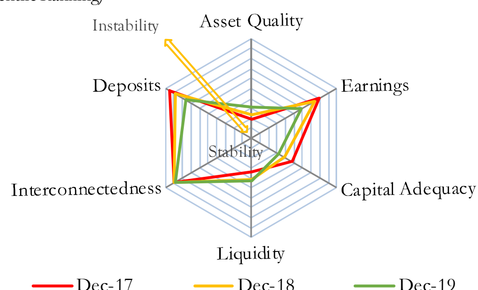
[173] As per BPRD circular No.2 of 2018, the balance sheet as of end CY19 includes 'acceptances' as part of 'other assets' which, till previous year, was being treated as off-balance sheet item. (http://www.sbp.org.pk/bprd/2018/C2.htm).

[174] There was a negative 20.73 percent growth in outstanding amount of prize bonds during CY19 compared to 17.14 percent in CY18 and 3-years' average of 16.58 percent during CY16-18.

the origin) and Banking Sector Vulnerability Index (downward movement in the index) (**Chart 3.1.2 and 3.1.3**).

Chart 3.1.2: Banking Sector Stability Map

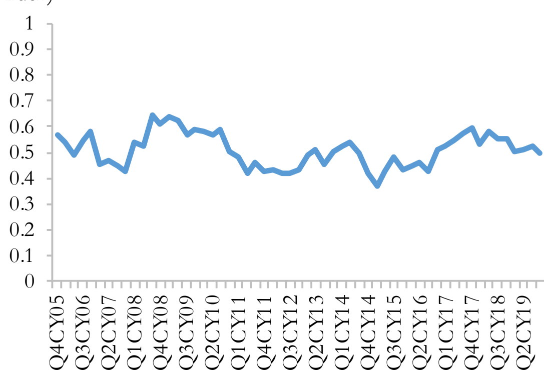
(Percentile Ranking)



Source: SBP

Chart 3.1.3: Banking Sector Vulnerability Index

(Index)



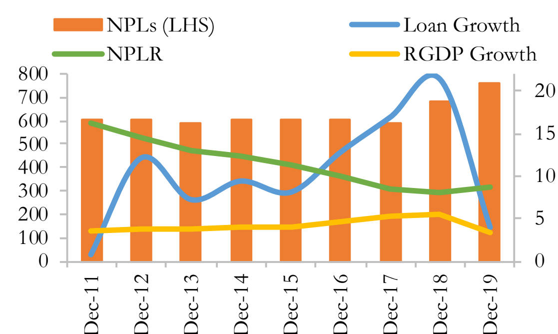
Source:SBP

Amid economic headwinds, the asset quality came under stress …

The tighter financial conditions stretched the debt repayment capacity of the borrowers, yet for another year. The financing cost kept escalating due to monetary tightening. The input prices increased owing to both the depreciation of domestic currency as well as the additional fiscal measures adopted. Moreover, economic slackness, particularly for the large-scale manufacturers, meant build-up of inventories leading to scaling down of business activities. These non-conducive business conditions translated into squeezed margins, slowdown in sales and accumulation of receivables causing cash flow problems for the borrowers.

Resultantly, the NPLs of the banking sector observed 11.97 percent (PKR 81.37 billion) addition during CY19, compared to 14.72 percent (PKR 87.20 billion) in CY18 (**Chart 3.1.4**). About 84 percent of the NPLs pertained to the domestic portfolio.

Chart 3.1.4: NPLs trend of the banking sector



Source: SBP

…with some deterioration in asset quality indicators…

With a rise in NPLs, the asset quality indicators of the banking sector deteriorated in CY19. The 'NPLs to gross advances' ratio increased to 8.58 percent by end Dec-19 from 7.97 percent by end Dec-18. The provision coverage, though still high, reduced to 81.43 percent in CY19 from 83.80 percent a year back.[175,176] Consequently, the 'net NPLs to net advances' ratio rose to 1.71 percent in CY19 from 1.38 percent a year ago. The credit risk coverage of the capital also reduced with the rise in 'net NPLs to capital' ratio to 8.91 percent in CY19 from 7.83 percent in CY18. The overall increase of credit risk in banking books was consistent with

[175] As per the existing provision requirements, only loss category of NPLs is provided for 100 percent while other categories i.e. substandard and doubtful attract 25 percent and 50 percent provisioning, respectively. Thus, the rise in NPLs reduces the provisioning coverage unless NPLs are downgraded to loss category.

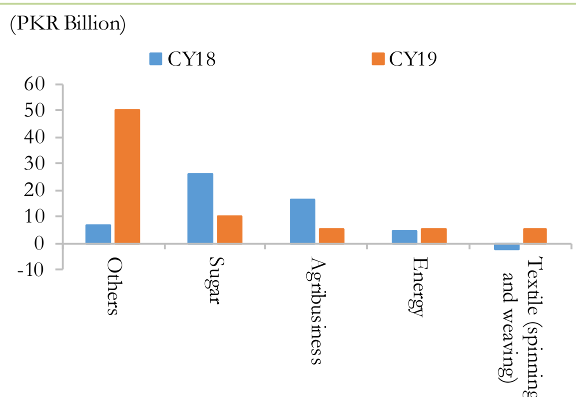
[176] Further, SBP granted several relaxations to banks to combat COVID-19 in March 2020 including Restructuring/Rescheduling of Financing Facility (R-8 of Prudential Regulations). This will limit the impact of further downgrading of loans (if any) parked in other categories of NPLs (e.g. subordinated, doubtful) as well as the additional provisioning expense. (See BPRD Circular Letter No. 13 of 2020)

the observations related to corporate borrowers who observed downgraded credit risk ratings and rise in default probability **(See Chapter 5.1)**.

…mainly due to a number of idiosyncratic factors …

Additional domestic classification occurred in the agriculture, sugar, energy, textile (spinning) sectors (**Chart 3.1.5**). Besides, a sizeable portion of infected loans arose in the 'others' category, which primarily pertained to real estate sector. It also included defaults by shipbreaking companies caused by a fire incident and some delinquencies in the metal industry.

Chart 3.1.5: Sector-wise flows of NPLs



Source:SBP

Sugar sector borrowers, comprising individual farmers, defaulted due to cash flow problems caused by late start of purchasing and crushing of sugarcane and delayed/non-payment by sugar mills. Similarly, delinquencies in the agriculture sector occurred due to lower procurement by the public sector procurement agencies forcing farmers to sell their produce at lower market price (than support price). Moreover, willful default in calamity declared areas, utilization of wheat sale proceeds for the sowing of cotton crops (instead of repaying to banks), higher input cost (e.g. fertilizer, pesticides, seeds etc.) also resulted in additional NPLs.

Though the overall NPLs in the textile sector declined, the spinning and weaving sub-sectors observed a rise due to low international prices (of exports) and higher input cost, particularly, imported yarn.[177] The energy sector defaults arose owing to losses incurred due to unfavorable movement in the exchange rate (i.e. exchange losses) and lower demand of oil products.[178]' Further, the stuck-up receivables also undermined the payback capacity. The energy sector continued to face problem of circular debt. Thus, the accumulated receivables on the books of these companies could not be adequately converted into cash, which caused liquidity problems leading to defaults on banks loans (**please see Special Box on 3.1 for detail**).

While a portion of foreign portfolio also corroded…

The foreign operations of the banking sector also witnessed rise in NPLs of 12.06 percent (PKR 13.5 billion) during CY19. Most of these NPLs were concentrated in Gulf Cooperation Council (**GCC**) states, which faced economic slowdown due to repressed international oil prices.[179] The NPLs, mostly, belonged to electronic/electrical equipment, real estate, and telecommunication sectors. In addition, PKR equivalent amount of foreign operations' NPLs has, partially, escalated due to depreciation of domestic currency.

It may be recalled that an episode of surge in NPLs was also observed during Mar-08 till Jun-12. However, increase in NPLs during the last couple of years was significantly different from the previous episode. For example, previously, NPLs continued to rise for 15 quarters while in the

[177] During CY19, the overall volume of textile exports remained almost stagnant as low international commodity prices significantly diluted the competitive edge the industry gained due to depreciation of local currency during the reviewed year.

[178] One private sector company defaulted due to 'acceptance overdue'. However, the loans were regularized later.

[179] As per the WB estimates, regional GDP growth of GCC countries dropped to 0.8 percent in CY19 from 2.0 percent in CY18.
Source: World Bank (http://documents.worldbank.org/curated/en/886531574883246643/pdf/Economic-Diversification-for-a-Sustainable-and-Resilient-GCC.pdf)

recent episode the increase in NPLs was short-lived. Moreover, the pace of NPLs' growth (particularly during CY08-10) was quite higher.[180] The asset quality indicators such as infection ratio, provisioning coverage ratio, and net NPLs to advances ratio showed a marked deterioration in the previous episode compared to marginal weakening during this episode (**Table 3.1.1**)

Table 3.1.1: Comparative Statistics - Two episodes of NPLs Rise

Recent Episode	Previous Episode
Length and Financial Soundness Indicators	
Period of rise: Mar-18 to Jun-19	Period of rise: Mar-08 to Jun-12
Aggregate NPLs increas: PKR 167 billion	Aggregage NPLs increase: PKR 437 billion
GNPLR rose to 8.8% from 8.3%	GNPLR rose to 16.7% from 7.7%
Provision to NPLs ratio fell to 78% from 89%	Provision to NPLs fell to 66% from 84%
Net NPLs to Advances ratio increased to 6.4% from 2.5%	Net NPLs to Advacnes ratio increased to 2.0% from 1.4%
Sector-wise Distribution	
76% share of Private sector	95% share of Private sector
30% share of Energy sector	33% share of Textile sector
19% share of Agribusiness	5% share of Agribusiness
17% share of Sugar sector	5% share of Electorics sector
Segment-wise NPLs	
78% share of Corporate sector	76% share of Corporate sector
19% share of Agriculture	14% share of SME 7% share of Consumers
Key Reasons	
Indutry specici issues Energy (cash flow problems due ot circular debt issue) Agribuisness (Low commodity prices, water shortages, etc.) Sugar Sector (legal issues, delayed mill operations, liquidity issues etc)	Macroeconomic High Policy Rate Economic slowdown Weak global economy Energy crises Law and order concerns

Source: SBP

The intensity of credit risk varied across banks…

The credit risk surged across all banking segments, except for the foreign banks (**Table 3.1.2**). The specialized banks, with already the highest infection ratio, observed a further deterioration. Notably, the slender provisioning coverage of this segment posed the risk to their equity base. Local private banks, having approximately 75 percent share in total asset base, had the second lowest infection ratio of 6.87 percent with provisions coverage of around 82.47 percent. Thus, despite rise in asset quality concerns, the actual risk remained somewhat muted.

Table 3.1.2: Asset Quality by Bank-wise Category (percent)

	CY18		CY19	
	Infection Ratio	Provision Coverage	Infection Ratio	Provision Coverage Ratio
	Percent			
PSCBs	12.75	88.21	13.16	88.72
LPBs	6.17	87.44	6.87	82.47
FBs	3.84	108.40	2.94	110.92
CBs	**7.47**	**87.80**	**8.11**	**84.65**
SBs	32.89	38.87	34.11	39.50
All Banks	**7.97**	**83.80**	**8.58**	**81.43**

Source: SBP

PSCBs: Public Sector Commercial Banks, LPBs: Local Private Banks

FBs: Foreign Banks, CBs: Commercial Banks, SBs: Specialized Banks

Along with the fall in demand for loans, the curtailment in supply also led to a substantial slowdown in advances…

On the supply side, banks became risk averse due to heightened credit risk. They refrained from extending fresh loans to borrowers. In addition, lucrative returns on offer on government papers pushed them towards safer avenues. Resultantly, the overall advances (net) off-take slowed down to 3.69 percent during CY19 compared to 22.15 percent in CY18 and 18.43 percent in CY17.

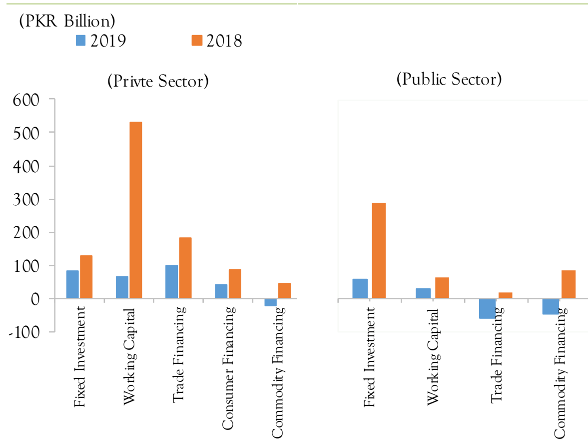
…across segments and sectors…

The domestic private sector advances decelerated across all segments, especially in case of working capital and trade financing (**Chart 3.1.6**). There was steep decline in the large-scale manufacturing index and a broad-based fall in imports during CY19.[181] Firms scaled down their businesses and enhanced their reliance on internal financing. SBP took some measures to facilitate exports and export led imports, but the slowdown in advances remained substantial.[182]

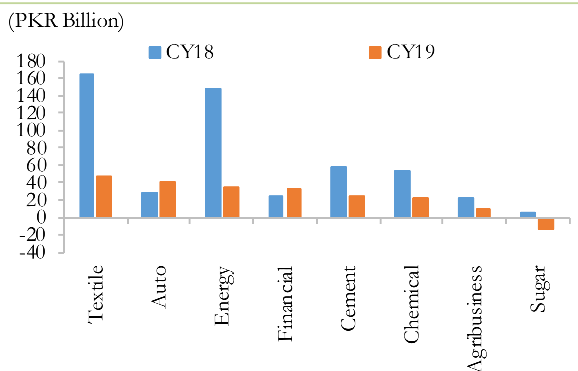
[180] During CY08-10 (3-years), the average yearly growth in NPLs was 37.0 percent.

[181] LSM index dipped by 3.80 percent in CY19 compared to 2.38 percent growth the last year. Similarly, imports of the country declined by 18.71 percent during CY19 compared to 7.43 increase in CY18.

[182] SBP kept the export finance rate unchanged at 3 percent throughout its monetary tightening regime. Also, in November 2019, SBP relaxed the advance payment of US 10, 000 from export led imports of raw material and spare parts (only) to general imports for manufacturing concerns (EPD Circular Letter 12 of 2019)



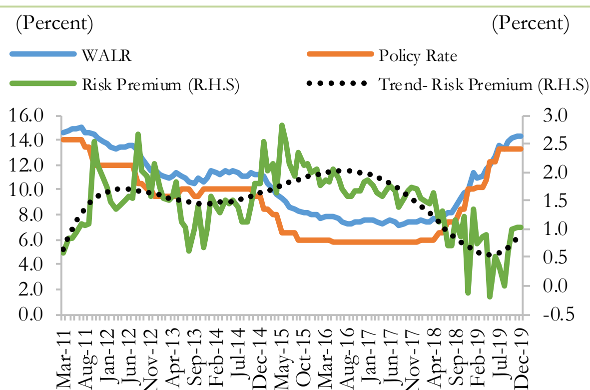
Sectoral distribution of private sector domestic advances flows also revealed a broad-based decline including textile, energy, cement, chemical, and agribusiness, sectors. Moreover, like the last year, sugar sector continued to observe deleveraging in CY19. This was due to higher sales[183] at higher market prices enabling borrows to off-load their liabilities (**Chart 3.1.7**).[184,185]



Public sector made net retirement of 0.72 percent in sharp contrast to 22.16 percent growth last year. The decline in the stock of commodity financing and sharp deceleration in disbursements to energy sector resulted in overall deleveraging by the public sector during CY19.

Banks priced-in the emerging risks…

With the spectrum of risks rising for the banks, the upsurge in interest rate spread was expected. The spread between weighted average lending rate (**WALR**) (on fresh advances) and weighted average deposit rate (**WADR**) (on fresh deposits) increased to 3.12 percent (on monthly average basis) during CY19 (2.83 percent during CY18).[186,187] The rise in spread indicates that anticipating further monetary tightening, banks were able to price-in the anticipated fall in interest margins. Similarly, the risk premium estimated by WALR minus the Policy Rate (risk free rate), was quite volatile during CY19 and started trending upwards as the policy rate increased sharply (**Chart 3.1.8**.



Interest rates had a strong bearing on asset quality…

During the high interest rate environment and non-conducive business conditions, banks' asset quality, generally, comes under pressure due to weakening of borrowers' repayment capacity. A synchronized pattern of movement between the

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183 The selected sample of listed companies revealed 89.05 percent rise in sales during CY19 (**See chapter 6**)

184 Please see 1st and 2nd Quarterly Reports of 2019-20 on 'The State of Pakistan's Economy'.

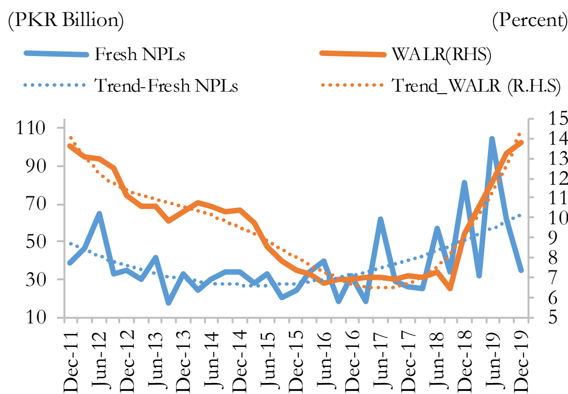
185 CY19 observed surge in the prices of refined sugar by 28.53 percent (3.00 percent in CY18) and sugar crop by 25.21 percent (5.01 percent in CY18).

186 Both WALR and WADR exclude zero markup as well as interbank transactions.

187 Generally, banks face interest rate risk in rate rising scenario as lending rate responds to policy rate with some lag (due to contractual nature of loans) compared to deposit rates, which appreciate automatically due to the Minimum Saving Rate (MSR) policy.

WALR and fresh NPLs was quite apparent (**Chart 3.1.9**).

Chart 3.1.9: Fresh NPLs and WALR

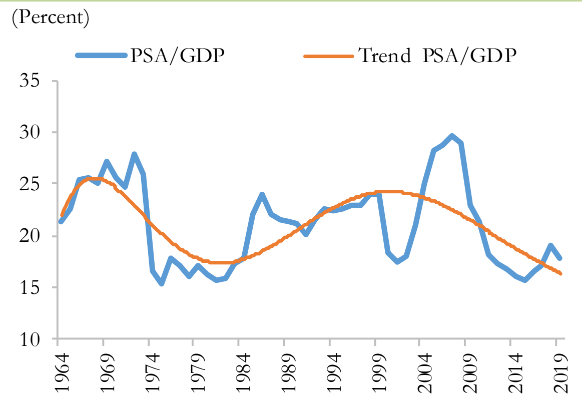


Source:SBP

Amidst low financing growth and asset price stagnation, the specter of pro-cyclical systemic risk did not arise…

Owing to monetary tightening, the "private sector advances to GDP' ratio followed a declining trajectory during CY19 (**Chart 3.1.10**). The ratio, a widely acceptable early warning indicator of pro-cyclical systemic risk, indicated containment of credit risk. Another sign of moderation in the systemic risk was that the gap between the ratio and its long-term trend was not only small but was also declining. Moreover, the link between the credit and asset prices remained weak. Most of the lending was collateralized by operating fixed assets (e.g. plans, machinery), which was not that prone to asset price booms like the residential real estate.[188]

Chart 3.1.10: Private Sector Advances (PSA) to GDP Ratio

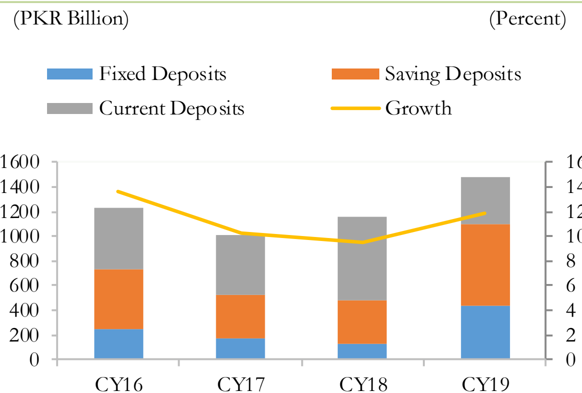


Source: SBP

Deposit growth revived as return on savings increased…

The overall deposit growth, after experiencing a deceleration over the last few years, revived to 11.92 percent in CY19 from 9.55 percent in CY18. The major thrust came from fixed and saving deposits while current deposits growth decelerated notably (**Chart 3.1.11**).

Chart 3.1.11: Category-wise deposit flows



Source: SBP

The minimum saving rate (**MSR**) on saving deposits, as prescribed by SBP, increased by 325 bps due to monetary tightening during the year. Similarly, the fixed term deposits also grew as their returns increased. In addition to improved deposit rate, this increase resulted from banks efforts to optimize their asset-liability maturities mismatches.

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[188] Further, the monthly Y-o-Y growth in house rent index (a proxy for the real estate prices which holds 19.26 percent weight in CPI index) revealed that it remained lower in CY19 (than CY18) from April-19 onwards (except for the month of Oct-19) (See monthly issues of (SBP's) Inflation Monitor).

Banks' increased investments in longer tenor PIBs (mostly in ten years' bucket) and, to raise corresponding funding sources, enhanced the mobilization of longer tenor deposits as well.

However, some de-risking occurred in the current deposits…

A number of regulatory initiatives to mitigate the concerns of Financial Action Task Force (FATF) along with tax-authorities drive to access the non-filers' deposit accounts created a non-conducive atmosphere. Some savers opted to keep their savings in cash as indicated by higher currency to deposit ratio.[189] Further, financial transaction tax on cash withdrawal remained in effect for the non-filers.[190] In addition, the banks themselves became risk averse and resorted to discontinuation of risky relationships.

…and borrowings from SBP filled the remaining funding gap leading to low level of interconnectedness

As the fiscal reliance on the banking sector grew, the banks' borrowing from SBP also increased. SBP's sizeable liquidity injections through its frequent OMOs kept the money market calm and the overnight repo rate within the target range (**See Chapter 2.1**). Resultantly, both the collateralized and clean interbank borrowings/lending remained low, though interbank fund placements were a bit higher.[191] Moreover, increase in deposits further downplayed the interbank transactions. With the restrained level of interbank transactions, the magnitude of interconnectedness within the banking sector remained low during CY19.

Banks continued to maintain more than adequate liquidity…

Banks' investment in Government papers further augmented their liquidity profile during the reviewed year, which further improved liquidity indicators. In terms of Basel III liquidity standards, banks maintained Liquidity Coverage Ratio (**LCR**) and Net Stable Funding Ratio (**NSFR**) at 180 percent and 159 percent, respectively, against the required level of 100 percent. The 'liquid asset to total assets' inched up to 49.65 percent by the end of CY19 (48.69 percent in CY18) and 'liquid assets to short-term liabilities' increased to 99.4 percent (94.9 percent in CY18). Similarly, Banks maintained liquid assets of 51.82 percent against their demand and time liabilities, which were well above the required 24 percent. Notably, the liquidity cushion improved across a broad spectrum of the banks (**Table 3.1.3**).

Table 3.1.3: Liquid Assets to Total assets by Bank Size

	CY15	CY16	CY17	CY18	CY19
			Percent		
Large	55.38	54.22	54.93	50.17	51.00
Medium	51.82	55.87	56.06	50.60	51.88
Small	45.74	42.70	40.06	33.49	43.67
Very Small	54.10	63.90	60.09	36.14	39.87
All Banks	**53.81**	**53.73**	**53.97**	**48.69**	**49.65**

Source: SBP

Interest rate expectations influenced banks investment decisions…

Within the six monetary policies announced during the reviewed year, SBP raised its policy rate in the first four. After observing the consistent monetary tightening during CY18, market anticipated a rise in the policy rate in each of those monetary policy announcement. These expectations were reflected in an increase in the average yield to maturity (**YTM**) on government papers with 3-months of

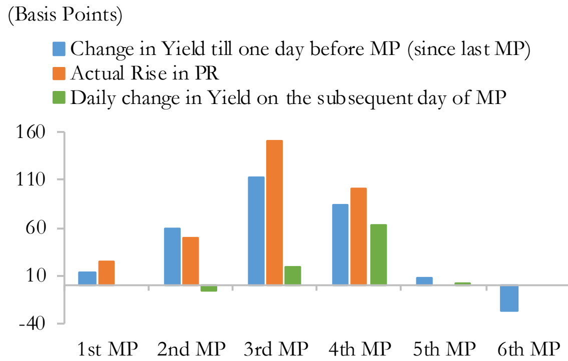
189 Currency to Deposit Ratio increased to 41.1 percent in CY19 (monthly average) compared to 38.5 percent in CY18.

190 The advance tax rates on withdrawal of deposits were revised vide Finance Supplementary (Second Amendment) Bill 2019. While the Bill exempted advance tax on cash withdrawal for filers, it maintained the tax rate of 0.6 percent on cash withdrawal and banking transactions for non-filers.

191 Interbank fund placements also enhance the interconnectedness within the financial intermediaries.

residual maturity before the announcement of monetary policy (**Chart 3.1.12**).[192]

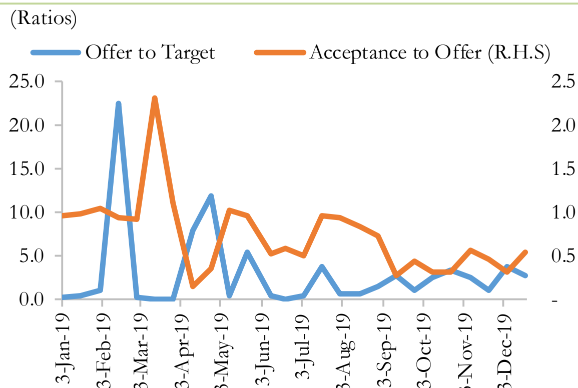
Chart 3.1.12: YTM on government securities (3-Months) - before and after Monetary Policy (MP) announcements



Source:SBP

Primarily influenced by their expectations, banks participation in auctions of MTBs remained passive near the announcements of monetary policy during the first half of CY19. In fact, the offer to target rate sometimes touched zero in the auctions (**Chart 3.1.13**). On the contrary, banks aggressively participated in MTBs auctions subsequent to the announcements of monetary policies. However, owing to the high bid rates demanded by the banks, acceptances remained far less.

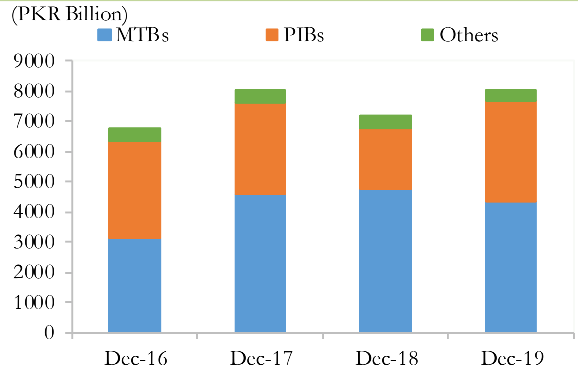
Chart 3.1.13: Target, offer and acceptance in MTBs auctions



Source:SBP

Nonetheless, banks changed their strategy during the second half of the year with a change in their interest rate expectations. Banks decreased offers for short-term MTBs, while took aggressive interest in long-term bonds that piled up stock of PIBs on their books by the year-end (**Chart 3.1.14**).[193]

Chart 3.1.14: Classification of banks' investment in government securities (outstanding)



Source: SBP

Increase in net interest income surged profitability…

Profitability of the banking sector rebounded with the rise in after tax profit by 14.34 percent in CY19 after experiencing moderation in the last few years. The key thrust came from interest earnings, both, on advances and investments. The interest rate impact dominated the volume of earning

192 The average YTM on government papers (traded in the secondary market) is also termed as Pakistan Revaluation (PKRV) rate.

193 Banks offered PKR 2.2 trillion in PIBs primary auctions during the first half of CY19, of which, PKR 0.77 trillion was accepted. In contrast, banks offered PKR 3.5 trillion in PIBs, of which, PKR 1.24 trillion was accepted.

assets impact **(Chart 3.1.15)**.

Chart 3.1.15(a): Earnings on advances - Rate vs. Volume Impact

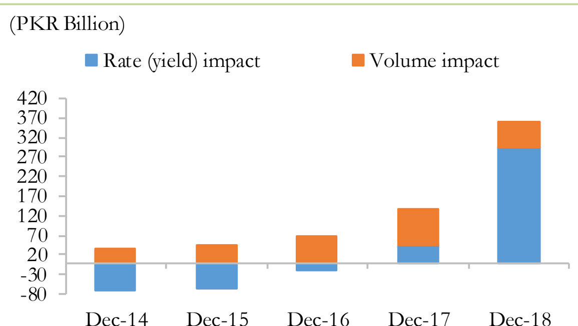
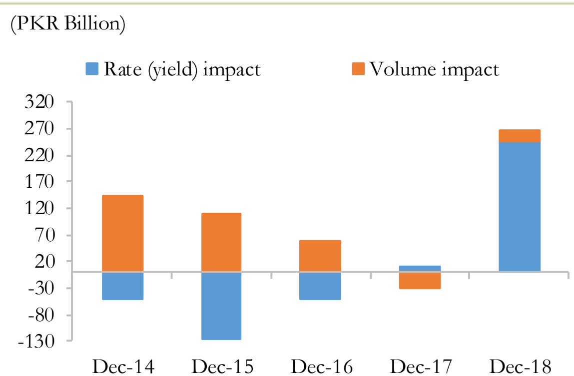


Chart 3.1.15(b): Earnings on investments - Rate vs. Volume Impact

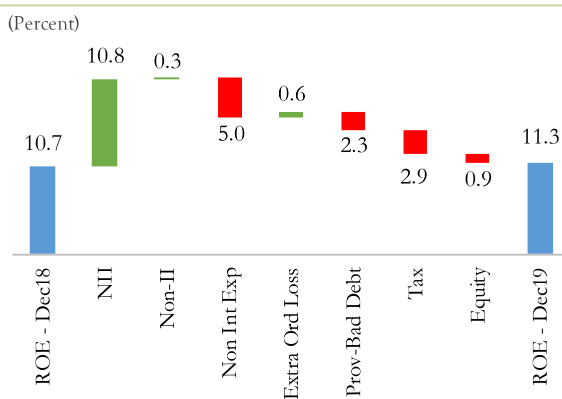


Source:SBP

Though there was some rise in interest expense as well, the Net Interest Income (**NII**) of the banking sector surged by 27.64 percent (23.38 percent after adjusting for the provisioning expense) during the reviewed period compared to 9.27 percent increase last year.

Consequently, all profitability indicators improved during CY19. The Net Interest Margin (**NIM**) stacked up to 4.00 percent by end CY19 compared to 3.40 percent a year earlier; Return on Asset increased to 0.83 percent from 0.81 percent , while Return on Equity (ROE) improved to 11.30 percent from 10.71 percent .[194] NII was the major factor which lifted the ROE during CY19 (**Chart 3.1.16**).

Chart 3.1.16: Factors impacting After-tax ROE during CY19



Source: SBP

Better earnings masked the underlying increase in cost …

The non-interest expenses of the banking sector increased by 16.10 percent in CY19 compared to 11.00 percent in CY18 due to the following factors:

- To comply with the requirements of the Financial Action Task Force (**FATF**), banks had to upgrade their systems and deploy additional human resources to mitigate ML/FT risks that entailed further costs. Similarly, the rising cyber security risk required banks to make additional investment in technology for the improvement of their systems and controls.[195]

- A reasonable growth in banks' physical and payment infrastructure increased the non-interest expenses of banks (**See Chapter 7 for detail please)**.

- Banks also had to confront higher salary and allowance expenses possibly due to higher inflation during the year.

- Banks booked 'right-of-use asset' expense on their leased assets (e.g. leased branches) in compliance with IFRS 16 w.e.f. January 1, 2019.[196]

[194] The after tax ROA saw the yearly increase in CY19, first time, after CY15.
[195] Banks amortization cost rose by 80.37 percent in CY19.
[196] 'Right-of-use asset' is depreciated over lease term and is classified as depreciation expense. The banks have lease contracts in the capacity of lessees for various properties used by their branches.

Therefore, banks depreciation expenses increased by 74.8 percent during the year.[197]

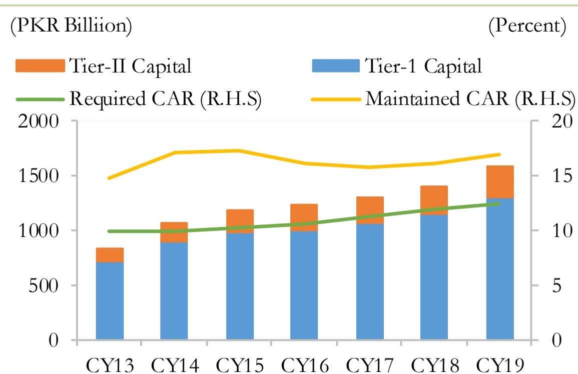
…as well as the higher tax burden.

The profitability increased during the year despite higher taxes on banks' profits. The tax expense increased as the phase-wise reduction in super tax was reversed vide Finance Supplementary (Second Amendment) Act, 2019 and was fixed, retrospectively, at 4 percent from the tax year 2018 till 2021. Moreover, the income generated from investing in additional government securities attracted another 2.5 percent tax. As a result, the tax contributions of the banks increased by 43 percent over the year, while tax as a percentage of profit before tax increased by 5.6 percent to 44 percent over the year.

Solvency improved due to improved profitability …

The banking sector resilience improved over the years manifested in robust solvency indicators. The Capital Adequacy Ratio (**CAR**) further strengthened to 17.0 percent in CY19; well above the minimum required level of 12.5 percent and international benchmark of 10.5 percent (**Chart 3.1.17**).[198,199]

Chart 3.1.17: Eligible capital and CAR of the banking sector



Source: SBP

The Tier I capital contributed the major part in the overall increase in CAR. The Tier I CAR inched up to 14.0 percent in CY19 from 13.2 percent in CY18; well above the minimum required level of 7.5 percent. Besides, one of the designated D-SIBs raised its additional Tier I capital by way of issuing Term Finance Certificate (TFCs) to meet additional loss absorbency and CAR requirements.

Moreover, the surplus on revaluation of assets created room for few banks to book additional Tier II capital. It enabled them to further augment their own as well as industry's CAR. Banks also maintained Leverage Ratio (**LR**) of 4.8 percent, higher than the required level of 3.0 percent.

The bank-wise CAR distribution exhibited a skewed picture as the majority of banks maintained healthy CAR i.e. above 15 percent (**Table 3.1.4**). The number of CAR non-compliant banks reduced to three from six last year. The meager asset share (1.47 percent) of the non-compliant banks in the industry poses negligible solvency risk for the banking sector.

Table 3.1.4: CAR Distribution of Banks

	CY16	CY17	CY18	CY19
	Number of Banks			
> 15 percent	17	18	18	21
Required<CAR<15percent	13	11	10	9
CAR<Required	4	4	6	3
Total	**34**	**34**	**34**	**33**

Source: SBP

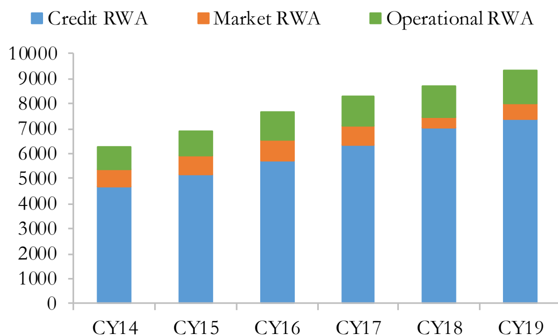
Risk-weighted assets, the denominator of the CAR, grew by 7.46 percent during CY19 compared to 4.82 percent in CY18. Banks re-positioned their risk profile with containment in credit risk weighted assets (**CRWA**) growth, while taking on more of the market risk assets (**Chart 3.1.18**).

[197] Though the depreciation expense substituted the rent expense, the rise in depreciation was significantly higher than the decline in rent expenses.

[198] Both, domestic and international CAR requirements included 2.5 percent of Capital Conservation Buffer (CCB) by end CY19.

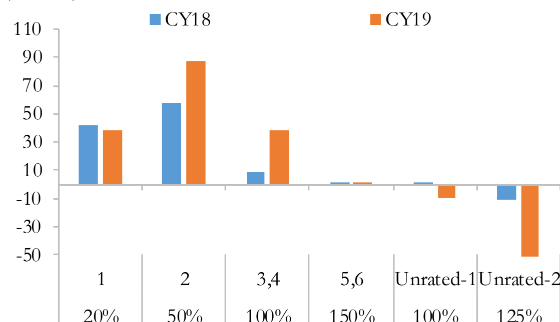
[199] As per the phased CAR enhancement, the minimum required CAR was increased to 12.5 percent as of end December 2019 from previous minimum of 11.9 percent.

Chart 3.1.18: Composition of Risk Weighted Assets (RWA)



Source:SBP

Chart 3.1.19: Share of banks' lending flows to corporate sector and SBP's supervisory rating grades



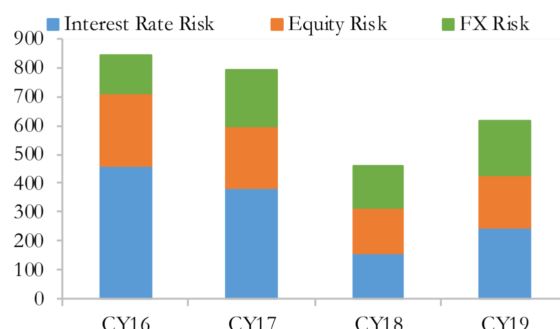
Source:SBP

Rating culture improved during CY19…

The CRWA decelerated, primarily, due to subdued financing activity and banks' reshuffling of portfolio towards credit risk free Government securities. Besides, a sizable portion of on-balance sheet corporate portfolio shifted from unrated (attracting 125 percent risk weight) to rated portfolio (mostly 20 and 50 percent risk weights) (**Chart 3.1.19**). That also helped in containing the overall CRWA. Flourishing the rating culture in the country is a positive sign from the perspective of credit risk assessment and its prudent management. However, generally, external ratings assigned by the rating agencies do not proactively react to changing business cycles. Therefore, banks should also use other credit risk models, especially, for their large corporate borrowers.

Market risk weighted assets (**MRWA**) accelerated by 33.70 percent during CY19 compared to contraction of 41.66 percent last year (**Chart 3.1.20**). The major part of growth was contributed by banks' sizable investments in PIBs, a longer-term instrument attracting higher capital charge as well as risk weights. Similarly, banks' higher FX and equity exposures lifted their MRWA against FX and equity price risks.

Chart 3.1.20: Market Risk Weighted Assets of the banking sector



Source: SBP

Operational risk weighted assets (**ORWA**) of the banks surged by 10.9 percent in CY19 compared to 4.5 percent in CY18. This was due to upswing in their gross (interest) income, which forms the basis of ORWA calculation under Basic Indicator Approach of Basel rules.[200]

[200] As per BIA, the gross income of the bank for each of the past three financial years as per annual audited accounts is used in determining the operational risk charge (See Q91: http://www.sbp.org.pk/bprd/Basel/FAQs-Basel-II-MCR.pdf).

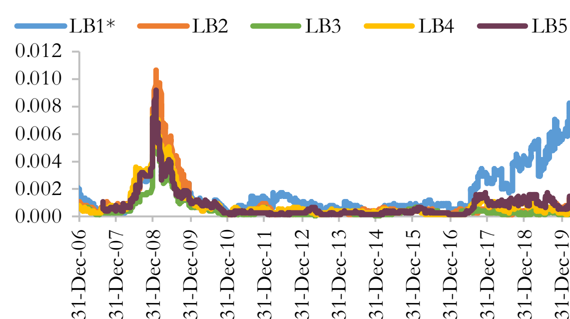
The risk of failure of domestic systemically important institutions remained low…

SBP continued to keep a close watch on its three designated Domestic Systemically Important Banks (**DSIBs**). These banks are required to maintain higher loss absorbency requirements in the form of Common Equity Tier 1 (**CET1**). Further, all DSIBs in Pakistan are subject to additional supervisory requirements, which include preparing a comprehensive risk appetite framework, conducting macro stress tests/scenario analysis, formulating recovery plans etc.

Moreover, the probability of default of the five largest banks remained low during CY19 (**Chart 3.1.21**). Though one of the banks observed rise in PD compared to last year, its absolute magnitude remained reasonably low. Further, the rise in the PD was due to escalated volatility in the equity market driven by transitory pessimistic sentiments of investors, instead of deterioration in bank's fundamentals (**see Chapter 2.1**). Overall, the financial health of the five largest institutions remained robust and their credit risk ratings stood high (AAA or triple A). This advocates that these institutions were well positioned to meet their short and long-term liabilities and do not pose systemic risk to the system.

Chart 3.1.21: Probability of Defaullts of five largest Banks

(Percent)



Source: Bloomberg

*LB1 stands for Largest Bank-1 (of five largest banks)

Banking sector of Pakistan maintained a decent global standing in terms of FSIs…

Pakistan's relative positioning, in terms of financial soundness, seems satisfactory as suggested by various FSIs (**Table 3.1.5**). The solvency, both CAR and Tier I CAR, of the banking sector of the country stands at a level higher than many other EDMEs and advanced economies. Similarly, the liquidity indicators are also robust with liquid assets comprising a high portion of balance sheet assets. Only a few countries, such as Myanmar, Turkey, Singapore etc., are maintaining relatively strong level of liquidity amongst the selected sample of countries. The profitability indicators, though improved compared to last year, are relatively lower than the peer and advanced economies.

The infection ratio, however, falls on the higher side. This is because the NPLs in Pakistan consist of legacy portfolio, and banks face issues in clearing their balance sheets due to the challenges in implementation of foreclosure standards and a large amount of infected portfolio in litigation pending adjudication. However, most of these loans are fully provided for. As such, the net NPLs to net advances ratio is quite low and comparable with other countries. Further, Pakistan has introduced various laws to strengthen the debt recovery regime in the country.

Table 3.1.5: Country-Wise Financial Soundness Indicators

	CAR	Tier I CAR	Infection Ratio	ROA - after tax	ROE - after tax	Non Interest Income to Gross	Liquid Asset Ratio	Liquid Assets to Short Term Liabilities
Pakistan	**17.1**	**14.2**	**8.8**	**0.8**	**10.7**	**57.4**	**45.4**	**87.3**
China	14.5	11.8	1.9	1.0	12.3	28.6	23.9	57.0
Indonesia	23.3	21.8	2.4	2.5	16.0	46.3	20.9	30.8
Malaysia	18.3	14.8	1.5	1.5	12.9	42.4	23.0	158.8
Myanmar	10.9	10.8		(0.0)	(0.3)	103.3	46.9	59.8
Philippines	15.3	14.1	2.1	1.5	13.8	57.6	32.3	49.6
Thailand	18.0	15.1	3.1	1.4	10.1	48.1	18.8	31.5
Bangladesh	11.7	8.0	11.5	0.8	12.7	55.5	15.8	37.8
India	15.2	14.5	8.8	0.1	1.0	54.3	7.9	24.2
Saudi Arabia	19.4	18.1	1.9	1.9	18.8	34.9	24.3	39.6
Turkey	18.4	15.3	4.7	1.4	12.7	42.6	49.8	65.1
Argentina	17.5	15.5	5.6	6.1	53.2	43.6	43.1	65.5
Brazil	17.7	14.8	3.0	1.8	16.5	48.2	14.5	238.1
Chile	12.9	10.2	1.9	1.3	16.5	47.0	13.6	20.7
Peru	14.9	11.7	3.4	2.2	17.8	45.0	21.5	36.4
Singapore	17.0	15.3	1.3	1.3	14.1	44.3	66.9	73.8
Russian Fede	12.5	9.4	10.0	2.0	16.7	83.1	24.5	204.8
Finland	20.2	18.0	1.4	0.6	8.4	65.1	17.1	38.4
Norway	22.4	19.8	0.8	1.6	15.1	41.7	13.8	26.7
Sweden	21.4	19.0	0.5	0.6	11.8	48.0	19.0	28.6
United Kingd	21.4	17.9	1.1	0.5	7.5	75.1	25.1	40.7
Canada	15.3	13.2	0.4	1.1	20.4	61.6	9.8	43.5
United States	14.7	13.8	0.9	0.4	3.5	57.3	11.7	80.6

Source: IMF