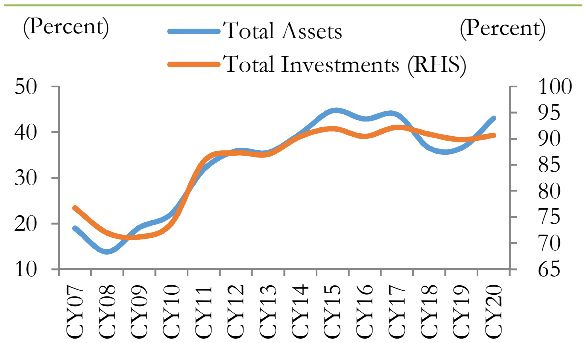
Box 3.1: Impact of Investments in Government Securities on Banks' Earnings[101]

This analysis offers the impact of banks' investments in government securities from two perspectives. One, the growing volume of the securities portfolio and second, the returns from the investments.

Historical analysis of previous 14 years reveals that banks' exposure towards the government sector, especially in the form of investments, has steadily increased due to budgetary needs. As a result, there has been a structural shift in the balance sheet of the banking sector where the investments in government securities have become more prominent; their share in banks' asset increased from a low level of 18.99 percent in CY07 to 43.06 percent in CY20. Consequently, share of total investments in total assets has risen from 24.74 percent in CY07 to 47.50 percent in CY20.[102] The share of these securities in total investments increased to 90.65 percent in CY20 from 76.74 percent in CY07 (**Chart B3.1.1**). Besides government's fiscal needs, interest rate dynamics and lower demand for financing from the private sector also contributed to the portfolio build-up.

Chart B3.1.1: Percent share of investments in Government securities

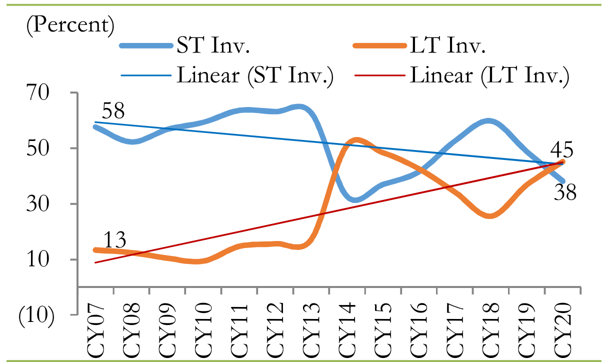


Source: SBP

As banks invested more of their funds in government securities over time, the income from these risk-free securities increasingly contributed towards total interest income. The share of interest income from government securities increased to 49.26 percent in CY20 from just 13.75 percent in CY07.[103] These statistics suggest growing importance of income from investments in government securities in banks' profitability.

Realizing the importance of returns from investments in government securities, banks attempted to have an optimal portfolio mix in which the higher income generating long-term bonds are sufficiently represented. Moreover, the Government strategy to improve the maturity profile of its debt also contributed to changes in the investment portfolio mix of the banks. Accordingly, the share of long-term (LT) investments in total government securities increased to 45.20 percent in CY20 (13.38 percent in CY07), while banks' exposure in short-term (ST) investments declined to 38.13 percent (57.68 percent in CY07) (**Chart B3.1.2**).

Chart B3.1.2: Percent share of short-term and long-term investment in total investments



Source: SBP

Besides, interest rate dynamics also affected the structure of the investment portfolio. The trend analysis of policy rate and growth of investments in government securities clearly suggest a positive

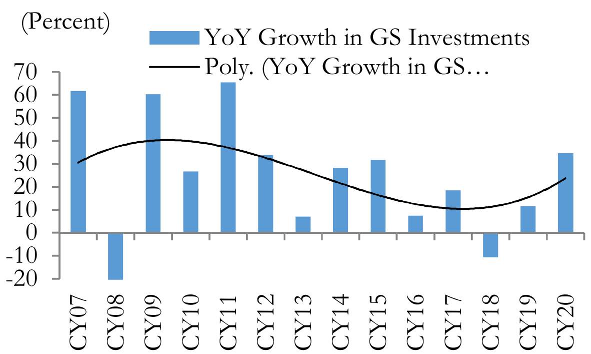
[101] While this Box explores the impacts of investment in government securities on banks' earnings, please refer to Box 3.1 of FSR 2019 for comprehensive analysis on different implications of public sector exposure for banks.

[102] If we include advances to the public sector, the exposure of the government sector has further risen from 20 percent in CY08 to 51 percent (in total assets) in CY20.

[103] On average, interest income from risk-free securities contributed about 38 percent in total interest income in previous 14 years.

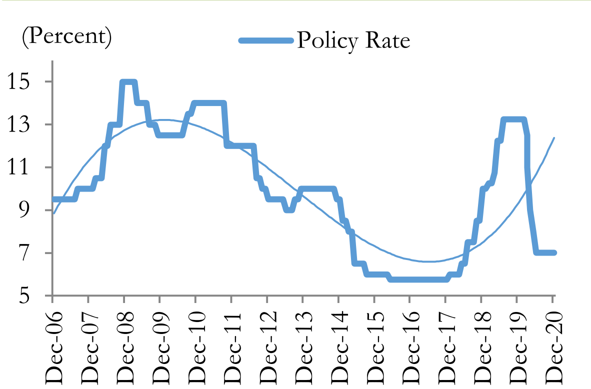
association between the two (**Chart B3.1.3 and Chart B3.1.4**). This phenomenon in fact also reflects the business cycles and underlying imbalances of Pakistan' economy, which is facing fiscal deficits and government's persistent demand for bank credit. Historically, the interest rate adjustment were made as a part of the stabilization programs to address the economic imbalances. This phase also mark the slowdown in economy and low demand for bank credit from the private sector. As the interest rates rise, while the aggregate demand—particularly the credit demand by the private sector—softens, it becomes more lucrative for the banks to invest in risk free securities. Accordingly, banks' portfolio of government securities accumulated over the years.

Chart B3.1.3: YoY growth in banks' holding of Government Securities



Source: SBP

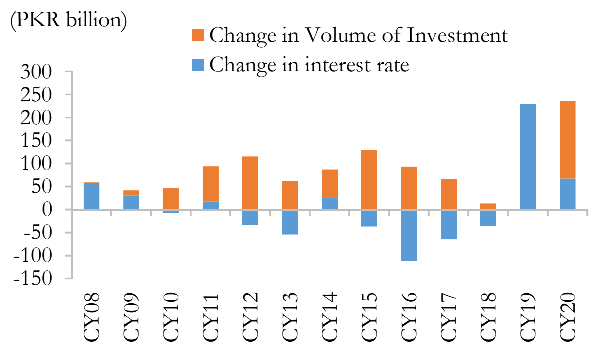
Chart B3.1.4: Policy rate



Source: SBP

As far as the interest income on investments in government securities is concerned, besides interest rates, the growing volume of investments has been a key driver (**Chart B3.1. 5**). In majority of the years since CY08, it is the volume factor, which contributed more to the income than the interest rates. This was also evident in CY20 in which despite drastic cut in policy rate, the income from investments increased. However, in CY08 and CY19, the returns were mainly driven by change in interest rates due to aggressive monetary tightening during these years.

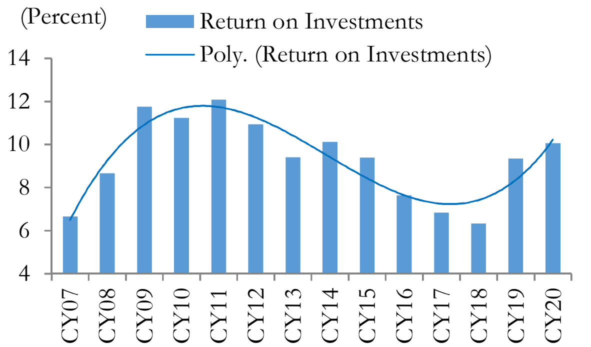
Chart B3.1.5: Change in Interest Earned on Investments in Government Securities due to ....



Source: SBP

In addition, the maturity profile of government securities also had an impact on the returns. Particularly, in CY20, return on investments (**ROI**) in government Securities have increased despite decrease in policy rate (**Chart B3.1.6**). As highlighted in C**hart B3.1.2** above, portfolio mix of government securities reflects increased maturity due to higher investment in longer term PIBs. As a result, this change in portfolio mix led to improved return on government securities during CY20.

Chart B3.1.6: Return on investments in Government securities



Source: SBP

Conclusion

i. This brief analysis reveals that in the previous 14 years, Government's reliance on the banking sector has steadily increased for fiscal needs. Resultantly, it has influenced the balance sheet structure of the banking sector.

ii. With increased exposure in government securities, share of interest earnings from government securities in total interest income has reached to around 50 percent in CY20.

iii. The level of interest earnings on these securities mainly depends upon the volume of investments, which is determined by the financing needs of the government, and the prevailing policy rates. In CY20, the increase in the tenor of the securities led to higher return on government securities, though the policy rates were significantly cut during the year.

iv. It is critical to note that the persistence of fiscal deficits and high demand for bank credit might have affected the risk appetite of banks and weakened their true economic role of financial intermediation. This bears far reaching repercussions for the future economic growth of the country.

v. Also, the maintained solvency backed by higher exposure in risk-free securities manifests low risk-taking and inefficient allocation of the capital.

vi. On the positive side, high concentration of assets in government securities provided necessary support to banks' earnings against business cycles particularly in downturn times.

vii. However, there is a need to strike a balance between financial stability and due risk taking, which is essential for effective financial intermediation between general savers and private sector enterprises. For this purpose, a comprehensive approach is required from all the stakeholders. Banks need to enhance their role in the provision of credit to private sector, especially to private enterprises and high-potential sectors like SMEs, Agriculture and Mortgage Finance. Given the broad based and far-reaching implications of the construction industry for the economy, SBP is pursuing different initiatives in coordination with the government to promote housing finance. On the other hand, the government needs to broaden its revenue base and look for alternate sources of funding for its fiscal needs to reduce reliance on the banking sector. Moreover, collaboration between policy makers and the market participants is essential to promote savings in the economy and develop a vibrant capital market for effective intermediation.