Box 6.1: Repayment Behavior and Financial Standing of Leading Borrowing Group of Banking Sector

Introduction

The large private sector corporate firms have always been major borrowers from the banking sector. The SBP has set concentration limits on the banks' exposure to single borrower and borrowing groups as well as aggregate limit on large exposures. As of end CY20, 71.58 percent of the banking sector loan were extended to corporate segment. Among these, delinquencies in large corporate borrowers and borrowing groups could have systemic repercussions for banking sector due to the large size of the exposure and borrowings from multiple banks. Therefore, the financial health and performance of large borrowers and borrowing groups is quite crucial for the stability of the banking system. In this box, repayment behavior and capacity as well as overall financial health of large borrowers and borrowing groups of the banking system have been analyzed based on the following:

a. Banks' own assessment of large borrowers and borrowing groups' credit worthiness as captured through Obligor Risk Rating (ORR) of borrowers assigned by banks.
b. Borrowers' repayment behavior in terms of any overdue in the payment of their obligations to banks.
c. Latest financial indicators and market-based indicators of leading corporate borrowers of the banking system[193].

Assessment of Credit Worthiness

The credit worthiness was assessed for top 30 borrowing groups (comprising 249 firms) based on Obligor Risk Rating (**ORR**) assigned by banks. Identified firms of these groups hold around 22.99 percent of the corporate/commercial lending portfolio of the banks as on 31-Dec-2020.

ORR framework: SBP requires banks /DFIs to compile both ORR (a kind of credit rating which is assessed by the lending institution itself) of corporate borrowers and Facility Rating of each financing facilities availed by them[194]. The ORR reflects the credit worthiness of the borrower and is one possible predictor of borrower's default or otherwise. The rating continuum comprises 1 to 12, with 1 to 9 scales for performing categories and 10 to 12 for default categories.

Assessment of Results

Based on ORR of different borrowing entities of the groups, overall average rating (weighted by size of loans) of each group was compiled to assess the strength of these groups. Our assessment indicated that most of the top 30 groups have medium or good quality ratings. It is important to note that during pandemic marked by lockdowns and slowdown in economic activity, especially during first half of CY20, top 30 groups of the banking sector largely maintained their credit worthiness in terms of ORR ratings. The internal credit rating profile of the large borrower groups improved over the period as reflected in the favorable shift in the frequency distribution curve of the credit rating (**Chart B6.1.1**)

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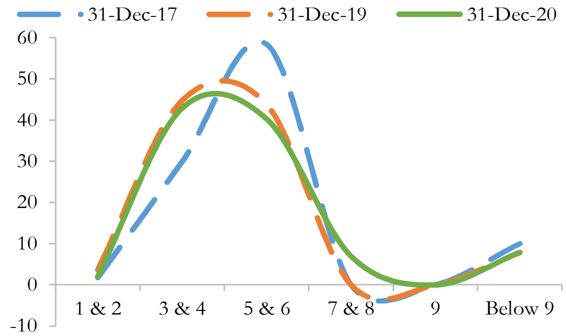
[193] Fetched from Bloomberg utility which captures and compiles indicators of listed firms

[194] BSD Circular No. 8 of 2007 <https://www.sbp.org.pk/bsrvd/2007/C8.htm>

Chart B6.1.1: Internal Credit Rating of 30 Large Groups

(Percentage of Borrowing)



Source: SBP Staff Calculations

The shift in ORR also reflects a conservative approach on the part of banks to lend to better quality borrowers. As discussed in the following paragraphs, the financial and market-based indicators show mixed performance in the financial and market position of the leading borrowing firms of the banking sector.

Financial Soundness and Market Performance of Listed Firms of Top 30 Borrowing Groups

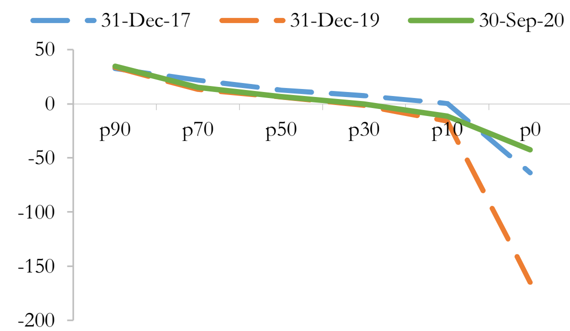
As per Pakistan Stock Exchange (**PSX**) data, a total of 530 companies (including default companies) were listed in PSX as of end CY20. Out of these 530 listed companies, 176 listed companies belonged to top 30 borrowing groups of the banking system. To analyze the financial soundness of these firms and assess how they are valued by the market and general investors, a detailed assessment of these 176 listed firms was done using the financial and market-based indicators. Following analysis provide evaluation of various indicators of these firms including ROE, Interest Coverage Ratio (**ICR**), Current Ratio (**CR**), P/E ratio and Gross Margin (**GM**) ratio for the periods December 2017, December 2019 and September 2020.

The analysis of the data shows that despite pandemic and consequent lockdowns and slowdown in economic activity during CY20, most of the top borrowing firms exhibited satisfactory financial performance. Various indicators improved due to early revival of economic activity and different policy support measures that helped the real sector to weather the untoward impacts of the pandemic.

The ROE across the entire population of these firms does not show any sign of slackness during first three quarters of CY20 – it rather shows a slight improvement over Dec-2019. However, profitability levels remain lower as compared to CY17, which was marked with exuberance in economic activity **(Chart B6.1.2).**

Chart B6.1.2: Percentile Distribution on ROE of Companies

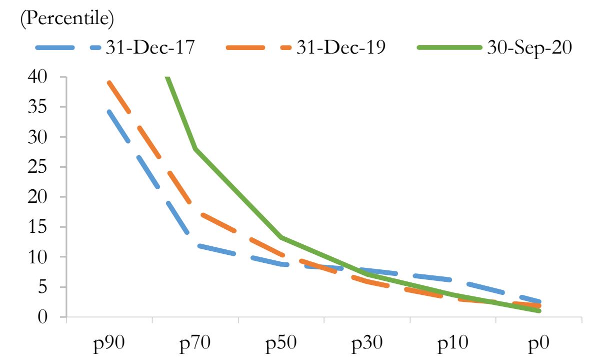
(Percentile)



Source: Bloomberg

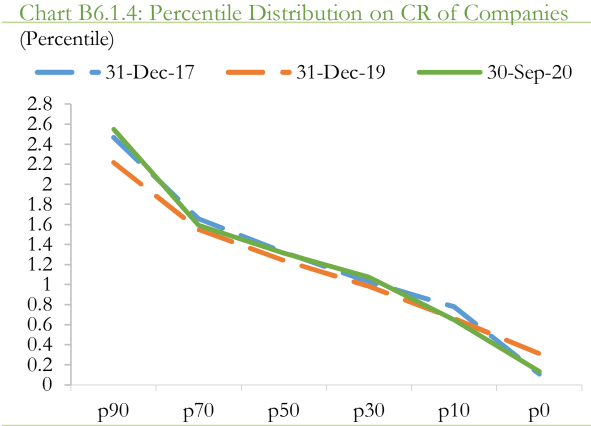
Better financial indicators and policy measures to mitigate the impact of pandemic also had favorable impact on the general investors' perception about the value and future earning potentials of top borrowing firms. The P/E ratio for most (around 70 percent) of the firms was higher in September 2020 as compared to both December 2019 and December 2017, while P/E ratio of 30 percent companies in September 2020 is the same as in December 2019 **(Chart B6.1.3).**

Chart B6.1.3: Percentile Distribution on P/E of Companies



Source: Bloomberg

Chart B6.1.4: Percentile Distribution on CR of Companies



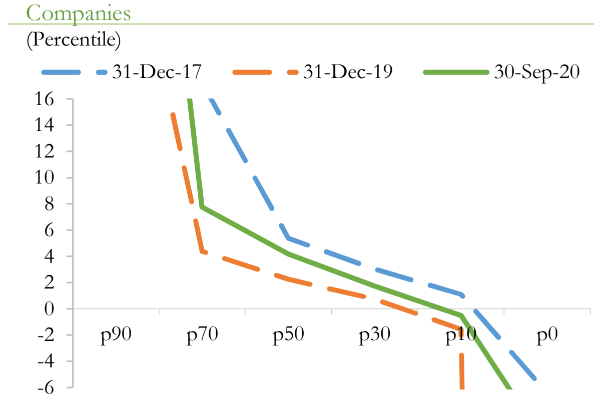
Source: Bloomberg

During CY20, the liquidity profile of the firms in terms of CR has improved as compared to December 2019 and almost reached the levels of December 2017 when business activity in the economy was quite munificent **(Chart B6.1.4).** The debt servicing capacity of the top borrowing firms in terms of ICR has also improved as compared to CY19, as the firms' earnings remained intact while financial costs decreased due to significant reduction in policy rate **(Chart B6.1.5).** The core earnings in terms of GM ratio has remained more or less stable over the four years period **(Chart B6.1.6)**.

Conclusion

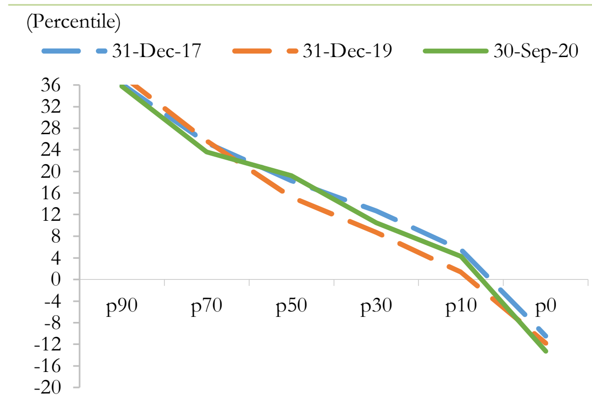
The comparative position of ORR of top 30 borrowing groups of the banking sectors shows that banks' have higher exposure on large corporates due to better credit worthiness.

Chart B6.1.5: Percentile Distribution on ICR of Companies



Source: Bloomberg

Chart B6.1.6: Percentile Distribution on GM of Companies



Source: Bloomberg

The COVID-19 pandemic and consequent lockdowns during CY20 raised significant challenges for borrowing firms in terms of operating environment and demand and supply constraints. However, due to early resumption of business activity during second half of CY20 and enabling support measures from central bank and government, the firms have largely weathered the impact of the pandemic. Their financial indicators show sign of resilience and investors maintained their confidence in the future prospects of these firms. Going forward, it is expected that if the impacts of the pandemic remain contained and it is satisfactorily curtailed, the general credit worthiness and financial performance of the large borrowing firms will improve. However, their performance will largely depend upon the evolving dynamics and impacts of the pandemic.